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Private Equity

In this issue

ILPA Revisions Add Clarity, Some Flexibility

by **Roger Mulvihill**

Earlier this year, the Institutional Limited Partners Association ("ILPA") published revisions (the "Revisions") to its much-heralded Private Equity Principles report introduced in September 2009 (the "2009 Principles"). The 2009 Principles, which were intended to improve the private equity industry by better aligning the interests of limited partners and general partners, were enormously successful (at least with LPs) and were endorsed by over 140 limited partners, including some of the largest and most active in the industry. Many sponsors of new or follow on funds specifically crafted their partnership principles and terms on the suggestions in the 2009 Principles. It didn't hurt that the ILPA's efforts the last several years coincided with a difficult fundraising environment, particularly for first-time funds. Nevertheless, many of the proposals in the 2009 Principles posed difficult issues for fund sponsors and provoked some significant criticism of the guidelines. One substantial general partner even reportedly hired lawyers to review the antitrust implications of ILPA's actions.

The stated purpose of the 2009 Principles and the Revisions is to improve the relationship between limited partners and general partners in three areas: Alignment of Interest; Governance; and Transparency. While the ILPA does not seek the commitment of LPs and GPs to any specific provision (and does not consider the Revisions as a "checklist"), the Association does hope the 2009 Principles as revised will receive careful

consideration from sponsors and investors as "best practices". The Revision also offered three appendices, one covering the best practices for Limited Partner Advisory Committees, a second on Carry Clawbacks and a third on best reporting practices. The following summarizes various provisions of the Revisions.

Alignment of Interests

While the Revisions retain a preference for the European style waterfall (where all LP contributions and any preferred return are first distributed), the Revisions provide for various ways to improve a "deal by deal" waterfall structure. These include a carry escrow of 30% or more of distributions; the testing of clawback triggers at designated intervals and upon specific events (like insufficient net asset value coverage); and a net asset valuation coverage test of 125%. After extensive discussions with GPs, the Revisions now concede that carried interest clawbacks can be calculated on an after tax (rather than gross profits) basis, since requiring the GPs to return funds already paid to the government as taxes would be unfair. However, the Revisions still strongly favor joint and several liabilities, but in lieu thereof it suggests a creditworthy guarantee of the entire clawback repayment could prove a workable substitute, such as by a substantial parent company or individual GP or subsets of GPs. In any event, the LPs should have robust enforcement powers, including the ability to directly enforce the clawback against individual GPs.

The Revisions also discuss the calculation of the tax exclusion provision in clawbacks. Instead of assuming the highest hypothetical marginal rate in a designated location as is currently typically the case, the Revisions would base the tax calculation on the actual tax situation of the GP member after taking into account (i) loss carry forwards and carry backs; (ii) the character of the fund income and deductions attributable to state tax payments; (iii) any ordinary deduction or loss as a result of any clawback contribution; and (iv) any change in taxation between the date of the limited partnership agreement and the clawback. One of the reasons for using a hypothetical tax calculation for all GPs in the first place was to avoid the complexity of analyzing individual tax circumstances and the time and expense involved for all parties. One wonders whether the advantages to the LPs of a more comprehensive tax calculation now outweigh these considerations, particularly under circumstances in which the relationship between the GP and its LPs may already be strained.

The Revisions state that a misalignment of interests can arise in the design of the management fee structure. There was widely reported LP concern in the past of some larger funds or groups of funds that earned very substantial management fees, even though the funds themselves performed poorly. Accordingly, the Revisions suggest that management fees should be based on reasonable operating expenses and salaries, and that GPs in the formation process provide prospective LPs with a fee model as a guide. Moreover, the Revisions provide that the amount of management fees should reflect the lower level of expenses generally incident to the formation of a follow on fund, and at the end of the investment period or if the fund's term is extended. While expenses may in fact decline under these circumstances, GP expenses can actually increase in the case of one or more troubled portfolio companies that may require much more GP attention.

The Revisions also enlarge the scope of GP fees that will offset the management fee by including any consideration charged by the GP to its portfolio companies of any nature. Importantly, however, the Revisions do not recommend a specific percentage of fee offsets unlike the 2009 Principles, which recommended a 100% offset. On the other hand, the Revisions recommend a 25% cap on LP givebacks for GP indemnification and a two-year limit on LP givebacks following the date of distribution, while the 2009 Principles tied the cap to a percentage of fund size.

In the absence of LP consents, the GP must fully liquidate the fund within one year after expiration of the fund term. In any event, fund extensions should be permitted in one year increments only and after approval of the LPs or an LP Advisory Committee. The Revisions make clear that GPs should make their entire contributions in cash rather than through a management fee waiver. The 2009 Principles only suggested a high percentage in cash.

The Revisions also prohibit GP co-investments (except under pre-disclosed arrangements, preferring that the GP's entire equity interest be held through the fund. Finally, fees charged by an affiliate of the GP, such as for an advisory or consulting service, to the fund or an underlying portfolio company should be approved by the LP Advisory Committee. Presumably affiliated charges appropriately approved are not management fee offsets.

Governance

As a general principle, the investment team is a critical consideration in an LP's commitment to a fund. The Revisions contemplate that an LP should be able to reconsider its decision in the event of any significant change in the management team. Accordingly, in the event of a key-man change or a cause event, the investment period will terminate permanently unless a defined super majority of the LPs in interest vote to reinstate the period within 180 days.

On the other hand, the Revisions relax the prior recommendations on no fault LP termination rights. The Revisions now recommend a two-thirds LP vote in interest to suspend or terminate the commitment prior (rather than a majority) and a three-quarters LP vote in interest to remove the GP or dissolve the fund (rather than two-thirds). Fund amendments generally would require the approval of a majority in interest of the LPs.

Consistent with its emphasis on the investment importance of the management team, the Revisions also provide that the GPs disclose to all LPs (and discuss with the LP Advisory Committee) any developments that would adversely impact the time a principal can devote to a fund, any changes in personnel and any event that would trigger the operation of a key-man provision. Changes to key-man provisions should be approved by a majority of the LP Advisory Committee or the LPs.

The Revisions note the importance of accommodating an LP's exclusion policies that might proscribe the use of its capital in certain sectors or jurisdictions. However, the Revisions recognize that the impact on the remaining LPs of increased concentration needs to be considered, and that the process and policies relating to potential non-ratable allocations must be transparent.

Given the significant discretion afforded GPs in the operation of the fund, the Revisions proscribe provisions that would permit a GP to reduce or avoid its fiduciary duties in any way, already common in many funds. GPs are expected to review all conflicts with the LP Advisory Board and seek prior approval for any conflicts or non arm's length transactions. Many GPs already follow this practice with any helpful affiliate relationships, particularly in large diverse firms, carved out in the formation documents. In particular, the Revisions would preclude any provisions that exculpate or indemnify GP conduct constituting a material breach of the partnership agreement or of fiduciary duties or for other "for cause" events.

The Revisions give an important role to the independent auditors. The recommendations anticipate that the auditors will alert the LP Advisory Committee to any conflicts of interest uncovered in the performance of their duties and present their views on valuations (and other relevant matters) to the Advisory Board at least annually. In addition, the auditors should review the capital accounts with specific reference to management fees and other expenses and review carried interest calculations to provide independent verification of distributions. While some auditors already perform some of these functions, the scope of the auditors' responsibilities contemplated by the Revisions and the related costs will not be popular with many GPs, and the auditors themselves may be less enthusiastic about assuming greater responsibilities and the inevitable liability exposure that goes with it. Also controversial is the Revisions recommendation that a reasonable minority of the LP Advisory Board should be able to engage independent counsel at the fund's expense on important matters of fund governance or on other matters where the interests of LPs and GPs are not entirely aligned.

Transparency

The Revisions require that GPs provide to the LPs detailed financial, risk management, operational, portfolio and transactional information regarding fund investments, while recognizing the LPs heightened responsibilities regarding confidentiality. In particular, audited financials and each capital call and distribution notice should disclose and classify all fees generated by the GP, and each audited financial report should disclose all fees charged to the fund or any portfolio company by an affiliate of the GP. Capital calls and distributions would provide information consistent with the Standardized Reporting Format accompanying the Revisions. Consistent with the emphasis on transparency, the Revisions require immediate disclosure to LPs with respect to inquiries by legal or regulatory bodies, material contingencies or liabilities and the breach of any fund documents. In addition, GPs should advise the LPs in writing of certain changes in the ownership of the fund, such as the formation of public listed vehicles, sales of interests in the management company to third parties, a public offering of management company shares and the formation of other investment vehicles. The Revisions contemplate that the GPs annual reports would include portfolio and fund information on material risks and the GPs' response. While many GPs provide much of this information anyway, the scope of the reporting obligations is broader and more comprehensive than some GPs are likely to find comfortable.

The three appendices provide specific directives or recommendations on three subjects. The first (Appendix A) deals with best practices in the formation and operation of LP Advisory Committees. The second (Appendix B) deals with best practices in carry clawback provisions, most of which are noted above. And the third (Appendix C) outlines the content of financial reports to LPs (both annual and quarterly and with respect to portfolio companies) and the capital call and distribution notice templates.

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Because of the summary nature of this article, the information provided herein may not be applicable in all circumstances, and legal advice should be sought with respect to specific situations.

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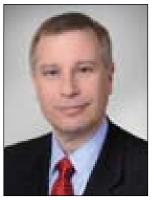
"Private" Placements of Securities: A London View of the Facebook Saga

by **Sean Geraghty** and **Christopher G. Karras**

According to a story in the *New York Times*, on Sunday night, 2 January 2011, Goldman, Sachs & Co. sent a number of its wealthy *U.S. clients* an e-mail offering them the opportunity to invest in an unnamed "private company that is considering a transaction to raise additional capital." The story identified the company as Facebook and the offering a US$1.5 billion sale of common stock with a US$2 million minimum investment and a lock-up until 2013. On 21 January, Facebook announced that Goldman Sachs had "completed an oversubscribed offering to its *non-U.S. clients* in a fund that invested $1 billion in Facebook Class A common stock." Goldman Sach's decision to exclude its U.S. clients from the Facebook offering highlights some fundamental differences between U.S. and European securities regulation and practice and has prompted the U.S. Securities and Exchange Commission (SEC) to re-evaluate its private placement rules.

Facebook's Offerings

Facebook operates a popular social networking website with more than 600 million active users. Experian® Hitwise® reported that during the first 11 months of 2010, www.facebook.com was the most visited website, logging 8.9% of all Web visits in the United States. Google's main site was second with 7.2%. Clearly, public awareness of, and interest in, Facebook is remarkably high.

In December 2010, Facebook sold US$500 million of Class A common stock to a Russian investment fund, Goldman Sachs and funds managed by Goldman Sachs. The January 2011 offering would be through a Goldman Sachs special purpose entity that would purchase shares on substantially the same terms as the December sale—in effect, a second closing of that offering. Both offerings were intended to qualify as private placements not subject to registration under U.S. securities laws.

Requirements of a U.S. Private Placement

The U.S. Securities Act of 1933 prohibits offerings in the United States of securities such as Facebook's common stock without either a registration statement filed publicly with the SEC or an exemption for the transaction. If the securities are privately placed in a "transaction by [a company] not involving any public offering," a registration statement is unnecessary. The statute does not define what constitutes a public offering, but the SEC has adopted Regulation D, a safe harbour for private placements.

Goldman Sachs appeared to comply with the Rule 506 of Regulation D: offerees would be pre-qualified as sophisticated and wealthy. Although not required to do so, Goldman Sachs did provide offerees a private placement memorandum of more than 100 pages describing the offering, and required them to keep it strictly confidential. Goldman Sachs has not stated publicly how many offerees received the memorandum, but it would not be surprising if they numbered in the triple digits.

In addition to requiring that the offerees meet a standard, Regulation D prohibits making the offer of securities "by any form of general solicitation

. . . including . . . [a]ny . . . article . . . or other communication . . . published in any newspaper." Certainly Goldman Sachs endeavored to keep its e-mail, the memorandum and the existence and terms of the offering confidential, and just as certainly they failed.

The press covered the proposed offering in voluminous and startlingly accurate detail. Goldman Sachs attempted to offer, on a confidential, private basis, shares of a company with the most widely viewed website in the United States and more than 600 million users. Substantial publicity was probably unavoidable, if not entirely foreseeable. The press reported that on Sunday, 16 January, Goldman Sachs informed its U.S. clients that they would not be permitted to purchase in the offering. The next day, Goldman Sachs announced that "the level of media attention might not be consistent with the proper completion of a U.S. private placement under U.S. law."

The Question, and Different Answers

It did not take long for many to ask what is the problem with general solicitation of offerings of securities that may only be accepted by sophisticated, wealthy investors or by institutional investors that manage at least US$100 million in investments? In March, Congressman Darrell Issa asked those questions of the SEC in a letter he made public. In April, Mary Shapiro, Chairman of the SEC, replied with a public, 26-page letter. Whilst that question continues to be addressed in the United States, the answer in the European Union has been known for some time.

The EU regulates public offers of securities by means of the EU Prospectus Directive, which has been implemented into national law by each EU member state. Those rules require a prospectus to be produced by any company who wishes to offer transferable securities to the public unless one or more of the exemptions are satisfied.

An "offer to the public" is widely defined; there is an offer to the public if "there is a communication to any person which presents sufficient information on the transferable securities to be offered and the terms on which they are to be offered to enable an investor to decide to buy or subscribe for the securities in question". The communication can be in any form and by any means, and it includes a placing of securities through a financial intermediary. Clearly the sort of solicitation Goldman Sachs undertook in the Facebook case would for these purposes be an offer to the public.

However, as noted above, companies can avail themselves of one or more of the various statutory exemptions to offer shares to the public without having to produce a prospectus; the commonly used exemptions include offers made or directed:

- at qualified investors (including banks, investment institutions and certain small and medium sized entitles and natural persons meeting prescribed criteria). Member states operate self-certification and registration systems for natural persons and small- and medium-sized entities meeting the criteria;
- at fewer than 100 persons, other than qualified investors, per European Economic Area state;
- where the minimum consideration that may be paid per investor is €50,000;
- where the securities being offered are denominated in amounts of at least €50,000.

These terms of the exemptions are changing, however, and EU members are required to implement amending legislation by 1 July 2012 to amend the definition of "qualified investor" to refer to investors considered to be or treated on request as professional clients or recognized as "eligible counterparties" under the Markets in Financial Instruments Directive. Companies will also be permitted to offer securities to up to 150 persons per EEA state, however the minimum consideration and denominations are also increasing to €100,000. The UK has already indicated that it will implement certain of these changes well ahead of the July 2012 deadline.

Prominent among the matters that Ms. Shapiro has instructed the SEC's staff to review is whether the general solicitation ban should be revisited in light of "current technologies, capital-raising trends and [the SEC's] mandate to protect investors and facilitate capital formation." London and the EU's regulatory regime can offer some useful guidance.

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Hong Kong to Strengthen its Corporate Governance Rules

by **Basil H. Hwang**

Introduction

Hong Kong is the preferred exit destination for China private equity portfolio investment? These investments will be directly impacted by the proposed new Hong Kong corporate governance proposals.

On 17 December 2010, Hong Kong Exchanges and Clearing Limited ("HKEx"), the parent company of the Stock Exchange of Hong Kong Limited ("SEHK"), published the Consultation Paper on Review of the Code on Corporate Governance Practices and Associated Listing Rules (the "Consultation Paper") proposing amendments to the Code on Corporate Governance Practices (the "CG Code") and related provisions of the Rules Governing the Listing of Securities on the SEHK (the "Listing Rules").

The Code and the Listing Rules together make up the principal corporate governance framework for companies listed on the SEHK.

The recent global financial crisis and the plethora of new rules implemented in other important financial jurisdictions (such as the United States and the United Kingdom) appear to have provided the impetus for these proposed amendments in Hong Kong.

The proposed amendments are intended to strengthen the corporate governance regime in Hong Kong. The HKEx's proposals address 17 specific issues under three broad categories, outlined below.

The consultation closed recently on 18 March 201. As the date of this writing, the results of the consultation had not been made available yet.

Rules-Based Versus Principles-Based Corporate Governance Frameworks

Corporate governance rules in the major global financial centers generally fall into two categories:

- A rules-based approach that relies on extensive legislation, mandatory compliance and an emphasis on regulatory enforcement rather than voluntary compliance. The current United States corporate governance framework is probably the leading example of this approach.

- A principles-based approach that includes some mandatory requirements but otherwise consists of non-mandatory recommendations. Listed companies are required to disclose publicly the extent of their compliance with the recommended practices, any deviations from those practices and alternative procedures implemented to meet the same corporate governance objective.

The Hong Kong corporate governance regime includes a mixture of mandatory rules, as well as non-mandatory codified best practices. As this article explains, however, after the global financial crisis Hong Kong appears to be moving toward a more rules-based approach to corporate governance.

The Current CG Regime in Hong Kong

The corporate governance rules for Hong Kong listed companies are found in the main text of the Listing Rules, the Code on Corporate Governance Practices found in Appendix 14 to the Listing Rules (the "CG Code") and the Model Code for Securities Transactions by Directors of Listed Companies found in Appendix 10 to the Listing Rules (the "Securities Dealing Code").

Listing Rules

The Listing Rules contain extensive mandatory corporate governance requirements, including the following:

- *Board Composition*. Every board must include at least three independent non-executive directors ("INEDs").
- *Audit Committee*. Every listed company must have an audit committee consisting of non-executive directors only. The audit committee must have at least three members, at least one of whom must be an INED with appropriate professional qualifications or accounting or related financial management expertise. The majority of its members must be INEDs and the chairman of the audit committee must be an INED as well. The Stock Exchange assesses fairly rigorously the independence and qualifications of candidates for appointment as INEDs of a listed company.
- *Securities Dealings*. Directors are required to comply with the Securities Dealing Code. The Securities Dealing Code provides, among other things, that a director of a listed company must not deal in securities of that company if he is in possession of material price-sensitive information or if he has not obtained prior clearance from the board (or a designated director) for dealing in the securities (except, in the latter case, in very limited exceptional circumstances). A director is also prohibited from dealing in the securities of the listed company in the 60 days preceding the publication of the annual results and the 30 days preceding the publication of interim results. Readers may also be interested to know that the Code on Takeovers and Mergers contains additional restrictions on and disclosure requirements in relation to dealings by directors and others in the course of a takeover offer.
- *Connected Transactions (Related Party Transactions)*. Hong Kong's related party transactions regime for listed companies is notoriously complex and can require public disclosure and/or approval by independent shareholders of a very broad range of transactions that a listed company might propose to enter. This is due primarily to

the encompassing definitions of the persons who constitute connected persons (or their associates) of the listed issuer, and of what transactions constitute connected transactions. A discussion of these rules would require a separate paper and is beyond the scope of this article.

- *Shareholder Approval of Transactions*. A listed issuer that proposes to acquire or dispose of material assets (including deemed disposals) will in many situations need to obtain shareholder approval for the transaction, in addition to publicly disclosing the transaction. The Listing Rules defines specific thresholds for transactions that constitute Major Transactions, and Very Substantial Acquisitions or Very Substantial Disposals, all of which must be made conditional on the approval by shareholders in general meeting. Any shareholder with a material interest in the transaction being considered for approval and his associates must abstain from voting at the meeting. Reverse takeovers are subject to similar requirements and will in addition be subject to scrutiny and review by the Stock Exchange as if it were a new listing applicant.

Code on Corporate Governance Practices

The CG Code is a principle-based set of recommendations for corporate governance practices that Hong Kong listed companies should adopt. It contains two levels of principles:

- *Code provisions*. Listed issuers should either comply with code provisions, or else provide considered reasons (in annual and interim reports) any deviations.
- *Recommended best practices*. Listed issuers are encouraged, but are not required, to state whether they have complied with these principles and give reasons for any deviations.

The language and tone adopted by the CG Code are consistent with its non-mandatory nature. The following is a summary of some of the significant code provisions:

- Board
    - The board should meet regularly and at least four times a year at approximately quarterly intervals. A majority of the directors entitled to be present should actively participate. A regular meeting does not include the practice of obtaining board consent by circulating written resolutions. Fourteen days' notice should be given of regular board meetings.
    - Directors should have access to the advice and services of the company secretary to ensure board procedures and applicable rules and regulations are followed. In addition, there should be a procedure agreed by the board to enable directors, upon reasonable request, to seek independent professional advice in appropriate circumstances, at the issuer's expense. The board should resolve to provide separate independent professional advice to directors to assist them discharge their duties to the issuer.
    - If a substantial shareholder (a shareholder holding 10% or more of the issuer) or a director has a material conflict of interest in a matter to be considered by the board, the matter should be discussed at an actual board meeting, at which INEDs who have no material interest in the transaction (and whose associates have no material interest) should be present.
    - Board committees may be constituted and should have clear terms of reference that include a requirement to report back to the board on their decisions or recommendations unless there are legal or regulatory restrictions on doing so.
- Chairman and CEO
    - The chairman of the board and the CEO should be different individuals. (It had been typical in Hong Kong in the past for individuals to have the title of Chairman and CEO of listed companies.)
- Board Composition
    - The INEDs should be expressly identified in all corporate communications that disclose the names of directors of the listed company. As a recommended best practice only, the CG Code recommends that INEDs constitute at least one third of the board.
    - There should be a formal, considered and transparent procedure for the appointment of new directors to the board. All directors appointed to fill a casual vacancy should be subject to election by shareholders at the

first general meeting after their appointment. Every director should be subject to retirement by rotation at least once every three years.

- Remuneration
    - A listed company should disclose information relating to its directors' remuneration policy and other remuneration matters.
    - There should be a formal and transparent procedure for setting policy on executive directors' remuneration and for fixing the remuneration packages for all directors.
- Internal Controls
    - The directors should conduct a review of the internal controls of the listed company and its subsidiaries at least annually, and report to shareholders that they have done so in their Corporate Governance Report. The review should cover all material controls, including financial, operational and compliance controls and risk management functions.
    - The board's annual review should, in particular, consider the adequacy of resources, qualifications and experience of staff of the listed company's accounting and financial reporting function, and their training programs and budget.

The Proposed Amendments

Changes proposed by the Consultation Paper include turning some of the provisions of the CG Code into mandatory provisions of the Listing Rules, revising a number of recommended best practices into code provisions and revising parts of the Listing Rules.

The following is a summary of some (but not all) of the principal proposals in the Consultation Paper:

- Directors' Duties and Time Commitments
    - The Consultation Paper called for views of whether there should be a limit on the number of INED positions in different listed companies held by any given individual, and what that limit should be. This was motivated by the Stock Exchange's observation that some individuals serve as INEDs on multiple boards, which could reduce their ability to perform their function as an INED diligently and competently on each board.
    - Most of the proposals related to making sure directors (including non-executive directors) commit the time and effort necessary for the performance of their duties. These include proposals that the nomination committee review regularly whether directors have spent sufficient time on their duties; that nomination letters to non-executive directors state exactly the time commitment required from them; that a director should limit his other professional commitments and acknowledge to the issuer that he will have sufficient time to meet his obligations; and that a non-executive director should confirm to the nomination committee annually basis that he has spent sufficient time on the business of the listed company.
    - It would be mandatory for issuers to disclose each individual directors' attendance at shareholders' meetings.
- Independent Non-Executive Directors
    - The Consultation Paper proposes that the Listing Rules make it mandatory for INEDs to comprise at least one-third of the boards of listed issuers. Listed issuers would be given a transitional period to comply with the requirement.
    - Possibly somewhat to the dismay of already time-challenged directors, the Consultation Paper also proposes that directors of listed companies attend a minimum of eight hours of continuous professional development training a year.
    - As code provisions, INEDs and non-executive directors should attend meetings of the board, board committee and shareholders. They should also contribute to the company's strategies and policies.
- Board Committees
    - The Consultation Paper proposes making it mandatory for listed issuers to establish a remuneration committee, composed of an INED majority and with a chairman who is an INED. The Consultation Paper proposes two alternative models. In the first model, the board delegates to the committee authority to determine the remuneration of executive directors and senior management. In the sec-

ond model, the board retains that authority, with the committee playing an advisory role.

- The establishment of a nomination committee and its composition and terms of reference would become code provisions. They currently are recommended best practices only.
- A new code provision would set forth the duties of a corporate governance committee. Somewhat curiously, however, establishment of a corporate governance committee would only be a recommended best practice. Reading the Consultation Paper, the idea seems to be that instead of necessarily establishing a separate committee, the board (or another existing committee, such as the audit committee) could perform the functions of such a committee.

- Audit Committee and Auditors
  - As a code provision, instead of meeting only once a year, the audit committee should meet at least twice a year with the issuer's external auditors. As a recommended best practice, the audit committee should also have a whistleblower policy that allows whistleblowers to raise potential issues safely.
  - As a new mandatory requirement, shareholders' approval at a general meeting would be required for any proposal to appoint an auditor and to remove an auditor before the end of his term of office. In the case of a removal, the issuer should send a circular to shareholders containing any written representation from the auditor. The auditor must be allowed to make a written and/or verbal representation at the general meeting to remove him.
  - As a code provision, management should ensure the external auditor attends the annual general meeting to answer questions about the conduct of the audit, the preparation and content of the auditors' report, the accounting policies and auditor independence.
- Directors' and Officers' Compensation
  - The Consultation Paper proposes requiring issuers to disclose the remuneration of senior management remuneration by band. Disclosure of the amounts paid to them should be the same as for a director and sales commission paid or payable to senior management should be disclosed in financial statements.
  - Issuers should also disclose the CEO's remuneration (if he is not a director) by name.
- Directors' Voting
  - Currently, the Listing Rules allows issuers' articles to state that a director may vote on a board resolution for a proposed transaction with a company in which he is beneficially interested in no more than 5% of that company's issued shares or voting rights. The Consultation Paper proposes removing this exemption.
- Directors' Insurance
  - As a new code provision, issuers should provide directors with adequate insurance cover. This requirement was previously only a recommended best practice.
- Management Financial and Business Updates
  - The Consultation Paper proposes a new code provision stating that management should provide board members with monthly updates which present a balanced and understandable assessment of the issuer's performance and current financial position. This monthly update may include monthly management accounts and management updates.
- Voting at General Meetings
  - The current Listing Rules require all matters at general meetings to be voted on by poll (and not by a show of hands). The Consultation Paper proposes that for procedural and administrative matters, voting need not be by poll and can be by show of hands if the chairman of the meeting so decides. Procedural and administrative matters will include among other things adjournments of meetings to ensure order or discipline or to respond to an emergency such as a fire, or to end a particular discussion that has gone on for too long (e.g. if there are deliberate irrelevant or repetitive questions from the floor). Presumably this is seen to be desirable in the context of activism at shareholders' meetings of Hong Kong listed companies.

- Company Secretary
  - Company secretaries of Hong Kong listed issuers play an important role in making sure the issuer complies with the disclosure and other procedural requirements imposed by the Listing Rules. The Consultation Paper proposes adding a new section to Chapter 3 of the Listing Rules defining the role, qualifications and duties of company secretaries. The current requirement that the company secretary be ordinarily resident in Hong Kong would be removed, and the Stock Exchange would consider a broader range or non-Hong Kong qualifications in assessing the suitability of any particular individual to be a company secretary. This proposed change appears to be a concession to companies from Mainland China listed in Hong Kong, who have at times found it difficult to hire company secretary fitting the very narrow set of Hong Kong qualifications and experience currently allowed.
  - A new section would be added to the CG Code setting forth the detailed role and responsibilities of the company secretary.

Conclusion

The proposals take a balanced approach to upgrading corporate governance standards in Hong Kong and attempt to achieve this in a manner that raises standards for internal governance without imposing excessive external regulation.

Hong Kong has considered a meaningful upgrade of its corporate governance standards for a number of years. The recent proposals are timely, considering that similar changes have already taken place in other jurisdictions such as the United States, United Kingdom and, closer to home, Singapore.

For many years, Hong Kong held the top place in CLSA's annual survey of corporate governance in Asia, *Corporate Governance (CG) Watch*. In 2010, Hong Kong was replaced by Singapore in that position. This and other events in Hong Kong, such as vocal public discontent with and mistrust of corporations and financial institutions, may have precipitated the recent proposals.

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Recent Developments in Acquisition Finance


by **Jeffrey M. Katz** and **Scott M. Zimmerman**

This article will survey some of the notable judicial and regulatory developments over the last several months impacting acquisition financings.

We previously discussed the unexpected decision of the U.S. bankruptcy court in Florida in the 2009 *Tousa*[1] case, which among other things ordered lenders in the context of an acquisition financing to disgorge loan repayments on the basis that, when incurring the acquisition debt, various subsidiaries of the borrower had not received reasonably equivalent value and were insolvent on a stand-alone basis. The decision also condemned the use of guaranty savings clauses, which are designed to limit a guarantor's obligations to those consistent with fraudulent transfer law, despite the longstanding use of such clauses in the context of subsidiary guarantees of parent debt.

The decision was reversed on February 11 by the U.S. District Court for the Southern District of Florida, on other grounds. If the lower court's reasoning on the solvency issue had been affirmed, the ruling may well have led to a universal requirement that sponsors demonstrate to acquisition lenders, separately for each entity in a target group, the solvency of such entity standing alone, on a pro forma basis after

giving effect to the acquisition in question (rather than on an aggregate, enterprise basis only). The opinion quashing the lower court's decision did not specifically address the stand-alone versus enterprise bases for determining solvency or the savings clause issue, but was otherwise sweeping. Additional appeals remain pending regarding this and other issues, and we hope to provide further updates in future installments.

There has also been a significant recent development in the *DBSD North America*[2] case, in which Dish Network, a competitor of bankrupt DBSD, attempted to implement a loan-to-own strategy by purchasing certain secured debt of DBSD in an effort to gain control of it through the reorganization process. We previously noted that the U.S. bankruptcy court in New York took the unusual step of disqualifying ("designating") the votes of Dish Network after finding that Dish Network's acquisition and ownership of DBSD's secured debt were "not in good faith" because done with a "strategic purpose" beyond recovery on its debt. In December, the Second Circuit Court of Appeals issued a summary order upholding the bankruptcy court's vote designation decision. The court's delayed opinion, filed on February 7, somewhat narrowed the lower court's reasoning, laying emphasis on the fact that Dish Network was already part owner of a direct competitor of DBSD, as well as being itself an indirect competitor of DBSD. The court relied on cases allowing designation either in the context of competitors who promote their own businesses at the expense of the debtor by attempting to obstruct its reorganization process or in the context of creditors who acquire enough debt to constitute a blocking position after a debtor has already proposed a plan of reorganization, for the purpose of blocking the plan. It would seem that the appellate court's reasoning is narrow enough to exclude a case where a party, which is neither an affiliate nor a direct or indirect competitor of the debtor, plans enough in advance so that it acquires debt of an entity before it files under chapter 11, or is in the early phase of its chapter 11 case and has not yet filed a plan of reorganization. Distressed investors attempting a loan-to-own strategy will need to be mindful of these and related potential pitfalls when pursuing that strategy.

In the case of *In re Bayou Group, LLC*,[3] the U.S. District Court for the Southern District of New York reversed a bankruptcy court decision granting a clawback, on fraudulent conveyance grounds, of monies paid by certain hedge funds to parties that had no information indicating that the transferor was insolvent or that the transfer was made for a fraudulent purpose. The ruling appears to have relevance also in other contexts in which clawback from payees may potentially be sought on fraudulent conveyance grounds, such as dividend recapitalization or LBO financings, and has also provided guidance in the context of the Bernard Madoff case for those attempting recovery on related grounds.

The bankruptcy court in *Bayou* found that the parties receiving the payments in question had been in possession of information suggesting "some potential infirmity in the investment" or "some infirmity [in the] integrity of its management," and that this was sufficient to require those parties to conduct a diligent investigation in respect of such information in order to avoid liability. In reversing the lower court's ruling, the U.S. District Court held that the proper standard is higher, and will impose a duty on a recipient to investigate only when it is in possession of information indicating that the transferor is insolvent or that the transfer is for a fraudulent purpose. The court noted that whether a recipient was in possession of such information is a question of fact for a jury.

A ruling in November by the Delaware Court of Chancery offers a cautionary tale for parties considering walking away from negotiated term sheets, even where they are expressly stated to be non-binding. In *PharmAthene, Inc. v. SIGA Technologies, Inc.*,[4] the court denied a technology owner's motion for summary judgment to deny enforcement of a term sheet that was unsigned and contained a legend stating that it was "non-binding and only an expression of interest." The court examined whether the parties intended to be bound by the term sheet and related documentation, which consisted principally of a merger agreement term sheet and a license agreement term sheet relating to a license that would take effect if the merger under discussion failed to occur. The court analyzed whether the documents exchanged between the parties contained all essential terms for an agreement. After reviewing the relevant history, the court concluded that it could not rule as a matter of law that the parties had not intended to bind themselves, and denied the summary judgment motion. Thus a term sheet that is found to express an actual agreement between parties potentially may bind them, notwithstanding an express disclaimer on the term sheet to the contrary.

Lastly, proposed IRS regulations released in January may have consequences for transactions in which bank loans are amended or otherwise modified, whether for covenant relief or otherwise, in return for increased lender economics beyond a de minimis threshold. The IRS proposal expands the circumstances under which debt will be considered "publicly traded" for such purpose (which is different from whether it's considered to be publicly traded under securities laws). The treatment of a loan as "publicly traded" can trigger adverse tax consequences for both the borrower and the lender if the restructuring of the loan constitutes a "significant modification" and therefore a deemed exchange of the existing loan for a new one. In such event, the issue price for the modified, "newly issued" loan must be determined by reference to the fair market value of the "publicly traded" debt, rather than its stated principal amount. A reduced issue price generally will result in greater original issue discount accruals for the lender, as well as cancellation of indebtedness income for the borrower. The proposal would expand the definition of "publicly traded" debt to include loans for which only indicative (as opposed to actual) quotes are available. It may be noted that the rebound in the secondary loan market, resulting in fewer loans being traded at steep discounts from par, presumably would lessen the impact of a potential tax hit in many cases. The proposal includes exceptions for small issues where the stated principal amount of the entire debt issue is $50 million or less, and in certain other circumstances.

We look forward to updating you further on these and other matters in the coming months.

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[1] *In re TOUSA, Inc.*, 422 B.R. 783 (Bankr. S.D. Fla. 2009), *quashed in part*, No. 10-60017, 2011 WL 522008 (S.D. Fla., Feb. 11, 2011).

[2] *In re DBSD North America, Inc.*, 419 B.R. 179 (Bankr. S.D.N.Y. 2009), *aff'd*, No. 09-10156, 2010 WL 1223109 (S.D.N.Y. Mar 24, 2010), *aff'd in part, rev'd in part*, 627 F.3d 496 (2d Cir. 2010).

[3] I*n re Bayou Group, LLC*, 439 B.R. 284 (S.D.N.Y. 2010).

[4] *PharmAthene, Inc. v. SIGA Technologies, Inc.*, C.A. No. 2627-VCP, 2010 WL 4813553 (Del. Ch. Nov. 23, 2010).

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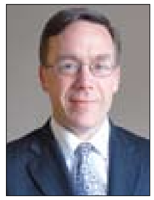
Investing in Corporate Startups: Strategies to Achieving Tax-Free Dispositions



by **Daniel M. Dunn** and **Kenneth C. Wang**

Small business has been described as the engine that drives America and is viewed as a vital source for spurring job growth. Therefore, in order to encourage investment in small business, the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 amended Section 1202 of the Internal Revenue Code to expand incentives for private investment. In particular, Section 1202 now generally excludes from income up to 100% of the gain on the sale of certain stock held by a non-corporate taxpayer for more than five years. Under current law, the 100% exclusion only applies to certain stock issued to the taxpayer between September 28, 2010 and December 31, 2011. On January 31, 2011, the Obama administration announced Startup America as part of the fiscal 2012 budget plan, which would make this exclusion permanent. Additionally, the gain on the sale of certain stock issued to the taxpayer may be eligible for a 50% or 75% exclusion under the old rules of Section 1202, depending on when the stock was acquired.

This article addresses the requirements for qualifying for the current 100% exclusion and describes how a taxpayer can structure its investments to take advantage of the exclusion. Note that the exclusion under Section 1202 applies to federal income taxes. Although many states follow the federal income tax laws, other states may not recognize, or may otherwise limit, this exclusion or may in fact have a more generous exclusion or other tax incentives.

Qualifying for the 100% Exclusion

General

Gain from the sale of stock that is acquired at original issue from a "qualified small business" is excluded, in whole or in part, from gross income under Section 1202 if such stock is "qualified small business stock"

("QSBS"). In order for the 100% exclusion to apply, the stock must satisfy the following requirements:

- The stock must be issued by a domestic C corporation, excluding certain types of corporations such as regulated investment companies or real estate investment trusts, among others;
- The stock must be issued after September 27, 2010 and before January 1, 2012;
- The taxpayer must acquire the stock directly from the issuing corporation (or through an underwriter), and not by transfer from another shareholder; and
- The stock must be issued in exchange for (i) money or other property (not including stock), or (ii) for services provided to the corporation by the taxpayer (other than underwriting services).

The issuing corporation may not have aggregate gross assets (meaning the amount of cash and the aggregated adjusted bases of other property held by the corporation) that, before and immediately after the issuance of the stock (determined by taking into account amounts received in the issuance), exceed $50 million. If the issuing corporation subsequently exceeds the $50 million limit, previously issued stock otherwise treated as QSBS would still be treated as QSBS, but the issuing corporation would be unable to issue QSBS going forward.

Additionally, the issuing corporation must use at least 80% its assets (by value) in the active conduct of one or more qualified trades or businesses during substantially all of the taxpayer's holding period of the corporation's stock. Assets used in research and development and certain other "start-up activities" will also count towards the active conduct of a qualified trade or business. However, for this purpose, a qualified trade or business does not include, among others, a trade or business (i) involving the performance of services in certain professional fields (including health, law, engineering, financial services and the performing arts), (ii) in banking, investing and finance, (iii) in farming and (iv) operating a hotel or similar business. Additionally, an issuing corporation will generally fail the active business test for any period during which more than 10% of the value of its assets consists of portfolio stock or securities in other corporations unless such other corporations qualify as subsidiaries of the issuing corporation (*i.e.*, if the issuing corporation owns more than 50% of the voting power or value of such other corporation).

Finally, the taxpayer must hold the QSBS for more than five years, and the issuing corporation must agree to submit reports to the IRS and shareholders as the IRS may require to carry out the purposes of Section 1202. To date, the IRS has not issued any regulations to require such reports of issuing corporations.

Limitations

The aggregate amount of gain that a taxpayer may exclude from gross income on the sale of QSBS with respect to an issuer for a taxable year is limited to the greater of $10 million (reduced by the amount of any gain previously excluded with respect to QSBS of the issuing corporation) or 10 times the adjusted basis in such QSBS sold during the year. By way of example, a taxpayer who invested $2 million on September 28, 2010 in QSBS and sells the issued stock for $25 million on or after September 28, 2015, would have a realized gain on the sale of $23 million, but would be able to exclude up to $20 million from gross income. The $10 million limit is an aggregate limit that is

imposed on a per-issuer basis and applied separately for each shareholder. Once a taxpayer has excluded $10 million of gain with respect to the QSBS of a particular issuer, it can only exclude 10 times the adjusted basis of any QSBS from such issuer that is sold during the year.

Additionally, depending on when QSBS is acquired and subsequently sold, certain amounts (generally 28%) of the gain excluded under Section 1202 must nonetheless be included in gross income as a preference item for purposes of calculating the alternative minimum tax. By way of example, suppose a taxpayer acquired QSBS on January 1, 2011 and sells such QSBS on January 2, 2016, and is able to exclude $20 million of gain from gross income pursuant to Section 1202. Based on current law, $5,600,000 of such excluded gain would be considered a preference item and must be included in gross income for purposes of calculating the taxpayer's alternative minimum tax for the 2016 taxable year.

Structuring Investments

In order to take advantage of Section 1202, a taxpayer investing in QSBS cannot be a C corporation and thus an individual taxpayer may not hold QSBS through a C corporation. However, a potential individual investor can hold QSBS through certain pass-through entities and still be eligible for the gain exclusion. Accordingly, funds structured as partnerships or limited liability companies (treated as partnerships for income tax purposes) can invest in QSBS and provide potential tax benefits to their investors.

First, in order for an investor in a pass-through entity to be eligible for the exclusion, the stock must otherwise qualify as QSBS in the hands of the pass-through entity (as if the pass-through were an eligible individual holder) and the pass-through entity must satisfy the five-year holding period with respect to the QSBS. Second, the individual investor must include in gross income the gain on sale of the QSBS by reason of holding an interest in the pass-through entity. However, the individual investor cannot exclude the gain to the extent that his or her share of the gain is greater than what it was when the pass-through entity acquired the QSBS. For example, if a taxpayer held 25% of the profits interests in a partnership on the date the partnership acquired QSBS, then upon the sale of such QSBS by the partnership only the gain allocated in respect of such 25% interest will qualify for gain exclusion under Section 1202, even if the taxpayer is allocated additional gain because he or she has acquired additional profits interests in the partnership between the date the partnership acquired the QSBS and the date of the sale. For this purpose, pass-through entities are: (i) partnerships, (ii) S corporations, (iii) regulated investment companies and (iv) common trust funds.

A potential investor may also acquire QSBS through the exercise of the issuing corporation's warrants or options, or through the conversion of stock that itself is QSBS. If stock is acquired through the exercise of a warrant or option, the QSBS requirements must be met as of the day the warrant or option is exercised. The holding period for such QSBS also will begin on the date of the warrant or option's exercise. On the other hand, when stock that itself qualifies as QSBS is converted, the QSBS requirements discussed above are applied at the time that the convertible stock was issued. Moreover, the holding period of QSBS acquired through conversion will include the holding period of the converted stock.

Potential investors will want to ensure that the issuing corporation satisfies the active business requirement during the period in which the investor holds the QSBS. Investors should consider covenants or other oversight in respect of the issuer's operations to ensure that the issuer uses at least 80% of its assets (by value) in qualified trades or business and complies with the other requirements necessary to qualify the stock as QSBS (such as the limitation on portfolio stock and securities described above). Similarly, investors should also consider restrictions on the corporation's ability to make certain significant redemptions of its stock. A particular investor's stock will no longer qualify as QSBS if the corporation makes certain redemptions of more than a de minimis amount of such investor's QSBS. Additionally, QSBS already issued by a corporation will no longer qualify as QSBS if the corporation makes certain redemptions of its stock that total more than 5% of the aggregate value of the issuing corporation's stock. These restrictions were intended to prevent issuers and investors from circumventing the original issuance requirement, and a well-advised investor should impose limitations on an issuing corporation's ability to effect redemptions.

Also, as previously discussed, the amount of gain that can be excluded under Section 1202 is limited to the greater of $10 million (reduced by the amount of any gain previously excluded with respect to QSBS of the issuing corporation) or 10 times the adjusted basis in such QSBS sold during the year. If the taxpayer has already excluded $10 million of gain with respect to QSBS of a particular corporation, then on a going-forward basis such taxpayer will only be able to exclude up to 10 times the adjusted basis of any QSBS issued by that corporation sold during the year. However, the $10 million exclusion is an aggregate cap imposed on a corporation by corporation basis. Potential investors should consider the benefits of investing in QSBS issued by different corporations if gain from the sale of such QSBS could exceed 10 times the adjusted basis of such QSBS.

Finally, in addition to favorable treatment under Section 1202, Section 1045 of the Internal Revenue Code permits a taxpayer to rollover gain from the sale of QSBS. Rollover treatment applies if a non-corporate taxpayer sells QSBS that it has held for more than six months and elects rollover treatment. Under rollover treatment, the taxpayer will only recognize gain from the initial sale of QSBS to the extent that such gain exceeds the cost of any QSBS the taxpayer purchases in the 60-day period beginning on the date of the sale, as reduced by the amount of such cost, if any, previously taken into account. Section 1045 may provide additional liquidity, at least among QSBS of different issuing corporations, and taxpayers should consider the possibility of utilizing Section 1045 in order to advantageously shift their QSBS investments.

Conclusion

The recent amendment to Section 1202 of the Internal Revenue Code creates a significant opportunity for investors to realize tax-free gains by investing in certain small business stock. However, in order to take advantage of this opportunity, and any additional state and local tax incentives, taxpayers should take care to properly structure their investments to ensure compliance with the technical requirements of Section 1202. For further information or for advice on how to structure an investment to take advantage of the exclusion, please contact the authors or any member of Dechert's Tax Practice.

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German Leveraged Finance in 2011: Bouncing Back, But Not as You Might Expect*

by **Michael H. Meissner**[1]

For the first time since the beginning of the global financial crisis and credit crunch in July 2007, the prospects for the leveraged finance market in Germany, Europe's largest economy, are positive again. For completed German loan transactions for the year 2010, the volume of leveraged buyouts (LBOs) was back up to 11% of the total German loan volume, and the spread for three-month EURIBORs—the mark-up on EURIBOR as the variable refinancing interest rate for EMU interbank lending reflecting risk—is now back at levels where the interbank market can function again. The volume of LBOs and private equity-related exits in the fourth quarter of 2010, as well as current mandates from private equity sponsors to arrangers for leveraged financings, demonstrate that there is liquidity again in the German loan market, resulting in a somewhat promising deal pipeline for 2011. While refinancing was still leading the tables in 2010 with 52% of the total 2010 German loan volume (in 2009 refinancing accounted for 51%), followed by strategic M&A with 18%, corporate lending with 16% and 3% for other loan purposes, the increase in LBOs from the 2009 historic low of 1% of the total German loan volume back to 11% in 2010 seems significant enough to expect more to come in 2011.

However, this will not predominantly be the long-awaited return of large-cap buyout M&A activity with purchase prices of at least €750M, but rather mid-cap M&A in the €200M purchase price range or small-cap M&A with purchase prices of less than Euro €100M.

The German economy with the *Mittelstand* as backbone for German industry, including primarily mid-sized, privately held companies in traditionally strong German industry sectors such as automotive, chemical, engineering and manufacturing, seems ideal for the small to mid-cap M&A segment. Most importantly, it should be noted that loans for LBOs will be structured differently going forward in light of lessons learned during the credit crunch and collapse of interbank lending. In analyzing what might happen here, it is imperative to examine market developments and transaction structures pre-credit crunch versus post-credit crunch before outlining what to expect in 2011.

Pre-Credit Crunch Transaction Structures

When the M&A market started to boom in 2005, lenders were no longer entirely in control of pricing and financing documentation. Banks in particular were competing for LBOs—traditionally the domain of private equity funds. The transaction structures that resulted offered favourable terms to borrowers. In addition to the senior facility as senior secured loan with a variable cash-interest rate plus margin and fees, financing structures also included various layers of subordinated debt like second lien, mezzanine, payment in kind (PIK) loans and high-yield bonds. The order of priority, the process of demanding repayment from the borrower and other matters regarding the relationship among creditors would be set forth in a separate intercreditor agreement or be part of the relevant finance agreements. Further, a security trust agreement would set forth the process of realising security interests in the assets provided by the borrower as collateral pursuant to the order of priority.

Second lien loans primarily attracted institutional investors such as insurance firms and pension funds as lenders and were subordinated to the senior facility while having priority over any mezzanine loan. Therefore, a second lien loan would have a variable cash-interest rate plus margin with a longer term than the senior facility but with a shorter term than the mezzanine loan; its security interest in the assets provided by the borrower would rank second to the senior facility as first lien. The mezzanine loan as hybrid instrument between equity and debt capital would include a variable interest rate plus two margins—a cash margin and a PIK margin accruing interest until maturity (often a challenge due to the prohibition of compounded interest under the German Civil Code). Mezzanine loans could also grant warrants for shares in the target company (“equity kicker”). PIK loans are unsecured loans without any cash-flows from borrower to lender between utilization of the loan and maturity, thus, cash-pay lenders qualify PIK loans usually as “equity” or “quasi-equity”. Other “quasi-equity” instruments often used during the boom are vendor loan debts that essentially

constitute extension of purchase price payments by the vendor to the buyer with a fixed interest rate.

After the closing of loan documentation and the funding of the acquisition, the arranger would syndicate the loan by way of invitation and information memorandum to various interested lenders. If a bank had committed to an underwriting, it would bear the risk of the arranger's syndication efforts failing. However, this was almost never the case until mid-2007—on the contrary, many leveraged finance transactions were oversubscribed in the syndication process.

Major characteristics of pre-credit crunch structures included the following: high leverage multiples; often 6.0 to 8.0 times EBITDA debt multiples (with high-yield bonds issued by the borrower as additional financing one could even reach EBITDA debt multiples in the range of 10); low margins and fees; covenants "light" on financing documentation; and relatively moderate equity requirements for borrowers (on average less than 25% of the entire debt capital). The demand for debt capital to finance leveraged as well as strategic M&A transactions was enormous and led to record deal volumes from 2005 to 2007, with each of these years surpassing the previous year. Remarkably, the German LBO market for the first half of 2007 was so strong (with a LBO debt volume of Euro 27.8 billion) that 2007 was still an all-time record year despite a weak second half (with a LBO debt volume of Euro 5.8B, totaling 2007 at Euro 33.6B, compared to LBO debt volumes of Euro 21.9B in 2005 and Euro 17.3B in 2006).

Global Financial Crisis and Post-Credit Crunch Challenges

By the time the impact of the U.S. subprime crisis reached the German financial markets in the early summer days of 2007, it was apparent that what was initially perceived to be temporary instability in the U.S. credit market had grown into a global financial crisis and credit crunch. German banks had also invested in securitised, collateralised or otherwise "repackaged" subprime mortgaged loan products originating from the U.S. credit market, causing serious instability in the financial markets. Thus the interbank market, one of the most important mechanisms of the credit business, was no longer functioning; banks already had significant losses on their books and simply stopped lending to each other, which made it almost impossible to syndicate new loans or refinance existing ones. This had a severe impact on the financing of M&A transactions, resulting in the upturn in the German M&A market, which began in early 2005, ending abruptly in July 2007.

The German leveraged finance market now faced three challenges. First, the existing leveraged facilities did not necessarily provide for mechanisms to maneuver through the crisis; second, projected cash-flows for the performance of portfolio companies of private equity sponsors were ambitious, as were financial covenants; finally, if intercreditor agreements were put in place, they did not always give proper weight to potential insolvency scenarios.

Lenders were faced with the option to either accelerate their loan upon payment default or covenant breach (likely resulting in the portfolio's company insolvency), or to agree to debt restructurings through covenant resets (often imposing an additional fee on the borrower), loan amendments and maturity extensions.

Second, if new leveraged transactions were to be financed, terms and conditions needed to change drastically to the detriment of borrowers. Banks only offered significantly lower leverage multiples and requested higher margins as well as fees. Underwriting in mid-sized to large deals had practically vanished.

What to Expect in 2011

The fourth quarter of 2010 saw the strongest activity in the German leveraged finance market since mid-2007, with, for example, Triton's purchase of Wittur from a consortium of Goldman Sachs/Cerberus/Credit Suisse, Carlyle's acquisition of various mail-order businesses from subsidiaries and affiliates of Arcandor and the purchase of Amor Group from Pamplona Capital by 3i. The debt capital for all these transactions came from banks, further substantiating the expectation that in 2011 the leveraged finance groups of German banks will be back in business.

That should not exclude the possibility of high-yield bonds becoming a more sought after instrument in German leveraged financings. High-yield bonds would usually be issued as subordinated debt to the senior facility provided by banks. With second liens having disappeared in the European markets after the credit crunch, so far mezzanine loans have typically been used to finance the subordinated debt portion. However, the European high-yield bond market continued to increase, making 2010 a record year in issuances, and high-yield bonds have already partially replaced mezzanine debt (outside Europe—obviously in the United States, high-yield bonds are a customary route for private equity sponsors to access the debt markets). While up to now such issuances were primarily observed in the UK and France, it may well be that this uptick in high-yield bond issuances for leveraged financings will extend to Germany, particularly if the relatively expensive pricing structures for mezzanine continue. Such development could be facilitated by German legislation, i.e., the Act to Reform Collective Bond Offerings and Enforcement of Investors' Rights of August 4, 2009, which had the primary goal to provide a legal framework for German-law governed bond offerings reflecting customary international practices and attracting more bond offerings from companies in need for financing.

Other recent legislation that could become relevant to the return of the German leveraged finance market is the German Limited Liability Company Modernization Act of November 1, 2008, which essentially liberalises the German law capital preservation rules for a GmbH (the German law equivalent to a privately held corporation with limited liability). This Modernisation Act now permits, among other things, certain asset transfers from a GmbH to its shareholders that can include upstream security interests to secure loan liabilities of the shareholder of the GmbH, for instance in a leveraged finance transaction where the shareholder is the borrowing special purpose vehicle established by the private equity sponsor to effect the acquisition and the GmbH is the target company. Thereby, the lenders can now accept broader security interests from the borrowers that will facilitate the conclusion of leveraged loan facilities.

Insolvency Aspects

An important lesson learned from the credit-crunch in terms of structuring leveraged financings will be insolvency issues at the target company to be acquired by the private equity sponsor as purchaser and borrower of the loan facilities. While the major reforms of insolvency law in the 1990s resulting in the German Insolvency Code of 1999 instituted an insolvency plan-proceeding to enable an initially court-supervised restructuring as well as a U.S. Chapter 11-like debtor-in-possession proceeding, the liquidation of the debtor company under the insolvency administrator's power of disposal remained the standard insolvency procedure in Germany. Under the Insolvency Code, the insolvency administrator will be appointed by the insolvency court without the creditor's consent with the creditors having more of an advisory role through the creditors' meeting and a creditors' committee than actual power to influence the insolvency proceedings. Thus, similar to initiatives in other major European jurisdictions, the German legislator is presently pursuing additional reform of the Insolvency Code to further strengthen creditors' rights. For the time being, the finance documentation in German leveraged financings must consider the current rules under the Insolvency Code and ensure that out-of-court restructurings will not be complicated by certain provisions. In the case of multiple lenders, the preparation of an adequate intercreditor agreement will be of utmost importance dealing with the pre-default issues of priority, payments and amendments as well as with the post-default issues of acceleration/enforcement, insolvency and recoveries, i.e., how to share proceeds. The Loan Market Association (LMA) had identified this issue and produced a form for a LMA intercreditor agreement designed to fit with the primary leveraged facilities agreement in March 2009 and then revised it in November 2009 to include various mezzanine friendly options.

Generally, German leveraged finance transactions in 2011 will primarily be structured with senior facilities plus subordinated debt in the form of mezzanine or high-yield bonds. Second liens or PIK loans will not play any significant role, but vendor loan debts will possibly be included in the financing structure. For two reasons, it seems unlikely that banks will agree to a relevant number of covenants "light" again in the foreseeable future: first, to protect themselves; second, because covenant "light"-transactions will be extremely difficult to syndicate.

Regarding EBITDA debt multiples per LBO, it can be expected that on average they will be in the range of 3.5 to 5.5. Equity requirements for the borrower will probably still commence with a minimum of 30% up to 50%.

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[1] The author would like to thank Julia Braun for her contributions to this article.

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