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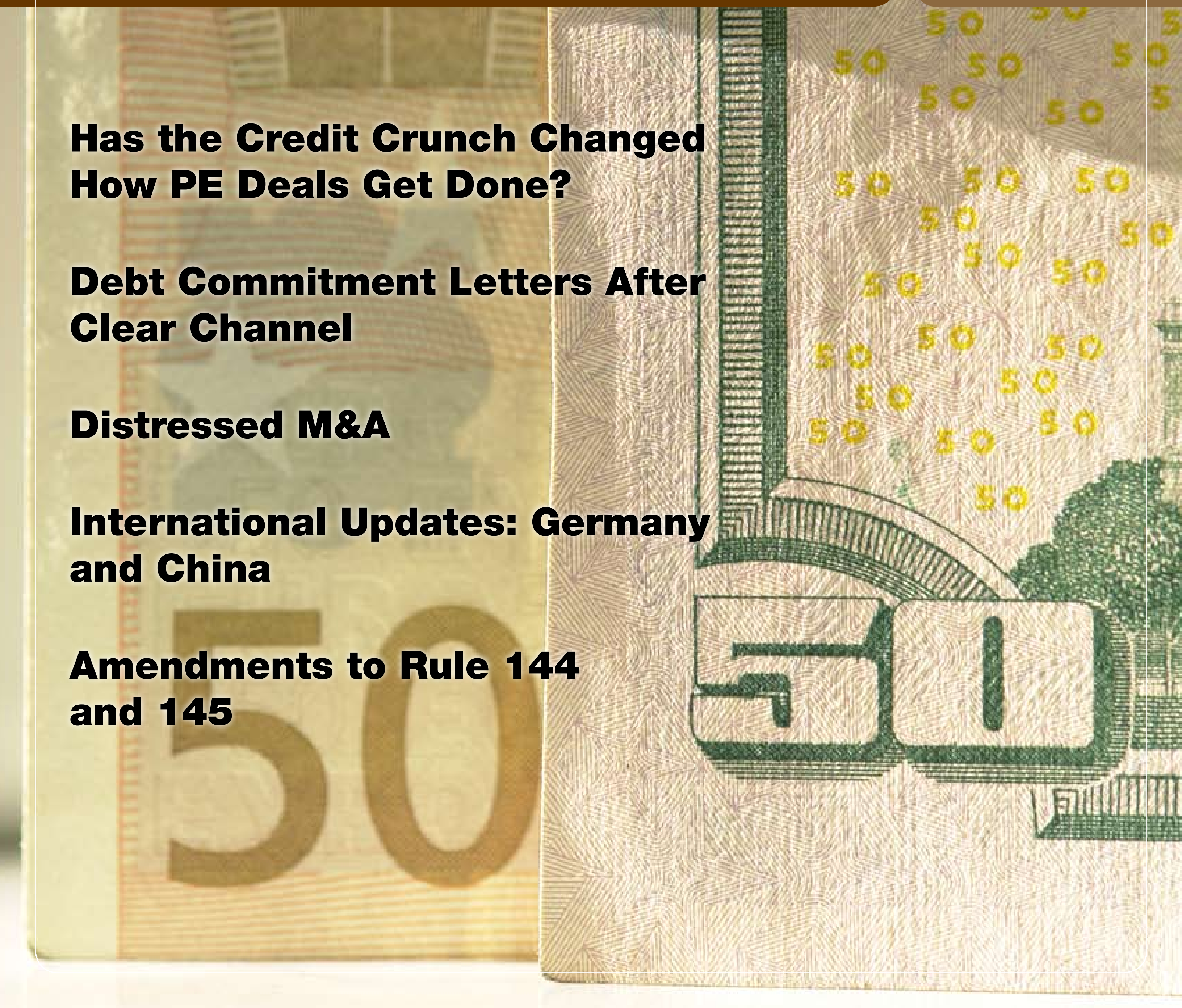
# PRIVATE EQUITY FOCUS



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## Private Equity Deal Terms: The Song (Largely) Remains the Same

*By Christopher J. Bellini[1]*

Until recently, the financing markets had been fueling a robust M&A market, with strategic and financial buyers easily able to obtain credit on very favorable terms. However, the collapse of the credit markets in the middle of 2007 has acted to put the brakes on M&A activity. While M&A has not disappeared altogether, there has been a noticeable slow-down in buy-out activity across all market segments, particularly in large, going-private transactions.

With the collapse of the credit markets, many commentators and M&A practitioners predicted that deal terms in private equity buyouts, particularly in going-private transactions, would undoubtedly change. Yet, while there is little doubt that financing terms have changed, including the disappearance of "covenant-lite" loans and other debtor-friendly loan features, there has been surprisingly little change in deal terms. In fact, a review of going-private transactions announced this year indicates that financial buyers continue to be willing to live with certain seller-favorable terms that have arisen in going-private acquisition agreements in recent years.

### Financing Conditions

In years past, "financing outs" or conditions to the buyer's obligation to close an acquisition based on the availability of sufficient debt financing, were an expected component of the definitive agreement executed by private equity sponsors in connection with leveraged buyouts. These financing outs are intended to insulate the private equity sponsors from the risk that the debt financing necessary to consummate an acquisition would not be available on the expected terms. In the buyout boom of recent years, however, target company boards of directors were successful in negotiating for the elimination of these conditions, as they sought to provide more certainty to their shareholders as to the likelihood of a transaction actually closing. And with the previous availability of easy credit, private equity sponsors apparently viewed the absence of financing outs as carrying little risk. In today's credit market, however, the lack of a financing condition can have serious consequences.

Yet despite the many failed deals resulting from failures to obtain debt financing, financing conditions have not made a comeback and have only appeared in one going-private deal so far this year. Perhaps the reverse termination fee (as discussed below) is a recognition on the part of target companies and private equity buyers that, despite the lack of a financing condition, financing is always at risk. The reverse termination fee simply attempts to quantify that risk.

### Reverse Termination Fees/Sponsor Guarantees

Reverse termination fees, fees paid by a buyer in the event it terminates an acquisition agreement, initially arose as a quid-pro-quo between public target companies and private equity sponsors. Historically, the typical going-private structure involved the use of a newly formed shell company as the acquisition vehicle and a merger agreement that included a financing out and did not provide for any recourse directly against the private equity sponsor if the shell company failed to perform under the merger agreement. In the buyout boom, public target boards of directors began to demand that the private equity sponsor stand behind these thinly capitalized shell companies by providing a guarantee

1 The author would like to thank Robert A. Rosenbaum for his assistance with the preparation of this article.

so that the public target company had a meaningful remedy in the event of a breach. Private equity sponsors usually agreed to this construct but insisted upon capping their liability and eliminating the ability of the target company to seek specific performance of the merger agreement. The cap was typically a reverse termination fee that mirrored the break-up fee paid by the target to the buyer in the event that it terminated the merger agreement in favor of a superior competing offer.

It is quite clear that the reverse termination fee structure remains intact, with all ten deals having such a provision, and all but two including a sponsor guarantee (in some instances, the guarantee was not just limited to the reverse termination fee). This is likely due to the fact that, appropriately drafted, reverse termination fees can effectively limit and quantify a private equity sponsor's liability, particularly when coupled with an explicit provision as to their being the target's sole and exclusive remedy in the event of a breach by the sponsor.

**Specific Performance**

The remedy of specific performance is an extraordinary equitable remedy that compels a party to execute a contract according to the precise terms agreed upon or to execute it substantially so that, under the circumstances, justice will be done between the parties. In the M&A context, specific performance grants the target the right to force the acquirer to complete the transaction.

Prior to the credit crunch, private equity deals generally followed one of two models regarding specific performance in the event the private equity sponsor refused to complete the transaction: (i) the only remedy of the seller was to collect the reverse termination fee and specific performance of the agreement was expressly prohibited or (ii) the seller had the right to force the acquiring entity to specifically perform its agreement. In the latter case, since the acquiring entity was a shell company, the specific performance right is more likely to be used to require the buyer to obtain regulatory approvals and enforce the debt and equity commitment letters. An example of how this might play out is the *Clear Channel* case where private equity firms Thomas H. Lee Partners and Bain Capital sued a group of banks (Citigroup, Morgan Stanley, Credit Suisse, Royal Bank of Scotland, Deutsche Bank and Wachovia) seeking "specific performance" of a commitment letter detailing plans to fund their $20 billion buyout of Clear Channel Communications. Interestingly, though, the agreement between Clear Channel and the private equity buyers barred specific performance against the buyers; THL and Bain nonetheless brought suit against the commercial banks. The parties have since settled their dispute (see article on page 6), but only after months of legal wrangling.

Private equity sponsors have continued to push back on this point, with a clear preference for barring specific performance. Of the ten going-private deals announced so far this year, all have had reverse termination fees and specifically or effectively barred specific performance of the agreement. Consistent with prior practice, all of the deals pair a reverse termination fee with a general prohibition on specific performance of the buyer's obligations.

**Go-Shops**

Instead of the typical "no shop" provision that has long been standard issue in merger deals — to keep sellers from soliciting higher offers after reaching an agreement to be sold — in the non-auction context target company boards of directors began negotiating deals with private equity buyers that allowed them to actively seek higher offers after reaching agreement. Pursuant to this "go-shop" provision, the buyer effectively acts as a stalking horse, with its price setting a floor for other potential buyers and providing a sense of certainty to shareholders.

While go-shop provisions arose in an effort by target company boards of directors to satisfy their Revlon duties in the absence of a pre-deal auction, the reality is that go-shops, to date, have seldom resulted in third-party bids. That's not to say that go-shops are simply a façade; rather, properly executed, they can serve to validate the deal price as a legitimate market-clearing price for the target, thereby supporting a deliberate and effective process that should satisfy a target board's fiduciary duties. Of the ten deals so far this year, six of the targets were effectively shopped prior to signing a definitive agreement. Of the remaining four deals, all contained a go-shop. Accordingly, expect go-shops to remain in going-private deals where there is no pre-deal auction.

So it seems that, on average, going-private deal terms have yet to move from where they stood prior to the collapse of the credit markets. With seller-favorable provisions remaining in these transactions, it may be due to the continued effort on the part of private equity firms to maintain their reputations, as their livelihood depends on their ability to maintain a healthy pipeline of deals. But perhaps the reason has just as much to do with the fact that target company boards of directors have learned much from the many failed deals arising out of the credit crunch, and have held firm on these provisions so as to afford greater protections to their shareholders.

While it is difficult to draw firm conclusions from only ten deals, we look forward to more data points to compare as the year progresses. There likely will not be any large going-privates for the balance of the year. Many are forecasting that the middle market will remain strong, however, given the lower dependence on debt for middle market deals (typical leverage for middle market deals is in the 3x-5x EBITDA range, compared to 8x-10x EBITDA range for larger transactions). Additionally, and perhaps even more important, middle market private equity groups have an estimated $200 to $400 billion in uninvested capital that they need to deploy. In other words, stay tuned.✤

| Announcement Date | Target | Private Equity Sponsor | Deal Value | Financing Condition | Reverse Termination Fee | Sponsor Guaranty | Specific Performance | Go Shop |
|---|---|---|---|---|---|---|---|---|
| April 25, 2008 | Industrial Distribution Group, Inc. | Luther King Capital Management | 131 | No | 3.5 | No | No | No |
| April 11, 2008 | The Trizetto Group, Inc. | Apax Partners | 1,400 | No | 65 | Yes | No | No |
| February 25, 2008 | Getty Images, Inc. | Hellman & Friedman LLC | 2,400 | No | 78 | Yes; not limited to reverse break-up fee | No | No |
| February 22, 2008 | CHC Helicopter Corporation | First Reserve Corporation | 3,670 | No | 61.41 | Yes; not limited to reverse break-up fee | No | No |
| February 20, 2008 | Industrial Distribution Group, Inc.[2] | Platinum Equity Advisors, LLC | 113 | No | 3.4 | No | No | No |
| January 28, 2008 | NuCO2 Inc. | Aurora Capital Group | 443 | Yes; subject to payment of reverse break-up fee | 15 | Yes; not limited to reverse break-up fee | Yes | Yes |
| January 18, 2008 | Performance Food Group Company | Blackstone Group, Wellspring Capital Management | 1,220 | No | 40 | Yes | No | Yes |
| January 15, 2008 | Manatron, Inc. | Thoma Cressey Bravo | 66 | No | 2 | Yes | Yes | No |
| January 15, 2008 | Lifecore Biomedical, Inc. | Warburg Pincus LLC | 239 | No | 9 | Yes; limited to reverse break-up fee | No | Yes |
| January 14, 2008 | Bright Horizons Family Solutions | Bain Capital Partners, LLC | 1,300 | No | 66 | Yes | No | Yes |

2 On April 25, 2008, Industrial Distribution Group, Inc. accepted a higher offer from Luther King Capital Management ("LKCM") and terminated its agreement with Platinum Equity Advisors, LLC ("Platinum Equity"). Platinum Equity matched LKCM's initial offer, but failed to exercise its right to match LKCM's second offer.

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## Ripples of Battle: Debt Commitment Letters After Clear Channel

*By Peter L. Harris*

Most participants in the private equity and leveraged finance markets are familiar with the recently-settled Clear Channel litigation. Although this litigation was recently settled by the parties, it is likely that the novel arguments and theories raised by the parties in that litigation will affect debt commitment letters for many years to come. This article explores some of the likely affects on debt commitment letters arising out of Clear Channel.

### The Clear Channel Litigation

The Clear Channel litigation arose out of one of the last large LBO transactions to be signed up immediately prior to the "credit crunch" of late 2007. The litigation raised many novel legal theories that demonstrate to deal lawyers what can go wrong with commitment letters.

In May 2007, Bain Capital Partners LLC and Thomas H. Lee Partners LP (the "Sponsors") and Clear Channel signed a merger agreement in which the Sponsors agreed to pay $39.20 per share for Clear Channel. Concurrently with the merger agreement, the Sponsors and a bank group lead by Citibank, N.A. (the "Banks"), negotiated and signed a 71-page long commitment letter. To allow for sufficient time to receive regulatory and third party approvals, the commitment letter and merger agreement each included a drop-dead date of June 12, 2008 for the closing of the definitive documentation. Notwithstanding the length of time before the closing, the commitment letter did not contain "market flex" or "syndicability" language.

In late summer of 2007, the subprime crisis and the resulting credit crunch apparently caused the Banks to approach the Sponsors "hat in hand" seeking some $600 million in concessions in the financing terms. The Banks also apparently had concluded that they would incur a $2.5 billion market-to-market loss on the loans immediately after the loans closed. The Sponsors rebuffed the Bank's attempt to renegotiate the deal, which caused (according to the Sponsors) the Banks to decide to go to "war" to kill the deal. As the Sponsors alleged in the resulting litigation, rather than trying to terminate the commitments outright, the Banks began demanding onerous deal terms, including new restrictions on the payment of the intercompany debt, that were at odds with the commitment letters and that the Banks knew that the Sponsors would be unable to accept. The Sponsors alleged that the Bank's design was to present the "facade" of negotiating in good faith while attempting to delay the closing until the June 12 drop dead date by demanding onerous and unworkable deal terms.

To seek to preempt these attempts by the Banks, the Sponsors sued the Banks in New York federal court seeking, among other things, to force the Banks to specifically perform the commitment letters. Clear Channel and the Sponsors also shortly thereafter sued the Banks in Texas state court seeking $26 billion in damages due, among other things, to alleged "intentional interference" by the Banks with the merger agreement due to their unstated unwillingness to fund the deal.

In the New York litigation, the Banks promptly filed a motion for summary judgment, among other things, alleging that specific performance is not available under New York law to enforce a commitment to fund loans. The New York Federal District Court, however, denied this motion and allowed the case to proceed to trial, thereby holding that specific performance was not precluded as a matter of law as a remedy to enforce a commitment to lend. The Texas court also denied motions for summary judgment, and allowed that court to proceed to trial.

In May 2008, after these motions were decided, the parties settled the dispute and the Sponsors agreed to pay a reduced purchase price — $36 per share — and the Banks agreed to finance the deal.

**Waivers of Specific Performance**

As noted above, the Banks in Clear Channel argued that specific performance is unavailable as a matter of New York law to force a lender to fund loans set forth in a commitment letter. They also argued that specific performance is not available in a non-real estate transaction, to which the Sponsors responded that the Clear Channel assets were unique assets similar to what would be the case if this were a strictly real estate transaction. The Bank's argument is consistent with wide-spread practice and understanding of lending lawyers in commitment letters prior to Clear Channel– that specific performance is not an available remedy in this context and therefore it is not necessary to include a waiver of specific performance in commitment letters. However, by denying the motion for summary judgment, the New York federal court effectively held that specific performance is an available remedy for loan commitments and is available in connection with non-real estate transactions such as Clear Channel so long as unique assets are involved.

In light of this, our experience after Clear Channel is that lenders are frequently and aggressively seeking waivers of specific performance in debt commitment letters. Sponsors are left to argue that such a waiver is unnecessary in light of the market flex and syndicability language in that those covenants render the final deal terms open to change and thereby make the commitment letter difficult to specifically enforce. If they are unsuccessful in removing a waiver of specific performance, sponsors would need to get comfortable with such waivers on a couple of grounds. First, most commitment letters are much less detailed than the 71 page commitment letter in Clear Channel, and leaving many open points, and therefore would be difficult to specifically enforce by the sponsor in any event. Second, most middle market transactions contain a much shorter pre-closing period than the year-long period in Clear Channel, such that a market disruption during that period is less likely to occur, thereby rendering it less likely that a lender will seek to escape its commitment.

**Shorter, Less Detailed Commitment Letters**

In Clear Channel, the Sponsors successfully argued that specific performance would not be a difficult remedy for the court to enforce because the 71 page commitment letter left very few terms to be negotiated and also provided that any remaining terms would be set according to the Sponsor's historical deal precedent. In light of this, it is likely that lenders will seek shorter, more nebulous commitment letters with many points left open for discussion. Lenders will also be very unlikely to allow unspecified terms to be determined according to the "Sponsor's historical deal precedent," and rather will want to simply provide that those terms are "to be negotiated" by the parties or, at most, subject to a "customary" deal terms standard. In the view of lenders, these mechanics will make it less likely that a court will order specific performance, as the many open items in the commitment letter, make specific performance too difficult to enforce.

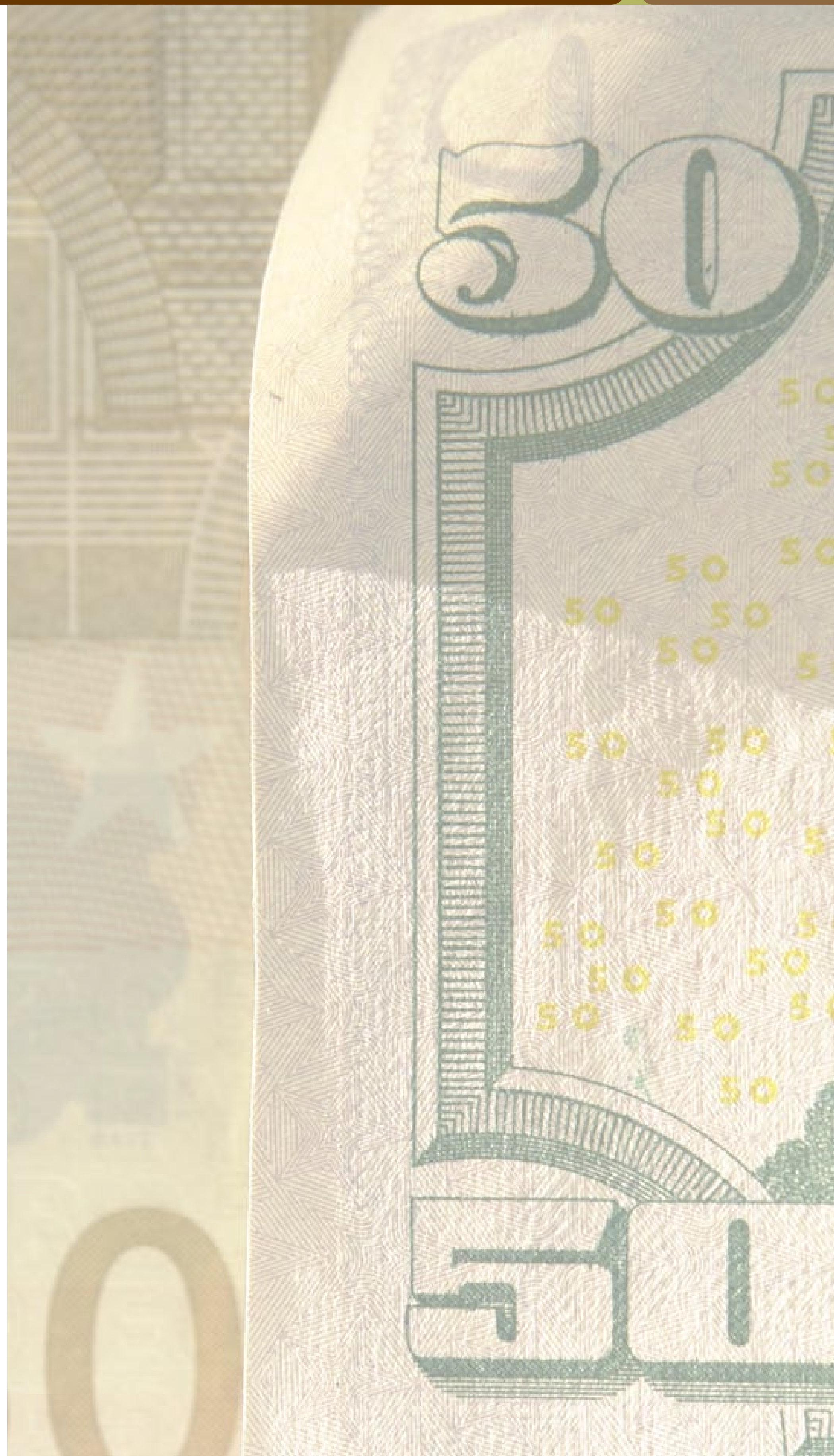
To counter this trend, sponsors will need to argue that they need more detail in the commitment letter because, if they sign a non-contingent purchase agreement, they need to be sure that there will be few surprises down the road with the financing. Sponsors may also attempt to push this issue down to the seller by making more frequent requests for financing contingencies in the merger agreement or by negotiating a lower reverse break-up fee if the merger falls apart due to the lender's unwillingness to fund. If neither of these options work, sponsors will need to get comfortable with the lack of detail in the commitment letter by making the time of the commitment and the closing as short as possible to reduce the chances of an intervening market disruption.

**Detailed Market-Flex and Syndicability Language**

As one of the last deals during the "covenant-lite" era, the Clear Channel commitment letter did not include "market flex" or "syndicability" language. Now that the credit crunch has hit, the days of a lender signing a 71 page commitment letter that does not include these provisions are long gone. Rather, it is more likely that lenders will seek ever-more-onerous market flex language, including language that allows for modifications to terms other than the main business terms of the deal. Sponsors will attempt to limit this language to the main business terms of the deal and seek to impose caps and floors on increases to interest rates and reductions to note amounts and the like. However, lenders will undoubtedly seek to push back on longer-term commitment letters because the risk of a market disruption is higher than for shorter term commitments.

**Claim Waivers and Limitations in Merger Agreement in Favor of Bank**

In light of the intentional interference claims by Clear Channel against the Banks, it is likely that lenders will become more actively involved in reviewing and commenting upon the claims waiver and claims limitation language in the underlying acquisition agreement. In Clear Channel, the merger agreement contained language to the effect that the $500 million reverse termination fee was the sole remedy against the Sponsors as well as the Banks. However, the language could have been clearer and did not expressly preclude the bringing of tort claims, such as claims for intentional interference of contract. Accordingly, lenders will likely start seeking strong waivers of tort claims (including intentional interference claims) and also be sure that the reverse termination fee effectively limits damages against lenders. Lenders should be able to enlist the sponsors as an ally in these discussions by making clear that the indemnification language in the commitment letter applies to this type of claim, and thereby making it in the sponsor's best interest to limit this type of claim in the acquisition agreement.✤



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# Buying a Troubled Business: Bankruptcy and Other Options

*Michael Foreman and Eric Lopez Schnabel*

## Introduction

Lately, we bankruptcy lawyers seem to be more popular with our Corporate and M&A colleagues. As default rates and fuel prices rise and as the malls seem a little or a lot less crowded, more transactional lawyers are finding their clients being interested in companies or business lines that are underperforming, negotiating covenant amendments or waivers with lenders, or projecting weakening results over the next six to 12 months. Strategic and financial investors are seeing more deals cross their desks that are being valued at less than the amount of the secured debt on the business. More investment bankers are circulating information memoranda which refer to the prospect of consummating "363 sales"[1] in bankruptcy, seeking "stalking horses"[2] or running a sale process governed with court-approved bidding procedures.[3]

What does all this mean for the investor – the potential acquirer – that finds its target is a troubled company? The investor is faced with a different set of transaction options, some of which may involve the target's expected Chapter 11 bankruptcy or the transaction needs to be assessed in consideration of a possible unexpected bankruptcy filing by the target. While certain investors have already spent the last few years spending quality time in the world of insolvency and distressed mergers and acquisitions, these numbers are now increasing as more and more strategic and financial investors are considering, and being presented with, deals for distressed businesses. Some of these deals may implicate the target's Chapter 11 bankruptcy filing, but the bankruptcy option may not be the right option for every deal involving a troubled company. How does an investor approach a distressed deal in 2008? When should an investor consider having its deal consummated through a target's bankruptcy? What should an investor do when its target insists that it must pursue the deal through a Chapter 11 bankruptcy?

## Common Distressed Deal Considerations

The structure of a distressed transaction typically will hinge on how the investor and target prioritize a number of important concerns, including:

- The target's debt and capital structure, including the presence of a single class or multiple classes of secured debt,

1 Section 363(b) of the US Bankruptcy Code, 11 U.S.C. Sec. 363(b), requires a company in Chapter 11 bankruptcy to obtain bankruptcy court approval of all transactions that are outside of the debtor's ordinary course of business, including sales of business divisions, product lines, or substantially all of the company's assets. Chapter 11 of the US Bankruptcy Code enables a company, as a debtor-in-possession, to reorganize under the bankruptcy protections from creditors while remaining in control of its business and assets. Accordingly, bankruptcy as discussed in this article as a transaction option refers to the target's sale or restructuring under Chapter 11.

2 A "stalking horse" is a bidder for the target's assets whose offer is then used to by the target to solicit competing offers, usually in an auction process run by an investment banker or other broker. The stalking horse typically will be protected against an overbid by negotiating a break-up fee and/or expense reimbursement.

3 A bankruptcy sale process will be governed by procedures approved by the bankruptcy court that provide for notice to creditors and interested parties, the form and content of competing bids (including whether a deposit will be required, the bidding increments, and, where groups of assets or business are being sold, whether bids will be entertained in part or in whole), and the scheduling of an auction and court hearing on approval of the "highest and best" offer resulting from the sale and auction process.

and a determination of which class of debt is the likely "fulcrum debt";[4]

- The immediacy and extent of target's financing needs – how quickly a transaction must close before the target runs out of liquidity, or its liquidity needs exceed its resources?;
- The potential costs and timing exigencies of the proposed transaction – how long can the target maintain its relations with key employees, customers and suppliers?;
- Consent rights of third parties (e.g., lenders, landlords, equipment lessors, key customers);
- The timing of critical events such as loan or bond defaults, payments due under critical agreements, production schedules;
- Considerations arising from a potential auction process, including the investor's willingness to participate in an auction, and the perceived and actual liability risks facing target's directors over issues of value; and
- Does the target have businesses and assets outside of the United States, and do these other foreign jurisdictions have laws and insolvency processes that are friendly to the investor's chosen sale process?

**Deal Options**

As assessment of these factors, in turn, will dictate the deal structure. The most common methodologies include:

**Out-of-Court Sale:** A traditional sale pursuant to an asset purchase agreement may turn out to be the best option for the parties if the target has a simple debt structure, third party and governmental consents are not needed or are readily obtainable, and the target's fiduciaries see little risk of liability to themselves in approving a sale. Under these circumstances, an out-of-court sale may permit the parties to minimize transaction costs, limit business disruption and close quickly.

**UCC Article 9 Sale:** Where the target has a relatively simple debt structure, with a single class of secured debt, the parties may be able to negotiate a consensual foreclosure by the secured creditor in conjunction with the creditor's sale of the assets to the investor. This approach has the advantage of permitting the investor to acquire the assets free and clear of liens in a relatively quick and inexpensive transaction. However, the more complex the business being acquired, the more disruptive this approach will be to the target's business. The parties may perceive that they are constricted in the amount of pre-sale planning in which the investor can be engaged. Further, unhappy creditors may counter an Article 9 sale with an involuntary bankruptcy filing, and seek to challenge the sale on fraudulent transfer grounds. Also, in the face of hostile junior creditors, the secured creditor may view this approach as presenting it with exposure to lender liability-type claims.

**Loan to Own:** Where the target needs financing but has not yet decided to put itself up for sale, or where the investor is not yet sure about the prospects of ownership, the investor may decide to make a loan to the target at the level of debt perceived by the investor to be the "fulcrum debt." Often, the "fulcrum debt" will be a junior lien or senior unsecured debt position that is permitted by the target's existing financing or consented to by the existing creditors. While the investor will have less control over the target than in an outright acquisition, the investor may be able to use loan covenants to dictate financial or operational performance parameters for the target. This approach more likely will be used by a financial investor who is less concerned about integrating the target's business into another, existing business.

**Debt Acquisition:** Depending on the circumstances, an investor may be able to acquire the target's existing "fulcrum debt" for a purchase price less than par or, with the cooperation of the target, in a restructuring of the existing debt on terms more favorable to the target. Indeed, an investor may acquire the target's debt even without the target's prior knowledge. By controlling the target's "fulcrum debt," the investor will expect to be able to exert great influence, if not effectively control, the target's efforts to restructure its balance sheet and operations. Depending on the discount to par represented by the purchase price, the investor may choose to hold the target's debt, or seek to take over the target by exchanging debt for the target's equity or by including all or a portion of the debt as a credit bid for the target.

**Bankruptcy Sale:** The Bankruptcy Code Section 363(b) sale process provides a target, creditors, and bidders with a stable and battle-tested auction environment. While the bankruptcy process presents the greatest transaction costs and requires the longest lead time prior to closing, it provides a court-authorized framework for obtaining assets free and clear of liens and claims, circumventing most consent rights or other assignment or sale restrictions (except, most notably, with respect to restrictions on intellectual property rights), and minimizing potential deal risks such as an investor's fraudulent transfer risk and the risk of litigation claims being brought against a target's directors.

4 The "fulcrum debt" of the target will be the point in the capital structure where the target's liabilities exceed the value of the target's business and assets: e.g., the debt that could control or greatly influence the bankruptcy process.

The bankruptcy sale process is often viewed as potentially the most disruptive of all of the sale methodologies, although parties often seek to minimize the potential for disruption by soliciting bids and negotiating a stalking horse bid, with an asset purchase agreement, prior to the target's Chapter 11 filing. Often, the complexities of the target's capital structure, or the presence of statutorily created consent rights from non-cooperative parties, will dictate the target's sale through Chapter 11. It is important to note that, with rare exceptions, the Chapter 11 process requires the target to solicit competing bids and to conduct an auction to determine the highest and best bid. As a result, some investors may seek to avoid the bankruptcy sale process if at all possible, while others may seek to be the stalking horse in order to gain the earliest possible entrée into the company, and to recoup their time and expense investments through a break-up fee and/or expense reimbursement. In some cases, an investor that is unsure of the target's value or unwilling to invest considerable time in a deal that may not close may wait until the target discloses its stalking horse offer and commences the process for soliciting competing bids.

A typical 363(b) Sale timeline looks like this:

| | |
|---|---|
| Initial submission of bids | Day 1 |
| Selection of Stalking Horse | Day 3 – 14 (time period depends on target's distress) |
| Negotiation of Asset Purchase Agreement; Filing of motion to approve bidding procedures, break-up fee and related sale matters | Day 7 – 21 (time period depends on target's distress) |
| Bankruptcy court approval of bidding procedures, etc. | Requires 20 days' notice to creditors and interested parties; time period can be shortened for "cause" |
| Auction for overbids against stalking horse bid – conducted by debtor's investment banker or broker, outside of court | Typically 20 days after bankruptcy court approves bidding procedures |
| Sale Hearing | Typically 1 – 3 days after Auction |
| Closing | 10-day appeal period can be waived by court to permit closing as soon as sale order is entered on the case docket. |

**Chapter 11 Plan:** In certain cases, the investor may seek to acquire the target by co-sponsoring the target's Chapter 11 plan of reorganization. A Chapter 11 plan would be voted on by the target's classes of creditors,[5] and must be approved by at least one class of creditors that is impaired under the plan. Through a Chapter 11 plan, the investor may seek to avoid the competitive bidding process inherent in the Section 363(b) sale process, since under Chapter 11 a debtor has an exclusive right to propose a Chapter 11 plan for the initial 120 days after its bankruptcy filing (which period may be extended up to 18 months from the bankruptcy filing). A sale under a Chapter 11 plan also enables the avoidance of transfer taxes which in certain deals can be of a significant benefit to the creditors of the target. However, even a Chapter 11 plan may be subject to competitive bids if, for example, a creditor or a class or group of creditors is successful in contesting the valuation of the target represented by the plan. In addition, the Chapter 11 plan process likely will have the greatest transactional costs and longest time period prior to closing.

5 A class of creditors will be found to have accepted the Chapter 11 plan if the plan has been accepted by creditors in that class holding at least two-thirds in amount and more than one-half in number of the allowed claims.

However, the Chapter 11 plan process may be useful to or necessary for the investor who is seeking to merge with the target, or who seeks to raise additional capital for the reorganized company through a rights offering to the target's existing creditors and/or equity holders.

**Conclusion**

In our current economic environment, troubled businesses are increasingly presenting strategic and financial investors with potentially attractive opportunities. The world of distressed investing presents a different range of transaction options than investors would consider in acquiring relatively healthier businesses. The bankruptcy Chapter 11 auction sale process is significant among these options, since it very much is the standard against which the other options are to be assessed, in terms of transaction costs and timing, ability to close with or without third party consents, potential exposure to the investor and target, and the ability to acquire assets free and clear of liens and claims.

Investors interested in troubled companies are well-advised to consult with counsel and other advisors having both M&A and insolvency expertise at the earliest possible stage of their consideration of a potential investment. We in Dorsey's M&A and Financial Restructuring and Bankruptcy practice groups have considerable experience in advising investors pursuing transactions with troubled businesses and would be happy to speak with you about your opportunities.✤

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## German Corporate Tax Changes: New Limitation of Interest Deductions, Exclusion of Loss Carry Forwards, Tax on Relocation of Functions

*By Bernd U. Graf*

New tax rules concerning non-deductibility of interest expenses, forfeiture of loss carry forwards, and tax on relocation of functions will require checking and/or rethinking of investment, financing, and group structures in order to avoid surprises at the level of German corporate tax. The legislative process on a draft law on venture capital activities should be monitored to keep abreast of the tax and regulatory framework for venture capital activities in Germany. Bottom line adverse effects may be avoided or mitigated if business/finance plans and structures are adapted in the light of the new law.

The recently enacted German Corporate Tax Law Reform 2008 will significantly affect private equity transaction planning, and business and group finance structures involving German companies. Most of the new law applies with effect as of January 1, 2008 and/or for fiscal years ending in 2008, respectively.

The main reason for the tax reform was to make German corporate tax rates competitive with other European countries' rates. The German corporate tax rate is now reduced from 25% to 15%, resulting in an overall tax rate for corporations of approximately 29.8% (down from nearly 40%), including the municipal trade tax and the Western-Eastern Lander solidarity transfer surcharge tax.

Not surprisingly, this significant rate reduction comes with a drawback. To set off the loss of tax revenues resulting from the rate cut, among other things, the tax reform introduced less advantageous tax base calculation and depreciation rules and, particularly relevant for the private equity market, new interest deduction limits and the exclusion of loss carry forwards post-acquisition. Also note-worthy is a new tax on the relocation of company functions.

### New interest deduction limits

Saying farewell to traditional debt-equity ratio rules, the German tax reform introduced an entirely new concept to limit the deductibility of interest expenses with a view to avoiding abusive financing structures. The new rules apply to both corporations and partnerships.

30% limit rule: The total "net interest expenses" after set off with interest income may only be deducted from the tax base to the extent they do not exceed 30% of EBITDA. EBITDA is to be calculated under the IFRS rules. There are three exceptions to the general rule:

(i) **Basket amount:** If the net interest expenses do not exceed EUR 1 million, they are fully deductible.

(ii) **Independent company:** The 30% limit does not apply if the company is not a member of, or is only partly a member, of a corporate group, and the company has not paid interest of more than 10% of the net interest expenses (a) to any shareholder holding directly or indirectly more than 25% of the share capital or (b) to any person related to such shareholder or (c) to a "harmful" third party lender having recourse against such shareholder or related person (e.g. by way of guarantees).

(iii) **Group debt-equity ratio comparison:** The 30% limit does not apply if, as of the end of the previous fiscal year, the debt-equity ratio of the company is the same as, or not more than 1% higher than, the company's group overall debt-equity ratio, and the foregoing threshold of 10% of the net interest expenses is complied with as regards any interest paid by any group entity to any qualifying (>25%) shareholder of any group entity (or related person or "harmful" third party lender, respectively) - i.e., roughly speaking, a qualifying shareholder may not have contributed more than 10% of the group's loan financing.

Non-deductible interest is carried forward. The new interest deduction rules apply for the first time to fiscal years beginning after May 25, 2007 and ending not before January 1, 2008.

For most private equity transactions, due to the usual group context resulting from investing companies' other holdings, the exemption item (ii), above, will not be available. Therefore, depending on the importance of the German investment, local and/or group-wide financing structures may need some adaptation in order to take advantage of one of the exemptions (i) (basket amount) or (iii) (group debt-equity ratio), respectively.

**Exclusion of loss carry forward post-acquisition**

Under previous law, loss carry forwards were forfeited where the economic identity of a company was changed significantly. This was generally presumed if at least 50% of the company's share capital was transferred and the operations continued with predominantly new operating assets, a rather vague concept when applied in practice.

The new rules are clear cut, but result in an automatic forfeiture of loss carry forwards. Where more than 50% of a company's share capital is transferred within a five-year period, losses can no longer be carried forward and are "lost" for tax purposes, regardless of whether there was or was not any change in the company's operations. There is a limited pro rata loss carry forward if only 25-50% of the share capital are acquired within a five-year-period, whereas acquisition of less than 25% of the share capital during such period does not affect loss carry forwards.

More inventive (or circumventive) structures are also covered: any capital increase changing the respective participation ratios of shareholders is deemed a transfer of share capital for the purposes of the foregoing rules. Furthermore, apart from any direct or indirect transfer of share capital, the rules also apply to the transfer of other participation rights, voting rights and/or any similar fact patterns.

The new loss forfeiture rules, applicable to tax year 2008 and share transfers after December 31, 2007, will significantly affect venture capital transactions, which typically are made during a company's loss phase. It is often difficult to keep VC-funding and share capital ownership below the new 25% or 50% thresholds for any 5-year period, particularly as the new interest deduction limitations (see below) may not necessarily permit a shifting to loan-based financing structures. Trustee-type shareholding arrangements that on its face would help to avoid exceeding the above thresholds might be viewed as a similar fact pattern or a circumvention arrangement covered by the loss forfeiture rules (although there is not yet any ruling directly on point).

**Draft law on venture capital companies**

In the light of the disincentive effect on risk capital investments, the government introduced a bill regarding venture capital companies that would, among other things, provide for a limited exemption from the foregoing loss carry forward forfeiture rules. The draft law's usefulness for international transactions appears limited. It currently only applies to German-based venture capital companies which may not be part of a corporate group for more than five years after having obtained a German government license for venture capital activities (in accordance with new regulatory requirements such as minimum capital of EUR 1 million). Loss carry forwards would be maintained only up to the amount of the silent reserves of the target company, provided that the target is a non-listed corporation that has been established in the European Economic Area (EU plus EFTA countries) for no longer than 10 years and whose share capital is not in excess of EUR 20 million. The transfer of the shares to a third party during a four-year minimum holding period would result in a loss of the exemption and trigger forfeiture of such (limited) loss carry forward. The draft law is still pending at Parliament and it remains to be seen what will come out of the legislative process and whether broader regulatory requirements would ensue.

**Tax on relocation of company functions**

Restructuring plans for the post-acquisition phase will need to take account of the new German tax on the relocation of company functions. In an attempt to tax the relocated profit center potential, the tax reform introduced a tax on the intra-group outsourcing of company functions to a new location outside Germany to be determined on the basis of the (theoretically higher) value of the overall transferred package rather than only individual asset valuations. The details of this new tax regime are still unclear, but the German tax administration has announced that it intends to apply the new rules introduced by the tax reform even if requisite implementing regulations are not adopted in time. The new relocation tax regime has drawn substantial criticism, given its potential to create double taxation situations.

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## Private Equity Firms Turning to Onshore Structures in China

*By Michael Chin and David Huang*

The prevailing market practice for foreign private equity and venture capital investors looking to invest in a Chinese company has, until recently, been to use an offshore structure. This typically entails using an offshore special purpose vehicle (such as in the BVI or Cayman Islands) established by the founders which will then acquire and hold the existing Chinese business operated by the founders. However, such method of investing, commonly known under the Chinese regulations as a "round-trip" investment, has essentially become unviable since the promulgation of the Regulations on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors (the "New M&A Rules") in August 2006.

The New M&A Rules have strengthened the regulation of "round-trip" investments by requiring approval of the Chinese Ministry of Commerce at the central level for any acquisition by an offshore company formed or controlled by any person affiliated with the Chinese target company. Such approval has been extremely difficult, if not impossible, to obtain.

With the continuing insatiable appetite for foreign capital in China and few pre-2006 restructured companies now available for investment, private equity firms have turned to alternative structures, including investing directly onshore through a Sino-foreign joint venture under the foreign-invested enterprise (FIE) laws.

The problem is that the FIE laws were introduced with the view to accommodating long term strategic direct investments, mainly in greenfield projects, and not the shorter-term, more sophisticated financial investments made by private equity firms.

Notwithstanding these fundamental difficulties, private equity firms and their advisors have found a way to build into these onshore JV structures the kind of rights and protections one would expect to see in a minority private equity investment, although not without a degree of uncertainty and risk.

### Onshore Preference Rights

Private equity investors are typically issued preferred shares which entitle the preferred shareholders to enjoy certain preferential rights over the common shareholders. Under Chinese law, the premise for a Sino-foreign joint venture is shareholder equality and mutual benefit, and as such preferred shares per se cannot be issued. However, the new Company Law of China, as well as other recent regulatory reforms, provide more structuring flexibility for private equity funds to replicate, to the extent possible, the features of their offshore investments in their onshore investments in China.

Under China's new Company Law, which also applies to FIEs such as Sino-foreign joint ventures, it is possible to provide contractually for both a preferential payment of dividends and a liquidation preference.

Another feature of private equity investments in China are valuation adjustments or performance ratchet mechanisms. Such valuation adjustment mechanisms will normally be provided through a an adjustment to the conversion price and effected through an exchange of preferred shares for a larger number of common shares if the investee company fails to meet certain financial targets.

Again, whilst there can be no conversion of preferred shares into common shares when investing through a joint venture, such mechanism can still be implemented by introducing a so-called "betting" clause in the shareholders agreement.

Typically, such clause provides that the founder(s) of the company shall transfer a certain percentage of equity interest in the company to the investors without consideration if the company does not meet certain financial performance targets. As a further protection, the investors can require the founders to pledge a certain percentage of their equity interest in the company to the investors in advance.

The new Company Law also permits greater flexibility for shareholders in determining their voting rights in a company. Importantly, no Chinese laws or regulation prohibit a Sino-foreign joint venture from incorporating certain protective provisions into its shareholders agreement and articles of association to provide the foreign investors with veto rights in respect of certain major corporate actions or transactions.

Redemption rights are another feature that are permissible under the new Company Law in certain circumstances. In addition to the statutory right, redemption rights can be granted if agreed to by all shareholders. However, such redemption of equity ownership will result in a reduction of the registered capital of the investee company, which may give rise to certain statutory obligations under the Company Law, including a notice to creditors and public announcement of the redemption, repayment of outstanding debts or provision of security by the company in favor of creditors.

**Government Approval Uncertainty**

Unlike offshore investments, any foreign investment in China under the current foreign investment regime, including both “greenfield” projects and the acquisition of existing Chinese businesses, is subject to a multi-step, multi-agency government approval process. The nature and level of approvals required generally depends on the industry involved, amount invested and, in the case of an acquisition, the ownership of the target (e.g. state-owned, private, or publicly listed).

Although China has undertaken a series of broad legal reforms since its entry into the WTO several years ago, the legal framework of China still lacks transparency, stability and consistency which, combined with a large degree of discretion exercised by the government authorities, subjects foreign private equity investments to a substantial degree of uncertainty which may only crystallize at a late stage in the investment process.

Unfortunately, there have been instances where the relevant government authority has simply refused to approve a transaction on the basis that the terms and conditions are in violation of the principle of shareholder equality and mutual benefit. Even more problematic is the situation where, after closing the transaction, the private equity investor is prevented from exercising a preference right due to an inability to obtain government approval. For example, government approval may not be forthcoming for a reduction of registered capital of the Sino-foreign joint venture upon exercise of a redemption right.

**Lack of Exit Options**

The other primary concern for private equity investors going onshore are the available avenues for an IPO exit. Unlike an offshore investment, where the investors typically achieve an exit through listing of the offshore holding company on an overseas stock market such as the Hong Kong Stock Exchange, New York Stock Exchange or NASDAQ without incurring burdens to obtain Chinese government authorities’ approvals, the investors of an onshore company will have to consider exiting through listing on a Chinese domestic stock exchange (i.e., the Shanghai Stock Exchange main board or the Shenzhen Stock Exchange small and medium size enterprises board). Furthermore, the traditional “red-chip” listing is no longer viable because the New M&A Rules have practically closed the door on the necessary pre-IPO restructuring process.

Whilst the Shanghai and Shenzhen Stock Exchanges have become more attractive as they have continued to improve in the past few years, in contrast to a listing on a recognized overseas stock market, a domestic listing candidate must have a long track record of profitability—a criterion that most start-up companies find difficult to meet. Moreover, from the investors’ point of view, they must face a potentially long post-IPO lock-up period, ranging from one year to three years depending on the timing of the investment made and the shareholding percentage held by such investors.

**Where to Next?**

It’s not clear whether the rules in China will be further amended to bring back the ability for private equity investors to structure their investments offshore. However, what is clear, is that private equity investors desiring to do deals in China continue to find creative ways to do so.✤

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## Amendments to SEC Rules 144 and 145 Became Effective February 15

*By Bryn R. Vaaler*

On February 15, 2008, the most significant amendments in over a decade to Rule 144 under the Securities Act of 1933 went into effect. Rule 144 is the primary legal means, without Securities Act registration, by which (1) an affiliate (typically, a director, officer or significant shareholder) of the issuer may resell any securities of the issuer into the public market, and (2) anyone may resell "restricted securities" (typically, those acquired in exempt transactions and not in a registered offering or open-market purchase) into the public market.

The latest Rule 144 amendments:

- reduce the required holding period for restricted securities issued by companies that have been subject to SEC reporting requirements for at least 90 days ("reporting companies") from one year to six months.
- eliminate all Rule 144 restrictions other than the holding period for resale of restricted securities by non-affiliates (except that non-affiliates must comply with the current public information requirement when they resell restricted securities of reporting companies until they have completed a one-year holding period).
- relax the Rule 144 restrictions that remain in place for affiliates by (1) raising thresholds for Form 144 filing from 500 shares or $10,000 to 5,000 shares or $50,000; (2) eliminating the manner-of-sale requirement for "debt securities" (defined to include non-participatory preferred and asset-backed securities); and (3) adding a new alternative volume limitation permitting resale of up to 10% of a tranche or class of debt securities per three months.

The amendments also codify in the text of Rule 144 several important interpretations by the SEC staff, including those permitting tacking of holding periods in holding-company reorganizations and in cashless exercise of options and warrants and those restricting use of Rule 144 by "shell companies" (companies with no or nominal operations and either no or nominal assets or assets limited to cash or cash equivalents).

At the same time these important amendments to Rule 144 went into effect, amendments to Rule 145 under the Securities Act also went into effect. These amendments eliminate application of the Rule 145(c) "presumptive underwriter" provision to business combination transactions (e.g., mergers, exchanges) that do not involve a shell company. This important change makes securities issued in business combination transactions that are registered under the Securities Act freely tradeable in the hands of an affiliate of the acquired company if such affiliate does not become an affiliate of the acquiring company.

The amendments to Rule 144 and Rule 145 will apply to securities whether acquired before or after the effective date. The full text of the Rule 144 and 145 amendments is available in the SEC's adopting release at http://www.sec.gov/rules/final/2007/33-8869.pdf

These amendments add important new liquidity for securities sold in exempt financings and in business combination transactions. They are likely to have a significant impact on the terms and structuring of such financings and transactions by decreasing incentives for Securities Act registration generally, making Rule 144A, PIPES and other exempt financings more attractive and reducing or eliminating the need for onerous registration rights.✤

## Dorsey Locations Around the World

Your business operates in a global marketplace. Your lawyers should too. From 18 offices in the United States, Canada, Europe, and Asia, more than 650 Dorsey attorneys collaborate with clients to create solutions built on service and a determination to succeed. Geographical reach and vast experience enable Dorsey to handle complex legal work wherever you conduct business.

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