Can Strategic Partner + Antitrust Risk Management = Cash-Free Deal for PE Buyer?

by Paul T. Denis and Gorav Jindal

Managing antitrust risk historically has not been regarded as an essential skill for private equity buyers. The proposed buyout of Dynegy Inc. by Blackstone Group LP should change that view. Although it now appears that Dynegy has rejected Blackstone’s revised “best and final” bid to acquire the company, Blackstone’s approach nonetheless demonstrates that the ability to identify and manage antitrust risk can enable private equity buyers to structure potentially high-return transactions that otherwise might appear to be beyond their reach.

Dynegy is a wholesale provider of electricity. Like other producers in this sector, Dynegy’s stock price had declined precipitously since the onset of the recession, down about 90% from the summer of 2008. A glut of low-cost natural gas had also driven down electricity prices and contributed to its decline. In a bet that the markets for electricity would rebound, private equity giant Blackstone proposed to acquire Dynegy, a company that,
 Despite its weakened condition, owns and operates more than 20 U.S. power plants with an enterprise value, comprised mostly of debt, of over $4.6 billion.

Blackstone initially offered to acquire Dynegy for $543 million (roughly $4.90 per share), which it upped to more than $600 million ($5.00 per share). But Blackstone did not have to put any cash into the deal. Instead, Blackstone conditioned the purchase of Dynegy on the simultaneous sale of four Dynegy natural gas-fired power plants to NRG Energy Inc. (“NRG”), a rival power generation company, for $1.36 billion. By using this approach, Blackstone could have netted more than $750 million in cash while still owning what was left of Dynegy. Together, the transactions, therefore, demonstrate how a private equity firm can team up with a strategic buyer to pull off a deal that otherwise might appear to be beyond its reach, all without bank financing.

As a general matter, it is in the seller’s interest to maximize the number of interested buyers. Blackstone’s incentives in its proposed second-step sale of Dynegy’s four natural gas plants were no different. The difference between pure financial buyers and strategic buyers, however, is that strategic buyers can often increase their bids by sharing a portion of the extra value they expect to derive from efficiencies unique to strategic buyers. But the involvement of a strategic buyer requires the private equity firm to assess and manage its antitrust risk accurately, an exercise that private equity firms have not had to conduct in most deals.

Blackstone’s choice of its strategic partner, NRG, reflected this analysis. Its ability to close on the main Dynegy transaction depended on its assessment that the concurrent sale of four natural gas plants to a rival with ownership interests in more than 40 power-generating plants in the U.S. would clear antitrust hurdles and not ensnare Blackstone’s acquisition of the remainder of Dynegy in a lengthy antitrust investigation. Antitrust due diligence also provided Blackstone essential context in its negotiations with Dynegy, including comfort that it could accept certain contractual conditions undoubtedly important to Dynegy, such as the $100 million it ultimately agreed to pay Dynegy as a break fee if it was unable to close the deal. Ultimately, Blackstone’s antitrust homework paid off as the federal antitrust authorities cleared both the Blackstone and NRG transactions by granting early termination, removing antitrust as an impediment to closing.

In order for other private equity firms to utilize this tactic, they will need to understand the implications for antitrust risk assessment of the New Merger Guidelines, which provide the primary blueprint for analyzing mergers and acquisitions under the antitrust laws. Although the federal enforcement agencies will investigate the same ultimate question as under the predecessor 1992 Horizontal Merger Guidelines (the “Old Merger Guidelines”)—whether the transaction is likely to substantially lessen competition and harm consumers—the New Merger Guidelines depart in significant respects from the Old Merger Guidelines.

The New Merger Guidelines articulate a flexible approach to merger analysis and introduce new analytical tools and scores of new terms not found in the Old Merger Guidelines, a systematic analytical framework that had guided the business community for 18 years. And while it is too soon to predict the long-term effects of these changes, we can gain insight into the agencies’ future approach to merger enforcement by focusing on key thematic changes between the two versions.

Most significantly, the New Merger Guidelines attempt to curb the importance of defining the sphere of competition in which merging rivals operate, known as “market definition.” Market definition, which has both product/service (the range of offerings that compete with those of the merging firms) and geographic (the geographic area in which competition occurs) dimensions, essentially played a gate-keeping function in merger analysis under the Old Merger Guidelines. In other words, in order to assess the competitive effects of a transaction, antitrust authorities have to first define the market in which the parties compete. The New Merger Guidelines—perhaps in response to frustration over losses in court that cast a spotlight on the agencies’ inability to define markets precisely (e.g., U.S. v. Oracle Corp., FTC v. Whole Foods Market, Inc.)—renounce the notion that defining markets is a predicate to an evaluation of a transaction’s competitive effects. The agencies have effectively attempted to make market definition optional, proceeding directly to the analysis of whether the transaction leaves any customers vulnerable to higher prices or lower quality.

In place of market definition, the agencies now look more to “proximity” or closeness of competition between their products or services of the merging firms. Two products are proximate if one is the next-best substitute for the other. The evaluation of proximity will differ based on the competitive setting in which the merging firms participate. In settings involving differentiated products (i.e., products that are not perfect substitutes because they differ in performance, branding or some other dimension), a simple analysis of the attributes of the products of the merging firms, how the products are sold and a review of ordinary course of business documents such as marketing materials will provide a useful starting point. These views can be refined with an analysis of customer
switching patterns, panel data and customer surveys. Agency economists will conduct systematic analyses of proximity by analyzing empirical evidence such as bidding or win/loss data, which reveal choices customers have exercised over time and incorporate them into new analytical tools (e.g., “diversion ratio” and “upward pricing pressure”) to predict whether the acquiring firm will be able to influence competition adversely after the merger.

In settings involving homogeneous or commodity products (products that are relatively uniform in composition and character), the agencies may determine proximity based on the relative location of the firms’ production or distribution centers to customers, particularly where transportation costs are high relative to delivered price. Although less clear in the New Merger Guidelines, the use of pricing zones and relative ranking found in company documents will also factor into the determination of proximity.

The New Merger Guidelines, however, offer no standards for evaluating proximity and determining when a merger between competing products may be anticompetitive. Under the Old Merger Guidelines, mergers resulting in shares in a properly defined market below 35% fell within safe harbors. Today, there are no presumptive zones of safety for transactions of any minimum combined share, which reduces predictability for the business community. And while the New Merger Guidelines raise concentration thresholds—measured using the Herfindahl-Hirschman Index (HHI), which is computed by taking the sum of the squares of each market participant’s market share—these new thresholds are unlikely to have a practical effect since they merely codify existing agency practice. In fact, the New Merger Guidelines now suggest that individual customers can form distinct relevant markets, a concept that the DOJ appears to be putting into practice in its first merger challenge under the Obama administration. See, e.g., United States v. Dean Foods Company, No. 10-cv-59 (E.D. Wis. Jan. 22, 2010), (complaint alleging that each school district in Wisconsin and the Upper Peninsula of Michigan is a separate geographic market).

At least in the near term, the New Merger Guidelines should generate more investigations, result in increased focus on potentially targeted customers, prolong agency investigations and impose greater costs as the agencies wrestle with how to apply notions of proximity. Private equity firms, like the rest of the business community, can benefit by mastering these concepts and having an effective antitrust game plan for any transaction that involves a strategic partner. As Blackstone attempted to prove in its bid to acquire Dynegy, the returns literally could be infinite.

1  We were counsel to Whole Foods Market, Inc. in the litigation.
2  We are counsel to Dean Foods Company in the litigation.

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Recent Developments in Acquisition Finance

by Scott M. Zimmerman and Jeffrey M. Katz

In the last several months there have been some important legal developments in the statutory, regulatory and judicial arenas that will impact acquisition finance. This article will survey some of the more notable ones.

To the extent foreign lenders will be providing all or some portion of the financing, under the new U.S. Foreign Account Tax Compliance Act (FATCA), effective January 1, 2013, there will be a potential 30% withholding tax on interest payments owing by U.S. borrowers to foreign financial institutions if the foreign firms have not registered with the U.S. Treasury Dept. and made detailed disclosure to it as to any ultimate U.S. account holders or other U.S. investors in such lender institutions. Failure to comply with FATCA carries onerous penalties, including a withholding obligation of 30% of gross proceeds from a sale of the loan in question, as well as interest (including portfolio interest). Sponsors and borrowers will need to ensure that no contractual “gross up” provisions in credit agreements would require the borrower to bear any of the cost of such withholdings. Credit agreements will need to contain provisions requiring the relevant lenders to comply with FATCA, furnish to the borrower evidence of compliance, bear the cost of failure to so comply and be subject to being yanked from the deal for any such failure.

FATCA has a grandfathering provision that exempts from its coverage loans outstanding on March 18, 2012.
According to many observers, however, this exclusion, as crafted, may well not cover revolving facilities existing on such date that are drawn after that date. Furthermore, future regulations are expected to provide that a “significant modification” of an outstanding loan after such date (defined for tax purposes broadly and potentially including, for example, a loan amendment increasing the coupon by as little as 25 basis points per annum) will be treated as a new issuance, thereby eliminating any grandfathering exception.

There is another regulation potentially on the horizon that may adversely impact the market for revolving loans. As of this writing, one of the reform measures being proposed by the Basel Committee on Banking Supervision (of which the United States is a member and whose recommendations will likely be adopted by U.S. banking regulators), is a new liquidity ratio test, intended, along with the other proposals, to protect the international banking system from systemic risk. The proposal would require banks to hold liquid assets in the amount of their respective commitments under revolving credit facilities, whether or not drawn. This effectively would require a revolving lender to internally match-fund all such commitments, even those undrawn. A bank would need to raise such funds at its own cost of borrowing and presumably would pass along the cost to the borrower. So instead of charging, for example, 50 basis points per annum as an unused line or commitment fee, a lender would be charging an annual fee at a rate in the vicinity of Libor (which, though low now, won’t stay that way forever).

Revolving facility costs could thus dramatically rise, and such facilities could potentially be priced out of the market. In that scenario, less expensive replacements would likely begin to emerge (e.g., “synthetic” revolving facilities consisting of term loans combined with specialized cash-management techniques to ensure liquidity as needed).

In this past summer’s newsletter, we noted that, in the context of loan-to-own strategies, a U.S. bankruptcy court in New York disqualified (“designated”) the votes of Dish Network, which had purchased certain debt of bankrupt DBSD in an effort to gain control of it through the reorganization process. The case surprised many because the court ruled that certain objectives associated with the acquisition and ownership of debt, such as gaining control, are impermissible “ulterior motives” and can subject the debtholder to disqualification of its right to vote on or object to a plan of reorganization. This decision, affirmed on its initial appeal, is now on appeal to the Second Circuit Court of Appeals, which has as of this writing just recently issued a stay on the implementation of the bankruptcy court’s order confirming the debtor’s plan of reorganization, in an apparent effort to preserve the status quo ante pending the resolution on appeal.

In addition to the issue above concerning noteholders’ motives for acquiring debt and the branding of certain motives as disqualifying, the case also presented the issue as to how “equivalent” an asset needs to be in order to be deemed the “indubitable equivalent” of collateral securing a creditor’s obligations for purposes of replacing it and treating the secured creditor as “unimpaired” by virtue of the replacement. The DBSD bankruptcy court decision explicitly went beyond settled law in the area (generally satisfied with replacement assets of the same value and no greater risk profile) by loosening standards and regarding a lesser-valued collateral package as the “indubitable equivalent” of a higher-valued one. It reasoned that the lesser value was offset by, among other things, a higher nominal interest rate. Unless reversed, this more flexible...
view of the standard could potentially lead to all sorts of different types of restructuring proposals and plans of reorganization for chapter 11 debtors, where unsecured or undersecured creditors or equityholders could attempt to reinstate (or “cram-up”) secured creditors with assorted instruments and collateral security that will be argued as giving the secured creditor, when viewed together, the indubitable equivalent of its debt instrument, thus leaving the latter unimpaired and deemed to have automatically approved a plan of reorganization that the unsecured or undersecured creditors or equityholders (as the case may be) support.

Another decision over the summer that could potentially increase costs for acquisition financings is *Harbinger Capital Partners Master Fund I, Ltd. v. Wachovia Capital Markets,* a decision by a New York trial court that ruled that claims for fraud made against a loan arranger could go forward notwithstanding express provisions providing for arranger exculpation in the underlying transaction documentation. The court employed the theory that, because the arranger may have been in unique possession of the undisclosed information, any such exculpatory provision is ineffective. It is obviously not now knowable how the liability issue ultimately will be decided, but for the time being this interim decision of the trial court stands. It may mean that arrangers will view themselves as vulnerable to an added risk that in some instances, depending on what they may or may not know, they effectively could become guarantors in the event of borrower fraud on the lending group. With additional perceived risk there may come additional cost.

On another note, portfolio companies acquired in leveraged acquisitions, as well as other borrowers, typically have the right to consent to assignments by revolving lenders of their lending commitments and outstanding revolving advances, so long as no event of default has occurred. On occasion borrowers under a term loan may have similar rights with respect to assignments by lenders of their term loans. The consent right is usually intended to address a borrower’s concern that, in the case of revolving commitments, assignments may potentially be made to a party that might not be able reliably to make revolving advances available from time to time as required under the credit agreement. In other cases, there may be concern that a loan potentially could be assigned to a competitor of the borrower which might have other interests vis-à-vis the borrower besides providing it financing.

Where a borrower may object to a loan assignment, a lender and its would-be loan buyer often can simply restructure their deal as a participation rather than assignment, and thereby avoid the need to obtain the borrower’s consent. (Participations generally convey a lender’s economic interests in its loan along with only limited consent rights and set-off rights, with the seller of the participation retaining its formal title as lender and formal relationship with the borrower.) As a result, such cases usually do not come up before a judge.

However, in a case decided last winter (which became noteworthy over the summer, as noted below), the U.S. District Court for the Southern District of New York, in *Empresas Cablevisión, S.A.B. de C.V. v. JPMorgan Chase Bank N.A.,”* ruled that a borrower could block a sale by a lender to a competitor of the borrower, even of a loan participation, where the borrower had refused to consent to an assignment of the loan to the competitor. The lender had attempted to end-run the assignment restriction by selling a participation instead, but the court held that the participation was effectively a forbidden assignment that breached the selling lender’s duties to the borrower of good faith and fair dealing. Borrowers may thus have some additional leverage in keeping unwanted holders away from their credits, at least until *Empresas* is overturned, as it is may well be, since its ruling runs contrary to what was commonly viewed as the state of the law regarding participations. The case seems to have been decided on the basis of a very particular set of facts. The case, originally decided last winter, had been the subject of an appeal and was widely viewed as reversible, but the appeal was dropped over the summer when the parties otherwise resolved their issues, thus leaving the decision standing.

We look forward to providing further updates on these and other matters in upcoming issues. Please feel free to contact us to discuss any of these items further.


3. 680 F. Supp. 2d 625 (S.D.N.Y.), aff’d & renaded by, 381 F. App’x 117 (2d Cir. 2010).

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Constraints on Equity Investments in Listed Companies

by François Hellot and Anne-Charlotte Rivière-Wilson

A private equity fund contemplating an investment in a listed company has to face a different environment from its “sweet spot” consisting of transactions in privately-held companies. It does not have the same flexibility to negotiate the terms and conditions of its investment with the target particularly in regards to fixing the issue price of the securities independently from the market price, determining in advance the percentage of the target it will hold after completing its investment if the offer has to be made to the other shareholders, or choosing the timetable for preparing and completing its investment. This article will describe the constraints applying to equity investments in French, German and English listed companies and analyze some solutions to deal with these constraints.

The investments subject to the most constraints are those that fall within the scope of the public offers regulations and require the drafting of a prospectus and its approval by the competent stock market authority. Given the time required to prepare a prospectus and have it approved, it is clear that avoiding the scope of public offers regulations will give more flexibility when investing in public companies.

The European Directive on prospectuses, dated November 3, 2003 (the “Prospectus Directive”), harmonizes the EU member states’ regulations on public offers and the circumstances in which it is necessary to publish a prospectus approved by the competent stock market authority.

The Prospectus Directive also defines a limited number of cases in which each member state may exonerate a company from publishing a prospectus when offering securities to the public. There are three main types of exemptions, relating to: the aggregate amount of the fundraising; the individual amount invested by each investor; and private placements.

To understand fully the constraints applying to such investments, it is also necessary to assess the rights issues regulations from a corporate perspective.

Prospectus Exemption Related to the Amount of the Fundraising or the Investment

In France, pursuant to the Monetary and Financial Code and the General Regulation of the Autorité des Marchés Financiers (“RGAMF”), regardless of the means used to offer the securities to the public (including advertising) and the qualification of the investors, rights issues do not constitute a public offer if the total consideration of the offer is less than €2.5 million and the issued securities represent less than 50% of the share capital of the company.

Nonetheless, such rights issues may only be implemented if the existing shareholders benefit from subscription rights. Consequently, the maximum number of securities available to a third-party private equity investor will be limited by the above mentioned caps and also by the subscription rights that will be eventually retained by the existing shareholders. As such, this exemption will only be useful if one or several significant shareholders agree to transfer their subscription rights to the third-party private equity investor to ensure it has sufficient rights to reach its expected amount of investment and level of financial interest in the target company. In such a rights issue, the issue price of the new securities may be freely determined by a shareholders’ general meeting or by the board within the limit of the authorization granted by the shareholders’ general meeting.
Under the German Securities Prospectus Act ("WpPG"), the exemption relating to the amount of the rights issue is very limited as it only applies if the total consideration of all securities offered is less than \(€100,000\) calculated over a period of 12 months. Due to its low cap, this prospectus exemption is not really useful in Germany.

In the United Kingdom, under the Financial Services and Markets Act 2000 ("FSMA"), the exemption relating to the amount of fundraising states that a prospectus is not required if the total consideration for the transferable securities being offered does not exceed \(€100,000\). As in Germany, it is necessary to look back at all offers that were made in the 12-month period preceding the relevant offer to see if this exemption is available. Nonetheless, if the total consideration for the offer is less than \(€2.5\) million (aggregated with all other offers for shares of the same class within the preceding 12 months), then no prospectus is required in respect of such an offer.

In addition, in France, Germany and the United Kingdom, rights issues where each minimum individual subscription amount exceeds \(€50,000\) do not fall into the scope of public offer regulations as the persons subscribing to such amount are deemed to be qualified enough to assess the risks of their investment.

### Private Placements

The private placement is the most commonly used means to invest in listed companies while bypassing the public offer regulations.

In France, Germany and the United Kingdom, there are two alternative criteria to qualify as private placement—either the offer of securities is addressed solely to qualified investors or securities are offered to less than 100 natural or legal persons per member state (even if they are not qualified investors)—and in the UK, the total consideration for the offer is less than \(€2.5\) million (aggregated with all other offers for shares of the same class within the preceding 12 months).

The definition of qualified investor slightly differs in each of these three jurisdictions, but it mainly covers institutions that conduct banking and investment business, insurance companies, national or foreign investment companies or funds, pension funds and other legal entities that are deemed to be qualified due to their size. Small or medium-sized companies (i.e., that meet at least two of the following three criteria: less than 250 employees, a total balance sheet not exceeding \(€43\) million and an annual net turnover not exceeding \(€50\) million) and natural persons may also be qualified investors provided they are registered in a national register. Such a register is held by the Autorité des Marches Financiers ("AMF") in France, the Bundesanstalt für Finanzdienstleistungsaufsicht ("BaFin") in Germany and the Financial Services Authority ("FSA") in the United Kingdom. Pursuant to the Prospectus Directive, the member states have agreed on a policy of mutual recognition of persons or entities who are qualified investors in another member state.

Despite the similarities between the jurisdictions, the corporate regulations render private placements very different in the three jurisdictions.

In France, pursuant to article L. 225-136 of the Commercial Code, a private placement requires that the shareholders’ general meeting resolve to cancel the shareholders’ subscription rights and empower the board of directors to implement a placement. Such a placement will be limited to 20% of the share capital of the company over a period of 12 months.

In such a case, the rights of the board of directors to determine freely the issue price will depend on the type of market (regulated or organized) and the percentage of dilution. For companies listed on a regulated market (for example, Eurolist of NYSE Euronext), the issue price of the new securities must be at least equal to the weighted average market price of the last three trading days prior to the issue of the securities reduced by a maximum discount of 5%. However, the shareholders’ general meeting may authorize the board to issue new securities in respect of which the issue price is disconnected from the market price up to a maximum of 10% of the share capital of the company over a period of 12 months. In such a case, the issue price or the conditions for determining that price are determined by the extraordinary general meeting. The flexibility on the issue price will consequently depend on the percentage of dilution that is acceptable for the target company and its shareholders (less than 10% or between 10% and 20%). For companies listed on an organized market (such as the Alternext market of NYSE Euronext), the issue price or the conditions for determining that price are determined by the extraordinary general meeting and can therefore be disconnected from the market price.

In Germany, the exclusion of the subscription right of the shareholders may be either a simplified or a regular exclusion. In case of a simplified exclusion, no exclusion justification will be required but the dilution resulting from such issue will be limited to 10% of the registered capital. On the other hand, if the company decides to use a regular exclusion, such exclusion will have to be in the best interests of the company, and adequate and fair to serve its corporate purpose (which is very difficult to
justify) and the issue will only be limited by the general cap of the authorized capital, which may not represent more than 50% of the registered capital.

In both cases of exclusion of the subscription rights of the current shareholders, the issue price must not be significantly below the current market price, i.e., the issue price must not be less than 3% to 5% of the weighted average market price of the securities in the last five days prior to the issue of the new securities.

In the United Kingdom, pre-emption rights exist under section 561 of the Companies Act 2006 and the Listing Rules (contained in the FSA Handbook). Due to these pre-emption rights, a company proposing to allot equity securities wholly for cash must first offer these securities to existing shareholders pro rata. Companies are able to disapply these rights, either on a case-by-case basis or generally. In addition, the directors of the company must be granted authority to allot the shares that can again be given generally or on a case-by-case basis.

In order to disapply the pre-emption rights, a special resolution of the shareholders of the company is required. For a special resolution to be passed, at least 75% of votes cast by shareholders will need to be in favor of the resolution. The grant of general authority to allot only requires the approval of a simple majority. In theory, a general disapplication of these rights can be as wide as the company wants, but in practice, the Investor Protection Committee (“IPC”) guidelines state that a general disapplication of pre-emption rights must not apply to more than 5% (7.5% in a three-year rolling period) of the existing issued ordinary share capital. The general authority to allot should not extend to an amount exceeding one third of the existing issued ordinary share capital. Whilst the IPC guidelines are not binding, the IPCs are powerful investor bodies and so listed companies endeavour to abide by their guidelines. Most companies seek limited authorities annually at their annual general meeting. Larger transactions will always require resolutions to be presented to shareholders at a specially convened general meeting.

In the Listing Rules, there is a restriction on the issue price for companies listed on the Main Market of the London Stock Exchange. The issue price cannot be at a discount in excess of 10% to the middle market price without shareholder approval. However, IPC guidance states that where the issue is under a specific disapplication of pre-emption rights, a discount of more than 5% should not be used.

### The French Legislation Gap Opportunity

The French Commercial Code provides for a specific regime for rights issues where the subscription right is cancelled by the shareholders’ general meeting in favor of a category of investors.

Such regime is primarily aimed at private companies, but it may also be implemented by listed companies. As such issues do not fall within the scope of public offers, they offer much more flexibility to listed companies that do not need to meet the above mentioned criteria for exemption to avoid the publishing of the prospectus or requiring the approval of the issue price by the AMF.

The shareholders’ general meeting will have to define the category which may consequently include non-qualified investors as well as qualified investors depending on its criteria, the cap of the share capital increase and the issue price or the conditions for determining that price. Such price or criteria may be disconnected from the market price.

The amount of such rights issues is solely limited by the shareholders’ meeting resolution and can consequently represent more than 20% of the share capital over a period of 12 months.

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How Can Banking Entities Participate in Private Funds Under the Volcker Rule?

by David J. Harris and Adam Gehrie*

The Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”), which President Obama signed into law on July 21, 2010, is largely focused on establishing new regulatory bodies, such as the Financial Stability Oversight Council (the “Council”) and the Bureau of Consumer Financial Protection, and mandating several new regulations. This article focuses on the so-called
“Volcker Rule” found in Section 619 of Dodd-Frank, which adds a new Section 13 to the Bank Holding Company Act of 1956 (“BHCA”) that, with certain exceptions for “permitted activities,” prohibits a “banking entity” from engaging in “proprietary trading” and from acquiring or retaining an ownership interest in or “sponsoring” a “hedge fund” or a “private equity fund.”

In particular, this article analyzes the implications of the Volcker Rule for banking entities that have business units devoted to the sponsorship of hedge and private equity funds, and explores possibilities for how such banking entities may remain in the business of advising hedge funds and private equity funds, notwithstanding the Volcker Rule’s prohibition on “sponsoring” such private funds. We also discuss how banking entities may continue to include assets managed by advisers to private funds in their portfolios outside of the private fund structure. In addition, investment in private funds structured as small business investment companies (“SBICs”) are exempt from the restrictions on investment set forth in the Volcker Rule, and therefore may represent an avenue for banking entities to remain in the private fund space.

As will be evident from this review, there are many areas where the statutory language must be clarified before the Volcker Rule’s restrictions reasonably can be implemented and its impact fully known. Dodd-Frank requires the Council to evaluate the impact of the Volcker Rule and a formal study (the “Volcker Study”) must be completed by January 21, 2011, the six-month anniversary of the legislation; public comments related to the first set of proposed regulations were due by November 5, 2010. Presumably additional opportunities to participate in the Volcker Study and to influence rulemaking under the Volcker Rule will be forthcoming.

Key Terms

Banking Entity. As indicated above, the Volcker Rule’s prohibitions apply to any “banking entity,” a term that is defined very broadly to include not just any insured depository institution (“bank”), but also any company that controls a bank, and any subsidiary or affiliate of such company.

Hedge Fund, Private Equity Fund. Subsection (h)(2) defines the terms “hedge fund” and “private equity fund” identically to mean an issuer that would be an investment company under the Investment Company Act of 1940 (“1940 Act”), but for the exclusions provided by Section 3(c)(1) (maximum of 100 beneficial owners) or Section 3(c)(7) (investors limited to qualified persons) of the 1940 Act (the “private fund exclusions”), or such similar funds as the financial regulatory agencies may by rule determine. Once again, the definition is extremely broad, encompassing many more entities than would ordinarily be considered hedge funds or private equity funds.

Impact on a Banking Entity’s Ability to Sponsor Hedge Funds and Private Equity Funds

Prior to the effective date of the Volcker Rule, which will be no later than two years after enactment, banking entities will not be directly limited in their hedge fund or private equity fund activities. There is the possibility for several extensions of the time period in which a banking entity must conform its existing activities, although there is no assurance that any such extensions will be granted.

What then are the activities related to the sponsorship of hedge funds and private equity funds that are prohibited by the Volcker Rule?

The short answer is that subsection (a)(1) provides, subject to certain exceptions, that:

a banking entity shall not … acquire or retain any equity, partnership or other ownership interest in or sponsor a hedge fund or private equity fund.

Applying the definitions discussed above, this means that the banking entity, except as otherwise permitted, may not acquire or retain an equity or ownership interest in, or sponsor, any investment vehicle that would be an investment company or for its reliance on Sections 3(c)(1) or (7) of the 1940 Act. Subsection (h)(5) provides that the term “sponsor” means (A) to serve as a general partner, managing member or trustee of a fund; (B) to select or control a majority of the directors, trustees or management of a fund; or (C) to share the same name or a variation of the same name with the fund.

Notwithstanding the general prohibition language above, subsection (d)(1) provides exceptions for a number of “permitted activities,” subject, however, to the general limitations in subsections (d)(2) and (d)(3). Among these permitted activities, a banking entity may organize and offer a private equity or hedge fund, including activities that would constitute sponsoring the fund, subject to a number of specific requirements discussed in greater detail below (significantly, banking entities may also conduct hedge and private equity fund activities, provided that such activities (i) are not directly or indirectly controlled by a U.S. entity; (ii) are conducted solely outside the United States; and (iii) no ownership interest in the relevant private fund is sold to a U.S. resident; the
purpose of this carveout is to avoid appearing to regulate foreign banks).

Specifically, subsection (d)(1)(G) authorizes a banking entity to sponsor, organize and offer a hedge fund or private equity fund, but only if:

- the banking entity provides bona fide trust, fiduciary or investment advisory services;
- the fund is organized and offered only in connection with such services and only to customers of such services of the banking entity;
- the banking entity does not acquire any ownership interest in the fund except for a de minimis investment that complies with the requirements of subsection (d)(4), which permits a banking entity sponsor of a hedge or private equity fund to provide seed capital sufficient to attract unaffiliated investors or to make a de minimis investment in the fund, provided that the banking entity actively seek unaffiliated investors and in any event reduces its ownership interest in the fund within one year (with possibly a two-year extension) to not more than 3% of the fund’s total ownership interests. In addition, in no event may the aggregate of all such investments by the banking entity exceed 3% of the banking entity’s Tier 1 capital;
- the banking entity complies with the restrictions of subsection (f)(1) and (2). Subsection (f)(1) prohibits the banking entity and any affiliate of such entity, from entering into any transaction with the fund that would be a covered transaction as that term is defined in the Federal Reserve Act. Taken literally, this section effectively prohibits the banking entity from acquiring any interest in the fund, in direct contradiction to subsection (d)(4)’s explicit authorization; this is an area that would benefit from rulemaking by the financial regulatory agencies;
- the banking entity does not directly or indirectly guarantee, assume or otherwise insure the obligations or performance of the fund;
- the banking entity does not share a name or a variation of the same name with the fund;
- no director or employee of the banking entity acquires an equity interest in the fund, except for a director or employee that is directly involved in providing investment advisory or other services to the fund; and
- the banking entity discloses in writing to prospective and actual investors that any losses in the fund are borne solely by investors and otherwise complies with any rules adopted by the financial regulatory agencies to ensure such losses are not borne by the banking entity.

Potential Solutions for Banking Entities Wishing to Remain in the Private Funds Space

As reflected in the above summary, the Volcker Rule will severely curtail the hedge and private equity fund sponsorship activities of “banking entities.” However, we believe that, in addition to the ability to sponsor private equity funds pursuant to the (d)(1)(G) exception, the following relationships between banking entities and private funds remain possible.

Advisory Relationships. Banking entities may serve as investment advisers to private funds, so long as they do not sponsor the funds as we have described above. Therefore, if a third party is willing to act as fund sponsor (generally by acting as general partner or managing member of the fund, and by facilitating the formation of the fund), a banking entity may enter into an investment advisory agreement with the fund whereby the banking entity exercises investment discretion over the fund’s assets and is compensated for its services. Any such investment advisory contracts should be negotiated on an arms-length basis.

Side-by-Side Investments and Direct Private Equity Investments. The Volcker Rule does not restrict direct investments in private equity, and banking entities may therefore continue to make direct private equity and merchant banking investments. This means that notwithstanding the 3% limitation on a banking entity’s investment in private funds, under certain circumstances a banking entity may invest side-by-side with a private fund. This would clearly be permissible if the fund is advised by another investment adviser and may even permit investment in a fund advised by the banking entity. For example, if the banking entity retains investment discretion over the side-by-side account (and has the right to decline to participate in some investments made by the related fund), then the banking entity potentially could retain investment exposure to the fund’s fundamental strategy without actually investing in the fund. Note, however, that the Volcker Rule’s prohibitions on fund sponsorship, as well as the Volcker Rule’s anti-evasion provisions, may place significant limitations on the extent to which the banking entity’s side-by-side investment with the fund may be used for marketing purposes by the fund.
SBICs. Subject to any restrictions or limitations that may be imposed by regulation, an exception to the Volcker Rule is provided for investments in SBICs. The exemption covers investment in SBICs, not sponsorship of SBICs, so there remains uncertainty as to whether prohibitions on fund sponsorship would preclude a banking entity from sponsoring an SBIC. Lobbying groups, including the National Association of Small Business Investment Companies, have taken the view that the Volcker Rule does not prohibit banking entities from sponsoring SBICs, and will seek to influence the rulemaking process toward this end.

The Volcker Rule significantly restricts the ability of banking entities to sponsor hedge funds and private equity funds. We are hopeful that the rulemaking process will clarify some of the ambiguities present in the legislation. In the meantime, we believe that banking entities may continue to have advisory relationships with private funds, and that banking entities may continue to include investments managed by advisers to private funds in their portfolios through side-by-side investing.

* Mr. Gehrie is a former Dechert associate.

1 The scope of this article is narrow relative to the Volcker Rule overall, and this article does not address many important points related to proprietary trading restrictions and other impacts of the Volcker Rule on the activities of banking entities. For a more comprehensive overview of the Volcker rule, see our July 2010 DechertOnPoint “Dodd-Frank’s Limitations on Risk Taking: An Analysis of the Volcker Rule’s Restrictions on Proprietary Trading, and Investments in and Sponsorship of Hedge Funds and Private Equity Funds” available at http://www.dechert.com/library/FS_16_7-10_Dodd-Frank_Limitations.pdf.

2 Interestingly, Title IV of Dodd-Frank, which deals with the private adviser registration requirements (available at http://www.dechert.com/library/FS-15-07-10-The_Impacts_of_the_Dodd-Frank_Wall_Street.pdf), takes a similar approach in defining the term “private fund” by reference to the private fund exclusions, but, in contrast to the Volcker Rule, provides exemptions from the adviser registration requirements for “foreign private advisers,” “family offices,” and “venture capital funds,” as such terms are defined in Title IV.

Caveat Emptor? What Are You Really Getting When You Get Someone’s “Best Efforts”? by Kenneth E. Young and Jeremy I. Levy

It’s happened countless times and it’s probably happened to you. It’s late. There are only a few issues left. You are ready to trade away something—so long as you can keep the “best efforts” standard on a covenant. You win the argument, but what have you won?

If asked, we believe many deal professionals may cite the classic case on the issue, Bloor v. Falstaff Brewing Corp. and say that while the party with the “best efforts” burden need not spend itself into bankruptcy, it would have to spend money and expend some—probably significant—efforts. We believe many deal professionals would go on to say that the other standards, “reasonable best efforts” or “commercially reasonable efforts,” by definition, require less effort than “best.”

Unfortunately, a review of the case law, including recent New York and Delaware cases, suggests that judges do not enforce contracts in a manner consistent with this view. In this article we examine the recent case law and caution practitioners to be careful when negotiating “efforts” clauses. Specifically we suggest that practitioners shift their emphasis to specific, measurable criteria that a court can understand and enforce.

Best Efforts

The leading case on the meaning of “best efforts” remains the Second Circuit’s 1979 case Bloor v. Falstaff Brewing Corp. In Falstaff, a family-owned brewery sold substantially all of its assets to Falstaff for a lump sum as well as for royalties related to the ensuing six years of sales of its brand, Ballatine. The purchase agreement required Falstaff to use its “best efforts” to promote and maintain a high volume of sales of Ballatine products. Three years later, Falstaff’s overall revenues had fallen substantially and the company had incurred losses of $22 million on Ballatine sales. At that time, control of Falstaff passed to Paul Kalmanovitz, who resolved to turn the company around by closing locations and otherwise
cutting costs, including by slashing the advertising budget for Ballatine brands by nearly 90%. Falstaff swung to a profit under Kalmanovitz’s leadership, but sales of Ballatine products plummeted.

The Second Circuit held that Falstaff had breached its best efforts obligation because it “simply didn’t care” about sales of Ballatine products in its quest for overall profits. In other words, the decision suggests that one cannot satisfy a best efforts obligation by doing nothing at all. Though this uncontroversial holding was followed as recently as in 2008 in the Delaware Chancery Court case Hexion Specialty Chemicals, Inc. v. Huntsman Corp. Professor Farnsworth points out in his treatise on contracts that Falstaff “did relatively little to add precision to the meaning of best efforts, since Kalmanovitz fell so far short of the mark.”

Falstaff’s influence stems, instead, from its descriptions of the boundaries of best efforts. On the one hand, one cannot satisfy a best efforts standard by doing nothing at all. On the other hand, the court stated that best efforts does not require one to spend itself into bankruptcy, that best efforts does not require a party to incur financially disastrous consequences and that a party under a best efforts obligation is entitled to give reasonable consideration to its own interests. But, these guideposts do little to help the practitioner who is looking for the line demarcating where best efforts end and where the modified efforts standards begin.

Courts have offered additional formulations of the best efforts standard. In Kroboth v. Brent, a 1995 case, the New York Supreme Court Appellate Division stated that best efforts requires the obligor to use all reasonable methods to satisfy its obligation. In 2005, the District Court for the Southern District of New York in Scott-Macon Securities v. Zoltek Companies read business judgment into Falstaff’s standard of reasonableness, saying that a party under a best efforts obligation may exercise discretion, within its good faith business judgment. The Zoltek court also cited Professor Farnsworth’s formulation with approval: that a duty of best efforts requires a party to make such efforts as are reasonable in light of that party’s ability and the means at its disposal and of the other party’s justifiable expectations. In 2006, the court in Ashokan Water Services, Inc. v. New Start found precedent in New York for all of the following definitions of the best efforts obligation: due diligence, all reasonable methods, reasonable efforts, good faith business judgment, genuine effort, and active exploitation in good faith.

Courts outside of Delaware and New York have also generated varied formulations of the best efforts obligation. A survey of case law by Kenneth Adams in 2004 uncovered a variety of best efforts standards being employed by courts. For example, the First Circuit has held that best efforts requires that a party act in good faith. The Third Circuit has held that the best efforts standard is one of diligence. The official comment to UCC §2-306 combines both of these standards with reasonableness, defining the implied obligation to use best efforts as an obligation to use reasonable diligence as well as good faith in performance of a contract.

Taken as a whole, these varied judicial definitions of “best efforts” have one thing in common: they impute a level of discretion to the obligor that we believe practitioners typically associate with “reasonable efforts.”

In 1979, the Falstaff court stated that the net result of its research on the law of best efforts was that such law was far from clear and that it was unfortunate that they had to apply it. Thirty years of jurisprudence has afforded little more clarity on what best efforts means, as the Delaware Court of Chancery stated in 2009, “it is doubtful that there even is a broadly and commonly accepted meaning to be ascribed to the phrase.” But we believe there is enough case law to make clear that whatever “best efforts” means, courts talk about “best efforts” in terms that most practitioners reserve for “reasonable efforts.”

**Compared with Other Efforts Standards**

Once we focus on the fact that courts view best efforts as an obligation defined by concepts such as reasonableness, good faith, diligence and business judgment, it should not come as a surprise that courts have not rendered a holding demarcating the difference between best efforts on the one hand and other types of “efforts” on the other hand.

On the contrary, in Zoltek, the court cited Timberline Development LLC v. Kronman for the proposition that New York courts use the term reasonable efforts interchangeably with best efforts. In Timberline, the New York Supreme Court Appellate Division stated, “the requirement to employ reasonable efforts or ‘best efforts,’ as it is generally expressed, in the performance of contractual obligations is deemed to be implicit in every agreement.”
Delaware courts similarly conflate the purportedly distinct standards. For example, though the relevant agreement in *Hexion* imposed a reasonable best efforts obligation, the Chancery Court applied the *Falstaff* approach for determining whether there was a breach of best efforts. Moreover, the court used the two phrases interchangeably throughout its opinion.

Though no court has held that there is a difference between best efforts and any other efforts standard, some courts have stated as much without citing authority for the proposition. In one case, the 1995 *LTV Aerospace and Defense Co. v. Thomson*, a New York bankruptcy court said that the standard imposed by reasonable best efforts is indisputably less stringent than that imposed by best efforts clauses.9 In another, the 2009 case *Alliance Data Systems v. Blackstone Capital Partners*, the Delaware Court of Chancery cited Lou R. Kling and Eileen T. Nugent’s book *Negotiated Acquisitions of Companies, Subsidiaries and Divisions* and included the following in its explanatory parenthetical: “it is not clear how far a party must go to satisfy best efforts, which is a more rigorous standard than reasonable best efforts.”10 Then, without irony, in the same footnote the court cited “best efforts” case law to support its holding that “reasonable efforts” is a lesser standard than an unconditional commitment.

**Negotiated Best Efforts Criteria**

While the case law provides little guidance as to how a judge may determine the way best efforts may be differentiated from other efforts, the courts do consistently look to the parties and their contracts for guidance on interpreting the clauses. In fact, some courts will not enforce best efforts provisions in the absence of objective articulated criteria to use in evaluating such provisions. The *Ashokan* court described the need for guidance from the parties this way: “part of the difficulty in adequately articulating the best efforts obligation is that the obligation operates in different transactional settings, and can serve different purposes in those settings.”

In *Ashokan*, the relevant agreement stated that Ashokan, a water company, must use “best efforts to bring about savings in [New Start’s] past, current and future utility bills” in the form of obtaining credits to New Start’s accounts. In exchange, New Start would pay Ashokan one third of all credits New Start received on its water/sewer utility accounts. When the Department of Environmental Protection granted credits amounting to $48,226.17 to six of New Start’s accounts that had been consolidated by Ashokan, New Start paid only a portion of the one-third Ashokan believed was due it according to the contract’s terms. New Start claimed that Ashokan’s action of consolidating the accounts had led to an increase in billing.

The court held Ashokan made a prima facie showing that it used best efforts to generate the credits. The court stated that best efforts can only be defined contextually, and that the most significant context for the best efforts obligation was the contract itself. The contract expressly allowed Ashokan to consolidate New Start’s accounts, and Ashokan showed that the credits came from Ashokan’s efforts. On this basis, the court held that a prima facie showing was made.

Though the *Ashokan* court did not ultimately decide whether the best efforts obligation was satisfied, the court was able to evaluate the obligation because it found sufficient criteria in the agreement. But the court also noted that “it is still unclear when and how an express best efforts provision is to be enforced in the absence of articulated objective criteria in the agreement.” As the court pointed out, many courts in New York have declined to enforce best efforts clauses if the agreement does not also contain clear guidelines for such measurement. On the other hand, other courts in New York have applied best efforts provisions in the absence of objective criteria. Still others have implied best efforts provisions where none were written into the agreement.

**Conclusion**

So what did our deal professional get for his or her client by trading something away to keep the best efforts provision? By itself, probably not very much. In 2009, the Delaware Chancery Court provided one answer: “perhaps a best efforts standard approaches an unconditional obligation, or perhaps it diverges by some material distance from an unconditional obligation.”11 And, regardless of what the clause may mean, in the absence of articulated objective criteria, our deal professional cannot be sure that the clause will be enforced at all.

Nonetheless, as practitioners, we think it’s fair to say that the best efforts standard—or some variation thereof—is an important drafting tool. It can help break log-jams or avoid a detailed negotiation. In most cases, it will never be litigated and therefore never tested. But when using this tool, it is critical to recognize what was noted in *Falstaff* and rehashed in the 2008 New York case *Mofet Etzion Ltd. v. General*
Dynamics Land Systems: the law on best efforts is far from clear. Courts may yet hold a distinction between reasonable efforts and best efforts in line with Alliance and LTV. More likely, the common law interpretation of these various standards will remain murky.

Where does this leave the practitioner? Back where we began—caveat emptor. If you intend to enforce the benefit of your bargain when negotiating one of these standards, be precise about what you mean. If you require a party to obtain a license or consent, specify a dollar amount the party must pay to get it. If you’re expecting performance according to a standard of care, specify the amount of time or money that standard contemplates and what milestones will be used to measure it. By making the effort to define efforts standards objectively, you greatly increase the chance that you’ll get what you bargained for.

(Special thanks to Sohana Barot for her contributions to this article.)

Summary Steps: Investment Adviser Registration

by Carl A. de Brito, George J. Mazin and Kevin P. Scanlan

Registration Requirements

Pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Act”), an investment adviser which acts solely as an adviser to private funds1 will be required to register with the Securities and Exchange Commission (the “SEC”) as a registered investment adviser (an “RIA”) under the Investment Advisers Act of 1940, as amended (the “Advisers Act”) upon reaching $150 million of assets under management2 in the United States.3 U.S. advisers (i.e., those with their principal office and place of business in the United States) are required to count all of their assets under management for purposes of the $150 million threshold and all of their clients for purposes of determining whether they advise solely private funds. Non-U.S. advisers (i.e., those with their principal office and place of business outside of the United States), however, would not be required to consider non-U.S. clients or assets that are managed from a place of business outside of the United States. Thus, a non-U.S. adviser should be able to rely on the $150 million threshold to avoid registration so long as: (i) the only U.S. persons advised by the non-U.S. manager are private funds and (ii) the non-U.S. manager advises no more than $150 million in assets from a U.S. place of business.

Key Exemptions

The Act provides exemptions from registration for certain types of investment advisers. In particular:

- Foreign Private Advisers. “Foreign private advisers” are exempt from registration as RIAs. Foreign private advisers are defined as investment advisers that (i) have no place of business in the U.S.; (ii) have, in total, fewer than 15 U.S. persons as clients or investors in the U.S. in private funds advised by the investment adviser; (iii) have aggregate assets under management attributable to U.S. persons of less than $25 million; and (iv) neither (A) hold themselves out generally to the public in the U.S. as an investment

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1 601 F.2d 609 (2d Cir. 1979).
2 965 A.2d 715 (Del.Ch.2008).
3 E. Allan Farnsworth, 2 FARNSWORTH ON CONTRACTS §7.17c (3d ed. 2004).
10 963 A.2d 746 (Del.Ch. 2009).
adviser nor (B) advise any registered investment company (mutual fund) or registered business development company.

- Family Offices. Advisers that are “family offices” will not be included in the definition of “investment adviser” under the Advisers Act, and thus will not be required to register as investment advisers. The SEC recently proposed a rule that provides a definition of “family office” for purposes of being excluded under the Advisers Act that encompasses the characteristics of the family offices to which the SEC has previously issued exemptive orders.

- Exempt Reporting Advisers. Advisers to venture capital funds and mid-sized private fund advisers described below will not be required to register as an RIA. However, such advisers, which the SEC refers to as “Exempt Reporting Advisers”, will be required to file basic disclosure information with the SEC on a newly amended Form ADV reporting form. Such advisers will also be subject to recordkeeping requirements (to be determined by the SEC at a later date) and certain provisions of the Advisers Act, including the anti-fraud provisions.

- Venture Capital Fund Advisers. The SEC recently proposed a rule defining venture capital funds as any fund that: (i) is a private fund; (ii) invests in equity securities of qualifying portfolio companies, which are generally companies that are not publicly traded at the time of investment, in order to provide operating and business expansion capital; (iii) has acquired at least 80% of its equity investment in each qualifying portfolio company directly from the qualifying portfolio company; (iv) offers significant managerial assistance to the qualifying portfolio company; (v) does not incur leverage in excess of 15% of the fund’s assets; (vi) does not offer liquidity rights to investors except in extraordinary circumstances; and (vii) represents itself as a venture capital fund to investors.

- Mid-Sized Private Fund Advisers. Under the SEC’s recently proposed rules, a Mid-Sized Private Fund Adviser will be any investment adviser solely to private funds with “Regulatory AUM” in the United States of less than $150 million in the United States. As noted above, the SEC proposes to treat U.S. advisers in a manner substantially different than non-U.S. advisers in determining qualification for this exemption.

If you believe that your business falls within one of these exemptions, please contact us to discuss the parameters of the relevant exemption in more detail.

**Steps to Registering as an RIA**

The process of registering as an RIA is fairly simple; most of the burdensome aspects of registration relate to compliance with the requirements imposed by the Advisers Act upon RIAs, not the actual registration process. Compliance under the Advisers Act is addressed below. The steps to achieving registration are:

- The first step in the SEC registration process is to create an Investment Advisers Registration Depository (IARD) User Account through a process called “Entitlement” that is managed by the Financial Industry Regulatory Authority (“FINRA”). This process involves completing several forms and sending them to FINRA. Approximately two weeks after receiving the forms, FINRA will send the firm a username and password to access IARD.

- Once the applicant has set up an IARD account, the next step is to complete Form ADV, the investment adviser registration form. Part 1A of Form ADV, which is intended to solicit basic information from the investment adviser (mostly through check-the-box and fill-in the blank style questions), must be filed electronically through IARD together with a nominal filing fee. Beginning January 1, 2011, new registrants must also prepare and file Part 2A of Form ADV (the “brochure”), a narrative brochure describing the adviser’s business, management styles and practices, fees and conflicts.

Both Part 1A and Part 2A will be available to the public through the SEC’s website and Part 2A must be provided to clients at or before engaging the adviser.

- The SEC will review Part 1A of Form ADV to confirm that it is complete and in compliance with the Advisers Act. Registration must be accepted or denied within 45 days (and generally advisers are notified within a few weeks).

As noted above, Exempt Reporting Advisers will also be required to file informational reports on a modified Form ADV and will need to create an IARD account.

**Complying with the Advisers Act**

Conducting business as an RIA subjects the investment adviser to certain substantive requirements, including the
requirement to establish a compliance program reasonably designed to prevent violations of the Advisers Act. There are many aspects of compliance with the Advisers Act that are beyond the scope of this memorandum; we have briefly listed those that we think will be of the most concern to an unregistered investment adviser. An RIA is expected to be in compliance with the Advisers Act and the rules thereunder upon registration, so the investment adviser should plan on being in compliance with the following requirements before submitting Part 1A of its Form ADV to the SEC. Exempt Reporting Advisers are exempt from registering as an RIA but are still required to comply with certain provisions of the Advisers Act, as well as become subject to examination by the SEC.

Development of a Compliance Program

Rule 206(4)-7 under the Advisers Act (the “Compliance Rule”) requires each RIA to establish an internal compliance program that addresses the adviser’s substantive and fiduciary obligations under the Advisers Act. Although the Compliance Rule requires all RIAs to implement internal compliance programs, it gives each RIA the flexibility to decide how to structure its own policies and procedures (although a number of suggested areas on which an RIA should focus are listed in the adopting release to the Compliance Rule).

Chief Compliance Officer

The Compliance Rule requires an RIA to designate a chief compliance officer with knowledge of the Advisers Act and who has the authority to create and administer appropriate compliance policies and procedures for the RIA. The chief compliance officer’s (and, if applicable, his or her subordinates’) duties could include, among others:

- Reviewing the policies and procedures of the RIA at least annually for adequacy and effectiveness;
- Reviewing brokerage arrangements and execution, portfolio management and trade allocation, and valuation procedures;
- Reviewing all advertising to ensure compliance with the specific requirements of the Advisers Act (especially those related to performance reporting);
- Managing personal trading procedures as required by the RIA’s Code of Ethics (see below);
- Managing the recordkeeping required by the Advisers Act (see below);
- Filing “blue sky” offering notices with the SEC and state regulatory authorities (actually required whether the adviser is registered or not);
- Filing SEC Forms 3, 4, 5, 13D, 13F and/or 13G, to the extent required (generally where the investment adviser takes significant positions in publicly-traded equity securities); and
- Serving as the point of contact for the SEC during inspections, examinations or other inquiries.

Development of a Code of Ethics

Rule 204A-1 under the Advisers Act (the “Code of Ethics Rule”) requires RIAs to develop and follow a Code of Ethics. An RIA’s Code of Ethics is largely comprised of procedures to promote ethical, fiduciary conduct and to monitor (and sometimes prevent) the personal activities of personnel that may conflict with the interests of advisory clients. The Code of Ethics must include standards of conduct, rules governing personal securities transactions, pre-approval of certain securities transactions and guidelines regarding the reporting of violations.

Recordkeeping

Under Rule 204-2 under the Advisers Act (the “Books and Records Rule”) an RIA must maintain (and retain) true, complete and current books and records relating to its investment advisory business. These books and records generally fall within three categories: (i) business records of the adviser; (ii) records of the adviser that relate to the adviser’s clients and the advisory activities of the adviser; and (iii) records relating to the adviser’s compliance program. Rule 204-2 lists many specific categories of materials which must be maintained; the RIA’s compliance staff will need training and guidance to develop an appropriate and robust recordkeeping system.

Exempt Reporting Advisers will be subject to recordkeeping requirements, the extent to which the SEC has yet to determine.

Custody of Client Assets

Rule 206(4)-2 under the Advisers Act (the “Custody Rule”) requires that an RIA which has custody of client assets (which private funds and managed accounts are generally deemed to have if they have authority to withdraw funds from the client’s accounts to pay fees) must maintain them with a “qualified custodian.” The Custody Rule is complex and requires attention to several considerations in order to ensure compliance.
Certain assets in which the RIA may invest (i.e., those which are (i) acquired from the issuer in a private placement; (ii) uncertificated; and (iii) transferable only with the consent of the issuer or the other holders of such securities) do not require custody with a qualified custodian to the extent that they are held in a private fund which is audited on an annual basis (such securities, “Restricted Securities”). However, if funds managed by the RIA hold securities which are not Restricted Securities, the RIA will be required to custody them with a qualified custodian (which could be the private fund’s prime broker).

With respect to a managed account, the RIA will generally need to avoid having custody of the assets of the account (other than custody derived from the ability to withdraw fees from the account) in order to avoid the account being subject to “surprise” audits under the Custody Rule.

Managed account clients must also receive quarterly statements directly from the qualified custodian.

**New Reporting Requirements for Private Fund RIAs**

The Act will significantly increase the burden of complying with the Advisers Act. In particular, RIAs and Exempt Reporting Advisers will be required to report to the SEC, on a regular basis, specific information with respect to each of their private funds, including among other things: (i) basic organizational, operational and investment characteristics; (ii) gross and net asset levels to determine a fund’s use of leverage; and (iii) identity and other information regarding certain “gatekeeper” service providers of the fund (i.e., auditors, prime brokers, custodians, administrators, and marketers).

Please do not hesitate to contact us if you have questions regarding any of the above. We look forward to assisting you in determining whether you are required to become an RIA or an Exempt Reporting Adviser and, if applicable, with the registration or reporting process.

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1. For purposes of the Act, “private funds” are defined as any issuer that would be an “investment company” (as defined in the Investment Company Act of 1940, as amended (the “1940 Act”)) but for the exceptions to such status set forth in sections 3(c)(1) and 3(c)(7) of the 1940 Act (i.e., most private equity funds, hedge funds and venture capital funds are considered to be “private funds”). Note, however, that (i) real estate funds that rely on the exception contained in Section 3(c)(5)(C) of the 1940 Act (purchasing or otherwise acquiring mortgages and other liens on and interests in real estate) and (ii) CLOs and CDOs that rely on the exception contained in Rule 3a-7 under the 1940 Act (certain issuers of asset-backed securities) are not considered to be “private funds.”

2. The SEC proposed a uniform calculation of assets under management for various purposes under the Advisers Act, including how an adviser must calculate its assets under management for purposes of determining whether it may rely on the $150 million exemption, referred to as “Regulatory AUM.” The SEC’s proposed rule would require an adviser to include the following assets when calculating its Regulatory AUM: (i) any proprietary assets, (ii) assets managed without receiving compensation, and (iii) assets of non-U.S. clients. For advisers to private funds, Regulatory AUM would also include: (i) the value of any private fund over which an adviser exercises continuous and regular supervisory or management services, including situations where the adviser serves as a sub-adviser to a private fund; (ii) amount of any uncalled capital commitments of a private fund (a new concept intended to capture, among others, private equity fund managers); and (iii) the fair value (as opposed to the cost basis) of such private fund assets.

3. Where no exemption is available, an adviser must determine whether it is eligible to register with the SEC or must, instead register with one or more states. As a general matter, registration with the SEC is permissible: (i) regardless of AUM for advisers that, among other things: advise a registered investment company; have their principal place of business outside of the U.S. or in a U.S. jurisdiction which does not have an investment adviser statute; or which would be required to register in a significant number of states; (ii) at $25 million in Regulatory AUM, if the adviser’s principal place of business is in a state that does not have a recognized adviser examination program; and (iii) otherwise, at $100 million in Regulatory AUM.

4. Although “family offices” will be outside of the definition of an investment adviser as a general matter and, therefore, not subject to the Advisers Act, a sub-set of “grandfathered” family offices will be subject to certain of the Advisers Act anti-fraud provisions. A grandfathered family office will be one that was not registered or required to be registered as of January 1, 2010, but falls outside of the SEC’s definition of family office solely as a result of advice provided to (i) certain of its officers, directors or employees, (ii) certain companies owned exclusively and controlled by the relevant family, or (iii) registered advisers who identify opportunities to, and co-invest on the same terms as, the family office, provided that such co-investments represent no more than 5% of the family office’s advised assets.

5. Although the private fund, rather than its investors, is the “client” for purposes of the brochure delivery requirement, it is considered a best practice to distribute the brochure to each investor in the private fund.

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Investor Strategies to Realize Returns in Troubled Situations

by Glenn E. Siegel and Davin J. Hall

The year 2009 set a record for defaults and restructurings. Ownership of companies changed rapidly and, given the freeze up in capital markets, most of the new capital structures were significantly deleveraged, leaving little role for pre-existing sponsors and other equity holders of troubled companies. Halfway through 2010, even though actual bankruptcies have declined, restructuring continues through an amendment and forbearance process that is driven by the potential consequences to stakeholders in a court supervised restructuring. Private equity and distressed debt funds are active participants in this process as a result of their equity positions in portfolio companies and as active investors.

This article will briefly discuss the way major players in these troubled situations achieve their goals with a particular emphasis on current shareholders and those who wish to become the shareholders at the conclusion of the process. These strategies can be employed by the current equity sponsor on its own or in collaboration with a partner (preferably a senior lender). Alternatively, an interested investor with the inclination to provide lending and other forms of liquidity during the transition to new ownership, can position itself as the likely acquiror of the business.

Given virtually every distressed business’s need for working capital and the inevitable constraints created by the covenants present in most credit agreements, the ability to raise capital provides the willing lender tremendous leverage in the operation of the business and the fate of ownership. Outside of bankruptcy, the pre-existing lender will insist that new dollars be put in on a junior basis and, in the case of the sponsor, may insist on a capital contribution.

An interested bidder for the business may seek to benefit from this dynamic by offering to purchase the existing senior debt (at par or at a negotiated discount) coupled with an offer to provide new liquidity. Increasingly, the interested bidder may even be a current lender with the flexibility to own the business or who may have bought into the credit previously allowing for the possibility of an opportunity to own. The existing equity sponsor can also seek to take advantage of this by purchasing the senior secured debt so long as it is not prohibited from doing so by the loan documents. This situation is most likely to exist where there is a second lien and the second lien holders have prohibited the purchase of senior debt by the sponsor.

The cost of this new liquidity may be a forced bankruptcy where the existing senior debt is converted to equity or the assets are sold at auction subject to a senior creditor’s right to credit bid. To insure greater control over the restructuring, a distressed investor can provide debtor in possession financing (“DIP financing”) to the company once it commences a chapter 11 case. DIP financing can enable the distressed investor to take control of the negotiations concerning the company’s chapter 11 plan or to control the sale of assets to the DIP lender by conditioning the extension of postpetition credit on the approval of covenants that require any chapter 11 plan or sale of assets must be satisfactory to the DIP lender.

At the conclusion of the restructuring (whether out of court or in court), new financing extended by the distressed investor can be converted into equity or exit financing of the restructured company, and additional liquidity for the target business can be raised through a rights offering. Below we briefly discuss a few recent, relevant bankruptcy cases to illustrate potential acquisition strategies and attendant risks for distressed investors.

Acquisition of Company by DIP Lender. In the Delphi Corporation case, the company filed a motion with the bankruptcy court seeking to sell substantially all of its assets to a third-party private equity firm, but the sale proceeds that would have been realized would have been insufficient to pay the DIP lenders in full. Subsequently, a
A consortium of investors purchased a requisite amount of the DIP claims to obtain the “required lender” threshold under the DIP credit agreement. These investors then directed the agent to object to the proposed sale as depriving the DIP lenders their right to credit bid under the DIP financing facility. The bankruptcy court recognized the rights of the required lenders to direct the agent to exercise remedies on behalf of all lenders, and eventually the company supported a sale of most of its business to the DIP lenders through a credit bid.

**Acquisition by Conversion of Senior Debt to Equity and Rights Offering.** In the chapter 11 restructuring of Lyondell Chemical, the company’s prepetition lenders extended approximately $3.25 billion in new DIP financing after the company entered chapter 11. The lenders then sponsored a plan of reorganization whereby they would contribute their claims for new equity in reorganized Lyondell as well as backstop a rights offering of new stock and new notes, using the proceeds of the rights offering to partially pay down their debt claims.

**Acquisition by Second Lienholders by Reinstatement of Senior Debt.** In the current environment, investors can take advantage of depressed valuations to acquire businesses with the potential for substantial returns or increase their ownership stakes in existing portfolio companies at favorable valuations. In order to maximize their chances of succeeding, investors must be willing to provide short term liquidity as a bridge to ownership while keeping in mind that they always run the risk of being outbid.

**Disallowance of Vote of Creditor that Purchases its Claim with the Goal of Buying the Business.** In DBSD North America, the company filed a plan of reorganization proposing to exchange first lien debt with a new secured note and convert second lien debt into equity. A strategic competitor purchased all of DBSD’s first lien debt at par and a substantial portion of second lien debt, and then voted against the company’s plan of reorganization. The bankruptcy court found that the strategic acquired the debt with the expectation of obtaining a blocking position with the goal of acquiring the company’s assets to the exclusion of every other restructuring alternative. The court viewed this as being outside the bounds of traditional distressed investment strategies and “designated” the competitor’s votes in bad faith (i.e., disregarded them). Accordingly, if the strategy employed to acquire the business precludes the possibility of a competing bid, the prospective purchaser runs the risk that its vote on the bankruptcy plan will not be counted.

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**Attempts to Block the Right of Secured Creditors to Credit Bid.** In the Philadelphia Newspapers case, the debtor tried to block its secured creditor from credit bidding in a sale to be held pursuant to a Chapter 11 plan for the company. After litigation in the bankruptcy court and the district court, the Third Circuit Court of Appeals affirmed bidding procedures that authorized only cash bids, and disallowed credit bids, in the context of a sale under a plan of reorganization. The Third Circuit held that, while a secured creditor has the right to credit bid in stand-alone sale of assets to a third party, the Bankruptcy Code would allow confirmation of a plan of reorganization over the objection of a secured creditor that was not allowed to credit bid if the creditor received the “indubitable equivalent” of its secured claim under the plan. In reaction to this decision, the secured creditors of Philadelphia Newspapers decided to bid cash at the auction and were the successful bidders. This strategy was easy for these creditors to implement since they had the available liquidity and knew they would receive the first cash from closing as the senior lienholder. Nonetheless, at least in the Third Circuit, this approach may allow another bidder to take advantage or an illiquid secured creditor by outbidding them at auction or purchasing their claim from them at a discount.

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