FRIED FRANK

Letter from the Editors

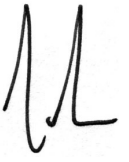
To our Friends and Colleagues,

We are delighted to publish a new issue of *Fried Frank PEP Talk*®, our newsletter for private equity professionals. As the financial markets continue to recover and the pace of deal activity increases, we believe it is an ideal time to address current issues that affect private equity funds and transactions.

Our feature article highlights the considerations faced by financial sponsors when structuring IPOs of portfolio companies. This issue also includes articles discussing recent developments in the financing markets, the FDIC's guidelines with respect to private equity investments in insured depositary institutions, potential SEC registration of private fund managers, and sponsor considerations in connection with secondary-market transactions in fund interests.

We hope these articles will be useful to you and look forward to working with you in 2010.

Robert C. Schwenkel
Co-Editor-in-Chief



John E. Sorkin
Co-Editor-in-Chief

Winter 2010

Fried Frank PEP Talk®

friedfrank.com/PEPTalk

FRIED FRANK

Preparing for the Portfolio Company IPO

By Robert C. Schwenkel and John E. Sorkin

With the reopening of the capital markets to equity IPOs over the past several months, there have been an increasing number of IPO filings for private-equity backed issuers. Portfolio companies considering an IPO need to address a number of organizational and governance issues in connection with preparing for a potential IPO.

IPO Entity

The sponsor should consider the need for an internal reorganization prior to filing the IPO registration statement, since in some cases there may be legal, tax, accounting or securities law reasons to take actions before filing the initial S-1 registration statement, before commencement of the road show, before the effective date of the registration statement and/or before closing. Sometimes, a new holding company will be created or various entities in the family merged or reorganized in contemplation of the IPO, in which case consents may be required under existing credit and other agreements. A subsidiary of the new public company may already file reports with the SEC as a result of a prior debt financing, in which case, subject to any contractual limitations, the public company can issue a guarantee and eliminate the subsidiary's separate reporting requirements.

Board of Directors and Committees

While many of the NYSE and Nasdaq rules relating to Board and Committee composition do not apply to "controlled" companies, the composition of the Board will likely need to change in connection with the IPO. A company generally qualifies as a "controlled" company so long as the sponsor (or a group of sponsors) holds more than 50% of the voting power.

Independent Directors

NYSE and Nasdaq rules both require that a listed company have a majority of independent directors unless it is a controlled company. Even if the company is controlled, however, SEC rules relating to the composition of a listed company's Audit Committee (which must have at least three members) require that the Audit Committee include at least one independent director at the time of the IPO, at least two independent directors within 90 days of the IPO and at least three independent directors by the first anniversary of the IPO.

Under NYSE rules, an individual is "independent" if the Board concludes that he or she does not have any material relationship with the issuer (directly or as a partner, stockholder or officer of an organization that has a relationship with the company). For Nasdaq-listed companies, the individual must have no relationship which, in the opinion of the Board, would interfere with the exercise of independent judgment in

(continued on page 2)

Inside

Recent Trends in Acquisition Financings
Page 3

House of Representatives Passes Bill to Require Registration of Private Fund Managers
Page 5

Bank Control Rules Evolving to Balance Need for New Capital and Regulatory Policies
Page 7

Heightened Manager Concerns for Secondary Transfers
Page 9

Fried Frank PEP Talk® Winter 2010 Copyright © 2010. Fried, Frank, Harris, Shriver & Jacobson LLP. All rights reserved.
Attorney Advertising.

carrying out the responsibilities of a director. In addition, the director must satisfy a number of additional tests. While affiliation with a controlling stockholder would not, in itself, disqualify an individual from being considered independent, certain financial and other arrangements between the sponsor and the portfolio company (such as the payment of management fees) in the period prior to the IPO may disqualify such a person from serving as an independent director. In addition, SEC rules governing Audit Committee independence prohibit affiliates from serving on the Audit Committee and, as a result, senior officers of the sponsor will generally not be considered independent directors for purposes of the Audit Committee rules.

Audit Committee Financial Experts

Each member of the Audit Committee must be financially literate or become so within a reasonable period of time (NYSE), or must be able to read and understand fundamental financial statements (Nasdaq). In addition, at least one Audit Committee member must be an "Audit Committee financial expert" at the time of the IPO, which requires that the member (1) understand GAAP and financial statements, (2) be able to assess the application of GAAP to accounting for estimates, accruals and reserves, (3) have experience preparing, auditing, analyzing or evaluating financial statements (or experience supervising persons engaged in such activities), (4) understand internal controls, **and** (5) understand Audit Committee functions. In addition, an Audit Committee financial expert must have (a) education as a CFO, CAO, controller, accountant or auditor, (b) experience actively supervising a CFO, CAO, controller, accountant or auditor, (c) experience overseeing or assessing the performance of companies or accountants with respect to the preparation, auditing or evaluation of financial statements, **or** (d) other relevant experience. While an individual associated with the sponsor may, subject to the SEC's Audit Committee independence requirements, serve on the Audit Committee and qualify as an Audit Committee financial expert, the increased potential liability associated with serving on the Audit Committee may make it preferable to select unaffiliated Audit Committee members (and, in any event, to select a non-sponsor director as the Audit Committee financial expert). Indeed, many sponsors, as a policy matter, prohibit their investment professionals from serving on Audit Committees.

Compensation Committee, Rule 16b-3 and IRC §162(m)

A controlled company does not need to have a Compensation Committee and, if it does have one, there are no requirements relating to its composition. However, if the issuer will not be a controlled company, then, subject to post-IPO transition rules, NYSE rules require that there be a Compensation Committee consisting solely of independent directors, and Nasdaq rules require either a Compensation Committee consisting solely of independent directors or that compensation decisions be determined only by independent directors. Legislation recently passed by the U.S. House of Representatives would require public company Compensation Committees to consist solely of independent directors. It is not clear if this provision will ever become law or, if it does become law, whether there would be an exception for controlled companies.

In order to comply with SEC Rule 16b-3 and Section 162(m) of the Internal Revenue Code, some companies establish a subcommittee of the Compensation Committee consisting of at least two independent directors. Rule 16b-3 exempts certain common stock-related transactions between the company and a director or executive officer from the short-swing profit recapture provisions of Section 16(b) of the Securities

(continued on page 11)

Recent Trends in Acquisition Financings

By F. William Reindel and Damian P. Ridealgh

The acquisition financing market showed gradual but steady improvement in 2009. In the spring of 2009, financing commitments for acquisitions by investment grade issuers, such as in the Pfizer/Wyeth and Merck/Schering-Plough transactions, were arranged as short-term bridge loans to be quickly taken out through asset sales or capital market debt issuances. By summer, confidence had returned to the point that seasoned, but more leveraged, issuers were able to arrange financing for significant bolt-on acquisitions and refinance their existing credit facilities, as was the case with Warner Chilcott's acquisition of Procter & Gamble's pharmaceutical business. Most recently, private equity sponsors obtained financing commitments for new leveraged buyouts, including Blackstone's acquisition of Anheuser-Busch InBev's theme park business, TPG's and CPP Investment Board's acquisition of IMS Health (the first public to private buyout announced since May 2008) and General Atlantic's and KKR's acquisition of the TASC division of Northrop Grumman – though all these transactions featured lower leverage and were far smaller in size than 2007's mega-buyouts.

Since the onset of the credit crisis, financing commitments have evolved to reflect ongoing market challenges, including higher pricing, financial covenants tied to the sponsor's business plan and tighter negative covenants. Further, arrangers are keenly aware of the warehousing risk posed by failed syndications, and have sought to expand their syndication rights–including wider pricing and structural flex–to account for this risk. Likewise, recent well-known litigations in which parties have sought to enforce financing commitments against lenders, with results often turning on the precise terms of the commitments, have naturally caused sellers, buyers and financing sources alike to focus intensively on the conditions under which financing commitments for new transactions may be drawn. At the same time, however, new commitments may include market-accepted borrower-friendly flexibilities derived from sponsor experiences with portfolio company balance sheet restructurings over the past 18 months, such as provisions allowing below par buy-backs, exchange offers and "amend and extend" rights without unanimous consent.

Further, arrangers are keenly aware of the warehousing risk posed by failed syndications, and have sought to expand their syndication rights–including wider pricing and structural flex–to account for this risk.

Broadening Syndication Rights and Increased Flex

Prior to the 2007 credit crisis, commitment letters often gave sponsors significant control over the syndication of financing risk by arrangers prior to the closing of the acquisition. While the buyer was required to cooperate with syndication efforts, the arranger remained "on the hook" for funding through closing, and borrowers often retained broad discretion over the timing of syndication and the composition of the syndicate (including veto rights over participating lenders). Arrangers relied on their limited "flex" rights to market difficult syndications.

As the market for leveraged acquisitions began to return in early 2009, arrangers sought to expand their syndication rights. Recent transactions seek to balance the sponsor/borrower's need for certainty (including having a known counterparty in the event that a consent or waiver is needed prior to closing) with the need for arrangers to quickly move exposure off their balance sheets.

(continued on page 4)

Recent Trends in Acquisition Financings

(continued from page 3)

One approach, illustrated in the Pfizer/Wyeth and Merck/Schering-Plough transactions, allowed the arranger to syndicate its commitment to a limited "club" of money center banks after announcement of the transaction, at which point the arranger was released from the syndicated portion of the commitment. In other transactions, such as Warner Chilcott's acquisition of Procter & Gamble's pharmaceutical business, the initial syndication was completed prior to the announcement of the transaction (with six banks each underwriting an equal portion of the total facilities, and none released from its proportional obligation until closing). Finally, several recent commitments have provided arrangers with greater flexibility to syndicate to buy-side accounts with the sponsor having consultation (rather than consent) rights as to the members of the syndicate. In most transactions, the syndication provisions require the lead arrangers to retain all rights to give consents or grant waivers with respect to the commitment until the closing of the financing.

Additionally, sponsors and arrangers are seeking out large buy-side investors, including large debt and hedge funds, to serve as anchor orders for the financing much earlier in the process than was the case in 2007. This helps test the market early in a financing, and ensures that broader syndication efforts will be successful. If appropriate, sponsors may need to address the diligence and economic needs of these investors in their bidding and negotiation timelines.

Arrangers are also mitigating syndication risk by negotiating wider pricing and structure "flex" than in 2007 financings. The degree of flex will obviously depend on fundamentals, including closing date leverage, industry conditions and the length of time between signing and closing. Pricing flex can include increases in interest rate margins (which can be taken through up-front discounts or fees), increases in minimum LIBOR and base rate floors and ticking fees on commitments that extend beyond a certain date. Structure flex can include reducing the absolute size of the senior facilities, moving some of the senior secured tranche to a mezzanine or high-yield tranche and conversion of secured term loans into *pari passu* secured bonds to be issued in a high-yield transaction. Both the borrower and seller must analyze the impact exercising flex may have on the basic sources and uses for the transaction to ensure that there is not a shortfall of funds at closing and/or a backdoor condition to funding.

Conditionality

2009 also saw a renewed focus on aligning conditionality in the financing commitments and acquisition agreement. The economic consequences to a buyer who is unable to obtain financing for a transaction are likely to be significantly greater than in 2007. Reverse break fees (or liquidated damages clauses) in recent transactions have approached or exceeded 6% of the deal consideration, and are no longer automatically symmetrical with the fees paid by sellers to terminate the agreement under "fiduciary out" clauses. Further, some buyers are agreeing to specifically enforceable covenants to complete a proposed transaction without an option to walk away by paying a reverse break fee. These covenants include the buyer's obligation to use strong efforts to obtain the financing under its debt commitment letters and to seek to enforce the commitment against the debt financing sources.

In this context, financing sources must be clear about the level of risk they are willing to underwrite. In some transactions, a specific "bright line" condition relating to minimum EBITDA, maximum leverage or ratings can quantify the acceptable level of risk. These bright-line triggers, however, are not likely to become common in private equity acquisitions with no financing out, as sponsors will strongly resist backstopping these conditions for their own account. Accordingly, key conditions, such as Company MAC, documentation and marketing period, must be carefully negotiated to allocate risk properly.

(continued on page 16)

House of Representatives Passes Bill to Require Registration of Private Fund Managers

By Richard I. Ansbacher, Jessica Forbes, Kenneth I. Rosh and Shanna Cohn

On December 11, 2009, the U.S. House of Representatives passed the "Wall Street Reform and Consumer Protection Act of 2009" by a vote of 223 to 202. The 1,279-page bill includes substantial changes added by amendment on December 10, 2009, and would bring about numerous reforms to the financial services regulatory system, including with respect to consumer protections, enhanced SEC regulatory authority, and regulation of entities perceived as posing systemic risks. The bill would enact, among other measures, the "Private Fund Investment Advisers Registration Act of 2009," to amend the Investment Advisers Act of 1940 by requiring SEC registration of many currently-exempt private fund managers, including most private equity fund managers, as well as the "Investor Protection Act of 2009," intended to strengthen investor protections for customers of investment advisers and broker-dealers. These reforms would, if approved by the Senate and signed into law by the President, establish significant new registration, reporting, recordkeeping, and disclosure requirements affecting many private funds and their advisers, and would impact advisers who are currently unregistered, as well as those who are already registered with the SEC.

The legislation would eliminate the "fewer than 15 clients" exemption under the Advisers Act, upon which many private equity fund managers currently rely to avoid SEC registration.

Repealed Exemptions from Advisers Act Registration

The legislation would eliminate the "fewer than 15 clients" exemption under the Advisers Act, upon which many private equity fund managers currently rely to avoid SEC registration. In addition, advisers to private funds would no longer be able to claim exemption under either the intrastate exemption for advisers whose clients are all residents within the state in which the adviser has its principal place of business or the exemption for advisers registered with the Commodity Futures Trading Commission as a commodity trading advisor. Under the bill, a "private fund" is any fund that would be an investment company under the Investment Company Act of 1940, but for the exceptions provided under Section 3(c)(1) or Section 3(c)(7) thereof.

New Registration Exemptions under the Advisers Act

Certain advisers to private funds would be exempt from registration under the Advisers Act, including:

- Any investment adviser to a "venture capital fund" (to be defined by the SEC),
- Any investment adviser that "acts solely as an adviser to private funds" and has assets under management (AUM) in the United States of less than $150 million,
- Any investment adviser solely to small business investment companies licensed by the Small Business Administration, and
- Any investment adviser who has no place of business in the United States and, during the preceding 12 months, has had (i) in total, fewer than 15 clients and investors in the United States in private funds advised by the investment adviser and (ii) aggregate AUM attributable to clients and investors in the United States in private funds advised by the investment adviser of less than $25 million (or such higher amount as the SEC may determine).

(continued on page 6)

(continued from page 5)

Venture capital fund advisers and private fund advisers with less than $150 million in AUM would have recordkeeping and reporting obligations as the SEC determines are necessary or appropriate in the public interest or for the protection of investors, while advisers to SBICs and exempt foreign advisers would be exempt from registration, reporting, and recordkeeping requirements.

Special Considerations for Non-U.S. Advisers

Non-U.S. advisers should be aware that, unlike in earlier versions of the legislation:

- The bill does not limit the definition of "private fund" to funds formed in the United States or to funds having a certain threshold of ownership by U.S. persons, and
- An adviser must count both its clients and private fund investors in the United States (and the aggregate AUM attributable to them) to determine whether it qualifies for the foreign private fund adviser exemption.

A non-U.S. adviser who does not qualify for the foreign private fund adviser exemption potentially may qualify for exemption from registration (but not reporting) if it acts solely as an adviser to private funds and has assets under management in the United States of less than $150 million. The legislation does not define "assets under management in the United States" or address whether an adviser would be required to look through an offshore fund to include amounts invested by U.S. persons towards the $150 million threshold.

Advisers to "Mid-Sized Private Funds"

The legislation grants the SEC authority to provide for registration and examination procedures with respect to investment advisers to "mid-sized private funds," taking into account the size, governance, investment strategy, and level of systemic risk posed by such funds. "Mid-sized private funds" are not, however, defined in the legislation, and it is unclear how this provision relates to the exemption for advisers with AUM in the United States of less than $150 million.

Reporting and Recordkeeping Requirements

All registered advisers would be required to maintain records and report to the SEC, on a confidential basis, regarding the private funds they advise as "necessary or appropriate in the public interest and for the protection of investors or for the assessment of systemic risk" as the SEC determines in consultation with the Federal Reserve Board. These records and reports would include, at a minimum, for each private fund:

- Amount of AUM,
- Use of leverage (including off-balance sheet leverage),
- Counterparty credit risk exposures,
- Trading and investment positions, and
- Trading practices.

The SEC could also impose additional reporting requirements as it deems necessary and, in making its determination, "may set different reporting requirements for different classes of private fund advisers, based on the particular types or sizes of private funds advised." This rulemaking authority does not require that the SEC consult with the Federal Reserve Board, and leaves open the possibility that unregistered private fund advisers could become subject to SEC reporting requirements. In addition, the SEC would be empowered to require registered private fund advisers to disclose "such reports, records, and other documents to investors,

(continued on page 20)

Bank Control Rules Evolving to Balance Need for New Capital and Regulatory Policies

By Thomas P. Vartanian

The manner by which the agencies that oversee U.S. financial institutions regulate private equity investment in the banking business profoundly affects the ability of failing banks to attract capital, avoid taxpayer bailouts and minimize losses to the Deposit Insurance Fund. However, private investors that have sought to structure non-controlling investments in failing banks may feel like they are not welcome to assist failing banks after the Federal Deposit Insurance Corporation recently proposed and adopted a policy statement regarding investments in failed banks. While the FDIC's final Statement of Policy dialed back certain proposals that were likely to significantly dampen private equity interest in troubled financial institutions, other aspects of the Statement will put private equity investors at a significant disadvantage to other potential investors when considering such investments.

The FDIC Policy Statement

In July 2009, the FDIC proposed a policy statement identifying certain core concerns with respect to private equity investment in failing institutions. While the proposal singled out private equity investments for increased scrutiny and regulation, it did not explain why banks owned by passive private equity investors posed greater risks to the Deposit Insurance Fund than institutions controlled by traditional publicly-traded shell holding companies. Despite significant criticism, the FDIC moved quickly to adopt the final Statement on August 26, 2009. While the Statement continues to single out private equity investors, the FDIC moderated a few of the most troublesome aspects of its initial proposal.

On December 11, 2009, the FDIC issued a set of interpretive FAQs, which it withdrew twenty-four hours later for reasons that were not made public. On January 10, 2010, the FDIC re-released the FAQs, which essentially address situations where certain interests of private investors in failed bank transactions would be exempt from the policy statement. Specifically, in order for a joint venture of private investors with an established banking organization to be exempt, the banking organization (or, in certain circumstances, its shareholders) must hold at least two-thirds of both voting and total equity of the investment vehicle. The FAQs also suggest that private equity investors may be found to be engaged in "concerted action" under circumstances not covered by other control regulations, which raises additional questions.

The Statement does not apply to, and strongly encourages, partnerships or joint ventures between private equity investors and established bank or thrift holding companies in which the holding company has a "strong majority interest" in the resulting bank or thrift.

Applicability

The Statement does not apply to "private investors" that own 5% or less of the total voting power of an acquired bank or its holding company, provided that there is no evidence of concerted action by investors. In contrast, the Board of Governors of the Federal Reserve System (FRB), the Office of the Comptroller of the Currency (OCC) and the Office of Thrift Supervision (OTS) generally trigger their control analyses at 10% of the voting stock of a bank or its holding company.

The term "private investor" is not defined and the FDIC has reserved to itself significant discretion to determine when the Statement applies. Investors can apply to terminate the application of the Statement if the covered institution has continuously received one of the top two composite ratings for safety and soundness for seven years.

(continued on page 8)

Bank Control Rules Evolving to Balance Need for New Capital and Regulatory Policies

(continued from page 7)

In contrast, the Statement does not apply to, and strongly encourages, partnerships or joint ventures between private equity investors and established bank or thrift holding companies in which the holding company has a "strong majority interest" in the resulting bank or thrift. This may create the opportunity for private equity investors with an appetite for making non-control investments to make significant investments in existing banks that would then take advantage of federal assistance to acquire troubled depositary institutions.

Capital Requirements

The Statement establishes independent capital requirements in addition to those already established by the FRB, OCC and OTS for bank holding companies, national banks and savings associations, respectively. Specifically, covered institutions must maintain a minimum ratio of common equity to total assets of 10% for three years, approximately double what a strategic buyer would be required to do. Under the initial proposal, such banks would have been required to maintain at least a 15% ratio of Tier 1 capital to total assets (which would have included perpetual preferred stock and other non-common-equity elements which cannot be taken into account under the Statement).

After three years, the new or acquired institution must maintain capital ratios sufficient to qualify as "well capitalized" under the prompt corrective action (PCA) provisions of the Federal Deposit Insurance Corporation Improvement Act of 1991. There is no express requirement for private investors to contribute additional capital to the institution, though current investors could face substantial dilution if the institution is compelled to raise capital from new investors in order to meet "well capitalized" standards.

Investors could face substantial dilution if the institution is compelled to raise capital from new investors in order to meet "well capitalized" standards.

If the bank falls below the required capital ratio, ***it*** (not the holding company or investors) is required to take immediate steps to come into compliance. However, given that PCA is the responsibility of the FRB, OCC and OTS with respect to State member banks, national banks and savings associations, respectively, it is not clear how the FDIC would enforce these "enhanced" PCA requirements.

Source of Strength

Although the FDIC's initial proposal would have required that non-controlling private equity investors agree to serve as a limited source of strength for subsidiary banks or thrifts by agreeing to raise additional capital through the issuance of equity or qualifying debt, the FDIC dropped this requirement in the final Statement.

Cross Guarantee Liability

Overlapping groups of private investors that hold 80% or more of two or more covered institutions must pledge their stock in each such institution to pay for any losses suffered by the Deposit Insurance Fund as a result of the failure of, or providing assistance to, any other such institution. Under the initial proposal, this threshold would have been set at 50%. The FDIC has not explained whether the 80% threshold applies to voting shares, total equity or, conceivably, combined debt and equity, nor why an investor who is a member of such a group, but that cannot control a bank or thrift, should be required to provide a cross guarantee.

Transactions with Affiliates

Insured depositary institutions are already subject to quantitative and qualitative restrictions on extensions of credit to, or for the benefit of, their non-banking, non-subsidiary affiliates. However, the Statement expands these prohibitions to covered transactions with any private equity investor in a covered institution, its affiliated investment funds and any portfolio investment in which the investor or fund has an at least 10% equity interest. In contrast, the

(continued on page 21)

Heightened Manager Concerns for Secondary Transfers

By Richard I. Ansbacher, Kenneth I. Rosh and Rebecca Neuschatz Zelenka

Liquidity concerns created by the recent financial crisis have resulted in fund managers receiving an unprecedented number of requests by investors to transfer interests in private equity funds. In particular, certain investors need to liquidate some of their holdings, even at low valuations, while others are looking for ways to avoid defaulting on their capital commitments. Although fund managers have, in the past, generally dealt with transfer requests as an accommodation to investors, current conditions may motivate fund managers to be more accommodating to these investors.

- Secondary transfers may help avoid investor defaults, which reduce the size of the investment pool and may have an adverse impact under a fund's contractual arrangements, including credit facilities. In addition, imposing remedies on defaulting investors may lead to complications and uncertainties in the operation of the fund.
- Because fund managers are generally interested in building a foundation of strong investors for future funds, admitting replacements for defaulting or financially weaker investors is an opportunity to build toward this goal.
- Secondary purchasers investing at today's reduced valuations may be more inclined to work with fund managers who may be looking to modify the terms of an existing fund or form follow-on vehicles.
- Accommodating a transfer by an investor with liquidity concerns may lay the groundwork for a future relationship once the transferring investor again has capital to invest.

The transfer provisions in many fund documents do not address situations arising in the current environment.

While there are many benefits to facilitating secondary transfers, fund managers should take into account various considerations before approving any transfer request.

Ambiguities in Fund Documents

The transfer provisions in many fund documents do not address situations arising in the current environment. For example:

Manager Acquiring Discounted Interests

Because of liquidity needs or fear of default, investors may be willing to transfer fund interests for deeply discounted prices. For various reasons (including trying to efficiently resolve potential default situations), fund managers may want to acquire these interests for their own account. Fund documentation, however, is often not clear on whether the manager can acquire discounted interests without offering the purchase opportunity to other fund investors. This situation is complicated by the fact that if the investor were to default, in many circumstances, the other investors would be credited with a portion of the defaulted interest. Therefore, there is a potential conflict if the manager acquires the interest at a steep discount prior to a likely investor default. Certainly, if the fund documents give current fund investors a right of first refusal or pre-emptive rights, those provisions would apply. But even in the absence of those provisions, the manager may be in a difficult situation in deciding whether to acquire the interest and at what price.

(continued on page 10)

Heightened Manager Concerns for Secondary Transfers

(continued from page 9)

Waiving Default Interest

In many circumstances, fund interests are sold after the investor has failed to meet a capital call. Almost all fund documents allow (and some require) the manager to impose late-payment interest charges on a delinquent investor. However, many fund documents do not address whether the fund manager has the discretion to waive interest that has accrued after a default in order to facilitate the sale of the interest. Although the fund manager in such a situation could reasonably take the position that it is in the best interests of all investors to facilitate a sale in lieu of a default, it is more difficult to take this position when the fund documents require that interest be charged.

Heightened Risks for Fund or Manager

Fund managers may face additional credit and other risks from transfers of interests.

Liability for Clawback Obligations

In general, fund-transfer agreements require the transferee to step into the shoes of the transferor with regard to all liabilities associated with the acquired interest. Accordingly, the transferee is typically responsible for meeting all capital call obligations, including those associated with an investor clawback (i.e., a recoupment of prior distributions to cover fund liabilities). In some cases, however, the transferor and the transferee may agree outside of the fund documentation, and without informing the manager, that the transferor will remain liable for these obligations. For example, the purchase and sale agreement between the transferor and transferee, to which the fund and the manager are not parties, may require the transferor to satisfy any investor clawback obligations relating to fund realizations prior to the transfer. In the event that an investor clawback arises in the future, the transferee may take steps to avoid the obligation, attempting to pass responsibility to the potentially financially constrained transferor. While the fund manager would ultimately have the legal right to recover from the transferee, there may be delays, enforcement costs, and potentially, damage to the manager's relationship with the investor.

When considering what action to take in a particular situation, a manager should take care to treat all defaulting investors fairly, to take actions that best fit the particular circumstances, to consider the precedent created by its actions and to consider the best interests of the fund and investors in evaluating default remedies.

Limited Liability Blocker Entities

A transferee may attempt to acquire a secondary interest through an entity that insulates the ultimate purchaser from liabilities associated with clawbacks or other unanticipated capital calls. In prior economic times, many fund managers paid little attention to investors who structured their investments through limited liability, judgment proof entities, especially when these entities were put in place for tax planning purposes. In the current economic environment, however, fund managers must pay attention to the entity that is admitted to the fund as part of a transfer, and should consider requiring parent guarantees for the financial obligations associated with becoming an investor.

Additional Manager Representations

Secondary investors generally conduct due diligence on funds and fund managers as part of their acquisition of a fund interest. Fund managers must balance their desire to facilitate a transfer with the need to protect themselves from potential liability. For example, if a potential transferee is reviewing the fund's financial statements, the fund manager should make clear in any transfer documents that the financial statements were not intended to be used for (and should not be relied upon for) determining the purchase price of an interest. Managers should be particularly careful not to make representations regarding potential investor clawbacks or recycling provisions. In addition, sharing detailed information with a potential secondary investor that is not shared with all fund investors can create an information asymmetry between the selling investor and the secondary investor, as well as between the secondary investor and the other investors.

(continued on page 23)

(continued from page 2)

Exchange Act of 1934. To comply with Rule 16b-3, equity grants or awards to directors or executive officers must be approved by the full Board or by a committee composed solely of two or more "non-employee" directors. In addition, Section 162(m) of the Internal Revenue Code prohibits a publicly held company from deducting compensation in excess of $1 million per year paid to certain senior officers. This limitation does not apply, however, to compensation based on performance goals established by a Compensation Committee consisting of two or more "outside directors."

Nominating/Corporate Governance Committee

Unless an issuer is a controlled company, subject to post-IPO transition rules, NYSE rules require that it have a Nominating Committee consisting solely of independent directors, and Nasdaq rules require that either the issuer have a Nominating Committee consisting solely of independent directors or for nominating decisions to be made only by independent directors. While a controlled company is not required to have a Nominating Committee, SEC rules require the issuer to disclose whether it has a Nominating Committee and, if not, to explain the reasons and disclose a significant amount of information regarding the nominating process. In light of these disclosure requirements, many controlled companies establish a Nominating Committee, even though it is not required by NYSE or Nasdaq rules.

Director Nomination Rights

In some cases, the sponsor and issuer will enter into a written agreement granting the sponsor the right to nominate a specified number or percentage of directors, which may ratchet down based on ownership levels.

Pre-IPO Reorganization

As discussed above, legal, tax, accounting and securities law considerations may make it desirable to restructure the company prior to the IPO, when the directors will begin to owe fiduciary duties to the public stockholders. In addition, the sponsor will need to establish certain rights and unwind certain relationships with the portfolio company prior to the IPO. For example:

Registration Rights Agreement

In general, it is good practice to put a registration rights agreement in place at the time of the original acquisition. However, if a registration rights agreement has not previously been entered into, the sponsor will want the company to enter into one prior to or at the time of the IPO. Typically, the sponsor will have the right to demand that the company file a registration statement covering the resale of some or all of its shares on a set number of occasions, as well as "piggyback" rights to include its shares in a registration statement filed by the company for itself or third parties. In addition, the agreement will include indemnity and contribution protections in the event the sponsor is sued in connection with sales of shares under any such registration statement. In many cases, the sponsor can require the company to file a shelf registration statement to permit the continuous resale of shares by the sponsor, and the agreement may also contemplate a registered in-kind distribution of company shares by the sponsor to its investors.

Veto Rights

The sponsor should consider whether it wants to have specific negative controls (either at the Board or stockholder level) over certain actions the company may take following

(continued on page 12)

(continued from page 11)

the IPO (e.g., M&A activity, equity or debt issuances, asset sales). These types of veto rights can be implemented in the charter or a separate stockholders agreement.

Share Transfers

Underwriters typically require the sponsor and other stockholders, including management, to agree not to sell their shares for 180 days following an IPO. While many lock-ups permit transfers to affiliates, the sponsor should consider completing share transfers to the entities which it wants to hold the stock prior to the IPO. Similarly, management and other stockholders should consider making any estate planning or similar transfers prior to the IPO.

Unwinding Management Agreement

If the sponsor has entered into a management agreement with the company providing for the payment of management and other fees, it will in all likelihood be terminated in connection with the IPO. In many cases, the company will pay the sponsor a lump sum termination fee. If an affiliate of the sponsor is a member of the underwriting syndicate, the underwriters will need to consider the potential impact of any prior management fees, as well as any fee to unwind the management agreement, on the calculation of underwriters' compensation.

Unwinding Consortium Agreement

In consortium investments, the sponsors will need to decide whether to eliminate any holding company that has been put in place to hold shares in the portfolio company, and if so, whether to implement a new stockholders agreement addressing issues such as Board representation, veto rights, restrictions on transfers and registration rights.

Loans to Directors and Officers

Public companies are not permitted to extend credit, or make loans, to their directors and executive officers. Any outstanding loans to directors and executive officers must be repaid prior to the initial filing of the IPO registration statement.

Section 13(d) Considerations

In general, a stockholder that holds more than 5% of the shares of a company prior to the time the IPO registration statement is declared effective is eligible to file a short-form Schedule 13G, rather than a long-form Schedule 13D, without regard to its aggregate ownership position or control intent. However, if the five-percent stockholder acquires additional shares after the registration statement is declared effective, then it must file (or switch to) a Schedule 13D if it acquires more than 2% of the shares in any 12-month period.

These provisions raise two important issues. First, if the company effects a restructuring in connection with the IPO and shares are issued after the effective time of the registration statement (e.g., on the pricing date), then shareholders receiving more than 5% of the shares in the restructuring will not be eligible to file a Schedule 13G unless they own less than 20% of the shares and qualify as "passive" investors. In addition, the SEC takes the position that shares acquired prior to effectiveness of the registration statement must be taken into account in calculating whether the 2% threshold has been crossed. As a result, if a shareholder that is eligible to file a Schedule 13G acquires additional shares in the 12-month period following the IPO, then any shares acquired in a pre-IPO restructuring will be taken into account in determining whether the shareholder must switch to the more burdensome Schedule 13D.

(continued on page 13)

Preparing for the Portfolio Company IPO

(continued from page 12)

Employee Benefits

The IPO will significantly affect employees who have previously received illiquid stock-based compensation, and typically results in significant changes to equity-based compensation arrangements.

Equity Compensation Plans and Awards

Companies often adopt new public-company-style equity compensation plans prior to an IPO, when the sponsor owns most of the stock and can provide the required stockholder approvals. Because a significant portion of the options previously granted to management may have vested prior to the IPO, the company will need to consider making new grants in connection with the offering.

In addition, company rights to repurchase stock from employees upon an individual's departure from the company typically expire in connection with the IPO.

Employment Agreements

The company may want to extend and/or amend existing employment agreements with senior management prior to the IPO because longer-term agreements can signify an alignment of management with the long-term interests of the company.

Director Compensation Plan

Outside directors typically receive cash fees for serving on the Board, for serving on various committees and for chairing committees. In addition, it is common to provide an annual equity award, either in the form of restricted stock or stock options.

Insurance and Indemnification Agreements

The company will need to review its D&O insurance policy in connection with the IPO. Typically, the premium will increase substantially due to the IPO. In addition, although the charter and bylaws will contain indemnification provisions for the benefit of the directors and officers, we recommend that companies enter into separate indemnification agreements with their directors (and possibly officers) prior to an IPO. Indemnification agreements should be reviewed by counsel in key countries where the company has operations, as some non-U.S. jurisdictions proscribe, or limit the extent of, such indemnification.

Legal, tax, accounting and securities law considerations may make it desirable to restructure the company prior to the IPO, when the directors will begin to owe fiduciary duties to the public stockholders.

Corporate Governance

The typical charter and bylaws for a privately-held company include terms that are not appropriate for a public company, and do no not include some common public-company provisions. It is customary to adopt a new charter and bylaws prior to the IPO. Following the IPO, the company will need to hold a stockholder meeting (or distribute an information statement) in order to make further charter amendments.

Number of Authorized Shares

The charter should authorize a sufficient number of shares of common stock to accommodate the IPO and subsequent needs, including under equity-based compensation plans, as well as an appropriate number of shares of "blank check" preferred stock. In many cases, the company will effect a stock split to create shares with an appropriate trading value prior to the IPO.

Corporate Opportunities

The charter should include a "corporate opportunities" provision to ensure that the sponsor is not prohibited from making other investments (including investments in related industries) while it is represented on the company Board.

(continued on page 14)

(continued from page 13)

Board Structure and Removal of Directors

The charter may provide for a staggered (or classified) Board, where the directors are divided into three classes of roughly equal size, with each class elected for a three-year term. If properly structured, this makes it impossible for stockholders to unilaterally effect a change in a majority of the directors at a single annual meeting because the directors may not be removed without cause. RiskMetrics and other proxy advisory firms generally oppose classified Boards. While the sponsor controls at least a majority of the voting power, it may prefer a single-class Board because it can remove directors without cause. Some IPO charters provide that the Board will become classified (and Section 203 of the Delaware General Corporate Law will become effective) when the sponsors own less than a specified percentage of the outstanding common stock. Similarly, the charter can provide that the right of stockholders to remove directors without cause is eliminated at the same time.

Majority Voting for Directors

Historically, most companies have provided for plurality voting in the election of directors. Proxy advisory firms and institutional stockholders, however, generally support adoption of majority voting in director elections, which means that a director nominee is elected only if a majority of shares voting in the election vote for the nominee. Typically, an incumbent director who does not receive the requisite majority vote must tender his or her resignation, and there is a process whereby the Board may consider whether or not to accept it. As of December 2009, approximately one-third of the S&P 1500 had adopted majority voting. However, only approximately 6.75% of companies that went public since January 1, 2007 have adopted majority voting.

If an affiliate of the sponsor is a member of the underwriting syndicate, the underwriters will need to consider the potential impact of any prior management fees, as well as any fee to unwind the management agreement, on the calculation of underwriters' compensation.

Stockholder Action by Written Consent; Special Stockholder Meetings

Unless the charter provides otherwise, stockholders holding at least a sufficient number of shares to approve the relevant action (assuming all outstanding shares entitled to vote on the matter are voted) may act by written consent without a meeting under Delaware law. For so long as the sponsor controls a majority of the voting power, it will be desirable to preserve the ability of stockholders to act by written consent, as well as the ability of stockholders to call special meetings. However, as with other provisions, the charter (or bylaws) may provide for the elimination of these rights once the sponsor's ownership falls below a specified threshold.

Poison Pill

The company will need to consider whether to adopt a shareholder rights plan (poison pill) in connection with the IPO. It is not typical for a new public company to adopt a rights plan because poison pills are generally viewed negatively by the proxy advisory firms and institutional investors. Instead, many companies have one "on the shelf" for adoption if a threat materializes.

Opt-Out of Section 203 of the Delaware General Corporate Law

Section 203 prohibits a person who acquires 15% or more of a company's common stock from completing a "business combination" with the company for three years unless (1) prior to such acquisition, the Board either approved the business combination or the transaction which resulted in the stockholder acquiring 15% of the company's common stock, (2) upon consummation of the transaction in which the stockholder acquired 15% of the common stock, the stockholder owned at least 85% of the voting stock outstanding at the time the transaction commenced, or (3) the Board and holders of two-

(continued on page 15)

(continued from page 14)

thirds of the voting stock not owned by the 15% stockholder approve the business combination. Because Section 203 potentially impairs a sponsor's ability to sell all or a portion of its remaining interest in a public company, some companies adopt charter provisions opting-out of Section 203 prior to going public, or provide for "springing" protection once the sponsor's ownership falls below a specified threshold.

Committee Charters

The NYSE and Nasdaq require Audit Committees to have charters containing specified provisions. In addition, the NYSE (but not Nasdaq) has specific requirements for Compensation Committee charters, and the NYSE and Nasdaq have specific requirements for Nominating Committee charters, but these requirements do not apply to controlled companies. Even if no requirements apply, the company should review and update its committee charters at the time of the IPO to assure that they are appropriate for a public company.

Corporate Governance Guidelines

The NYSE requires all listed companies to have corporate governance guidelines. These guidelines address director independence, committee composition, conflicts of interest and similar topics. Nasdaq does not have an equivalent requirement.

Internal Audit Function

The NYSE also requires all listed companies to have an internal audit function—either an internal auditor or an outsourced internal audit group. Nasdaq does not have an equivalent requirement.

Other Policies

If it does not already have them in place, the company will need to adopt (or review its current) insider trading and whistleblower policies, policies relating to communications with analysts and compliance with Regulation FD, disclosure controls policies, related transaction approval policies, a code of business conduct and ethics and, depending on the nature of its business, a Foreign Corrupt Practices Act policy.

Pre-IPO Communications

In general, a company preparing for an IPO can continue issuing press releases about major events consistent with past practices, issue quarterly earnings releases and hold quarterly conference calls consistent with prior practice (e.g., where required by an indenture). However, to the extent an IPO becomes more imminent, it should avoid out-of-the-ordinary press releases and interactions with the media. No one at the company or the sponsor should publicly discuss a potential IPO. All media communications should be carefully screened during the 30 days prior to filing a Form S-1 for the IPO. There should be no public discussion of expected financial results or projections. Counsel should be advised of potential management participation in public conferences at investment banks or other outside entities.

M&A Activity

Acquisitions can significantly impact the IPO process. Most importantly, once an acquisition becomes probable and the target company will be "significant" to the company, then the IPO registration statement may need to include audited financial statements with respect to the target company. Narrative disclosures about the acquisition would also need to be included in the IPO registration statement.

(continued on page 16)

Preparing for the Portfolio Company IPO

(continued from page 15)

Cheap Stock

The SEC typically looks at all equity issuances in the 12 months prior to filing the IPO registration statement for potential "cheap stock" issues. To the extent the issue price of the stock or exercise price of the options is less than the eventual IPO price, the SEC typically requires the company to take a compensation charge for the difference between the issue price and the IPO price. To the extent any equity is expected to be issued, the SEC would expect the company to have independent third party support (such as a valuation report) for the price at which the equity is issued.

Conclusions

An IPO of a portfolio company requires the same careful planning and analysis as the original investment. While much of the work needed to prepare a company for an IPO can be accomplished during the preparation of the prospectus and registration statement, other matters, such as implementation of necessary internal controls and procedures, effecting restructurings and identifying qualified independent directors, require longer-term planning. ■

Robert C. Schwenkel is a partner in the New York office and the chair of Fried Frank's corporate department and head of the Firm's private equity and M&A groups. He can be reached at +1.212.859.8167 or robert.schwenkel@friedfrank.com.

John E. Sorkin is a corporate partner in Fried Frank's New York office. He can be reached at +1.212.859.8980 or john.sorkin@friedfrank.com.

Recent Trends in Acquisition Financings

(continued from page 4)

Company Material Adverse Effect

Under most acquisition agreements, the buyer is not required to close (either through a direct condition or a "bring-down" of representations at closing) if there have been any events, conditions or circumstances that are reasonably likely to have a material adverse effect on the target's business, condition or operations since a specified date (often the date of the most recent audited balance sheet). This condition is designed to assure the buyer that it is not assuming the risk for material adverse changes in the business from when it agreed to the deal price. As the anticipated delay between signing and closing increases (e.g., because of a need for shareholder or regulatory approval), so does the emphasis on the Company MAC. However, the actual comfort a buyer can take from the "Company MAC" is subject to widely recognized contractual and court-imposed limitations.

The contractual definition of a "Company MAC" often includes a series of "carve-outs" that establish various conditions, events or circumstances that will not constitute or be deemed to cause a Company MAC. The list of exceptions usually includes generic events, such as changes in economic or market conditions, law, accounting standards and the industries in which the target business operates. The rationale for these carve-outs is that both parties are subject to the risks associated with changes in general market conditions, that the seller has no better insight or knowledge than the buyer as to such generic events and that the buyer should assume these risks as if it owned the target on the date the acquisition is announced. In many cases, buyers will insist that some or all of these generic carve-outs be further qualified (and "re-taken" into account in determining whether a Company MAC has occurred), to the extent that there is a materially disproportionate affect on the target as compared to comparable companies.

(continued on page 17)

(continued from page 16)

Additional carve-outs to the Company MAC may include events arising out of the announcement of the deal (including impact on employees, customers and suppliers), acts of war or terrorism and natural disasters. Other transaction-specific carve-outs may also be included. In some cases, carve-outs will include known risks the buyer has been able to diligence prior to signing the agreement (such as the potential results of a significant litigation).

The negotiated definition of a Company MAC must also be understood in the context of the applicable case law. For the most part, disappointed buyers in the recent downturn have been unable to establish in court that a Company MAC has occurred under the terms of the agreement either because of the operation of the contractual carve-outs or because, as stated by the Delaware Chancery Court in its decision in Huntsman's lawsuit against Hexion, an event must be "*...consequential to the company's long-term earnings power over a commercially reasonable period of time, which one would expect to be measured in years rather than months…*" in order to constitute a material adverse change as customarily drafted. Accordingly, financing sources must carefully consider the level of risk they are prepared to accept.

The buyer/sponsor wants the conditions to the financing to match those in the acquisition agreement so that there is no risk it will be required to close without financing. The most direct way for a sponsor to achieve this result is to eliminate any stand-alone Company MAC condition from the financing commitment, and instead require the financing sources to rely upon a condition that none of the conditions to the buyer's obligations under the acquisition agreement, including the Company MAC, be waived without the lender's consent. However, this condition typically requires that both the merger agreement condition being waived be "material to the interests" of the financing sources and that the financing sources not unreasonably withhold their consent to the waiver. Given the centrality of the Company MAC to the business risk underwritten by the financing sources, lenders will often require that the Company MAC be set forth in its entirety in the financing commitment. In this way, the financing commitment will be absolutely clear that the Company MAC is for the direct benefit of the financing sources and, as a practical matter, any waiver by the buyer/sponsor of the Company MAC in any respect will require the financing sources to be at the borrower's side in making that decision.

Until new market precedents are well established, buyers and their financing sources may end up taking ad hoc approaches to satisfy sellers that open terms will not derail a transaction.

A key element to being able to submit a timely bid in a competitive process is now to ensure that financing sources are included early in the process of determining the scope of the Company MAC, and to make sure that they are on Board with the level of business risk the buyer is willing to accept. In contrast to the 2007 process, where lenders were expected to accede to the buyer's agreed definition of Company MAC without comment or question, sponsors must now address the arrangers' concerns as to the scope of the Company MAC and negotiated carve-outs. For example, even if the buyer is comfortable with the risk, lenders will often require that the Company MAC (or the representation in which it is housed) contain some forward-looking element to take into account the prospect that an event or condition may be reasonably expected to have a material adverse effect on the credit in the future. In addition, lenders are unlikely to blindly accept the risk for carve-outs that they cannot underwrite or control, such as the impact of actions taken by the target at the buyer's request, or changes in the target's industry (or the laws or regulations affecting such industry). Recent transactions demonstrate that sponsors and their financing sources can work together to resolve theses issues, but the buyer must expend significant effort to ensure that the financing sources fully accept the Company MAC in the merger agreement and its carve-outs.

(continued on page 18)

Recent Trends in Acquisition Financings

(continued from page 17)

Finally, in add-on acquisitions by corporate buyers where the lenders will look to the credit of the combined businesses, the parties will need to address whether the arranger's obligations should be conditioned on the absence of a material adverse effect on the *buyer's* business or the combined business, in lieu of (or in addition to) the absence of a Company MAC. There is no easy answer to how risk should be allocated under these circumstances, and the result may depend on the duration of the financing commitment and the volatility of the buyer's business.

Market MAC

Recent transactions have not seen the re-introduction of so-called "market MAC" conditions, under which financing commitments may be terminated if market conditions materially deteriorate after delivery of the commitment. In lieu of a market MAC condition, lenders have generally opted to rely on flex rights to fill the gap resulting from changes in market conditions arising after the announcement of a transaction and prior to closing. This may, in part, be due to uncertainty as to the ability to exercise a market MAC, as illustrated by the results of a suit by Solutia against the lenders that issued a commitment for a $2 billion bankruptcy exit financing. The commitment for Solutia's exit financing was written in October 2007, at a time when the onset of the credit crisis, though not its gravity, was already widely acknowledged. The lenders withdrew the commitment in January 2008, purportedly in reliance upon a market MAC condition. Solutia sued the lenders, seeking an order for specific performance, and the case ultimately settled, with the lenders providing the original $2 billion in financing in return for re-negotiation of certain deal terms.

Definitive Documentation Condition

In the United States, 2007 financing commitments were often conditioned upon the execution of definitive financing documentation consistent with term sheets attached to the commitment letter, and otherwise consistent with so-called "sponsor precedent" for credit agreements for prior leveraged acquisitions by the same sponsor that had been successfully syndicated. In the current market, arrangers assiduously avoid reference to sponsor precedent, and instead seek provisions requiring that open terms be subject to good faith negotiation.

This level of ambiguity, even if acceptable to a buyer, may well leave sellers and their boards of directors uncomfortable in light of the experience faced in the Clear Channel buy-out, where the parties were purportedly unable to complete documentation prior to expiration of the commitment.

In order to address its concerns that open terms may result in a failed financing, a seller may ask that the buyer and its financing sources remove the documentation condition through the negotiation of definitive documentation prior to announcement of the transaction, as is typical in many European acquisitions announced on a "certain funds" basis. The requirement for pre-announcement definitive documentation, however, would result in significant additional expense for sponsors, and may be particularly difficult for both sponsors, especially in the context of an auction where buyers and their financing sources legitimately need (but are typically unable to get) access to target management to set appropriate covenant levels and baskets, and for arrangers, who may wish to avoid underwriting specific covenant language prior to the completion of marketing.

(continued on page 19)

Recent Trends in Acquisition Financings

(continued from page 18)

Until new market precedents are well established, buyers and their financing sources may end up taking *ad hoc* approaches to satisfy sellers that open terms will not derail a transaction. These solutions may include: agreeing upon a form of credit agreement or indenture for purposes of the initial funding (as is the convention in European "certain funds" transactions), agreeing upon a detailed definitive term sheet (including financial definitions and set covenant levels) or specifying an agreed upon post-2007 precedent agreement. To the extent that documentation terms are left open to be mutually agreed upon, sponsors may also fall back on their long-term experience and relationships with arrangers to get comfort that documentation will be completed in a manner satisfactory to their interests. Interestingly, this issue may be more easily resolved in add-on acquisitions by corporate buyers with existing credit facilities, if the financing sources specifically agree that, except as otherwise set forth in the term sheet, the financing will be made in accordance with the existing credit agreement. Undoubtedly, in auction situations where none of the prospective buyers has exclusivity, bidders will expend more time and expense in order to provide a definitive bid that addresses these concerns.

Marketing Period

Because arrangers are likely to remain intensely focused on their right to syndicate and off-load commitment exposure, buyers will want to be certain that they are not required to close an acquisition until the arranger has had the benefit of the marketing period required under its commitment letter, even if all of the other conditions to closing have been satisfied. The required marketing period will vary from transaction to transaction based on the nature of the financing and the information required to initiate and complete the marketing process. These terms must be carefully aligned in the acquisition agreement and the financing commitments. For example, both documents must require the seller and its management to provide information required to prepare any contemplated offering materials. Further, the buyer and its financing sources typically will not want to start a marketing process until closing is more certain – for example, after any go-shop period has ended and any required regulatory and antitrust conditions have been satisfied – so that the marketing will gain appropriate traction. Finally, once the marketing period has started, the arrangers must have a reasonable period to syndicate the financing in light of the investors being approached, with appropriate tolling of the marketing period for holidays and a tolling or restart of the marketing period for unexpected events (such as a restatement of the target's financial statements).

Conclusions

As the credit markets continue to thaw and issuers and private equity sponsors enjoy increased access to the leveraged financing markets, the terms of debt financing commitments, including as to syndication and conditionality, will, for the foreseeable future, undoubtedly be a focus point for most leveraged acquisitions. As recent transactions have shown, market terms have evolved significantly since the beginning of 2009, and can be expected to continue to change in 2010. ■

F. William Reindel is a corporate partner in the New York office and the chair of Fried Frank's leveraged finance practice. He can be reached at +1.212.859.8189 or f.william.reindel@friedfrank.com.

Damian P. Ridealgh is a corporate partner in Fried Frank's New York office. He can be reached at +1.212.859.8129 or damian.ridealgh@friedfrank.com.

(continued from page 6)

prospective investors, counterparties, and creditors, of any private fund" they advise as the SEC "may prescribe as necessary or appropriate in the public interest and for the protection of investors or for the assessment of systemic risk." The SEC may not, however, compel disclosure of proprietary information (e.g., "sensitive, non-public information regarding the investment adviser's investment or trading strategies") to counterparties and creditors.

As discussed above, venture capital fund advisers and private fund advisers with less than $150 million in AUM that are exempt from registration would nevertheless be subject to recordkeeping and reporting obligations as determined appropriate by the SEC.

The SEC would be authorized to make the records and reports available to the Federal Reserve Board and a newly created Financial Services Oversight Council. All records of a private fund maintained by a registered adviser would be subject to periodic, special, and other examinations by the SEC.

Additional SEC Rulemaking Authority

Many details of the new regime are left open to the SEC's rulemaking authority, which would be broad but not unlimited. For example, the SEC would have authority to ascribe different meanings to terms used in different sections of the Advisers Act, as it determines necessary to effect the purposes of the Advisers Act, except that the term "client" would not include an investor in a private fund managed by an investment adviser.

All registered advisers would be required to maintain records and report to the SEC, on a confidential basis, regarding the private funds they advise as "necessary or appropriate in the public interest and for the protection of investors or for the assessment of systemic risk" as the SEC determines in consultation with the Federal Reserve Board.

Requirements of Advisers Act Registration

Many unregistered private equity fund managers may be unfamiliar with the requirements associated with Advisers Act registration. These requirements include:

- Completing a Form ADV registration application (Part 1 of Form ADV, which is filed publicly with the SEC, describes the adviser's AUM, ownership, basic operations, and past disciplinary events, and Part II, which is required to be delivered to clients and prospective clients, describes the adviser's fees and investment program, and discloses conflicts of interest),
- Restrictions on marketing materials, including presentation of track record,
- Restricting the registered adviser's ability to charge performance-based fees to persons who are not "qualified clients," (the legislation would require dollar amount tests applied under this rule to be adjusted for the effects of inflation),
- Requirements for custody of client assets, including maintaining client assets with a "qualified custodian" and, in some cases, a "surprise audit" by an independent accountant and/or the preparation of U.S. GAAP audited financial statements of private funds,
- Adopting compliance measures, including implementing written compliance policies to prevent violations of the Advisers Act,
- Designating a chief compliance officer, and
- Becoming subject to routine and special SEC reviews regarding compliance with the Advisers Act.

Investor Protection Act

The Investor Protection Act included in the bill would establish various new requirements relevant to registered private fund managers, including that registered investment advisers maintain client funds or securities in excess of $10 million with an independent qualified custodian. The legislation also would create a specific fiduciary standard of conduct for

(continued on page 21)

House of Representatives Passes Bill to Require Registration of Private Fund Managers

(continued from page 20)

investment advisers when providing personalized investment advice to retail customers, and would apply that same standard to broker-dealers. Although earlier drafts of the bill would have required that the SEC consider the need to establish a self-regulatory organization for the investment adviser industry (e.g., FINRA), this provision was deleted by the December 10, 2009 amendments.

Timetable; Next Steps

The bill is currently in the Senate, where it awaits examination and debate. In addition, the Senate will take up its own version of financial services reform legislation. In November 2009, Senator Christopher Dodd (D-CT) introduced a discussion draft of reform legislation that would exempt private equity fund advisers from SEC registration, and would expand recordkeeping and reporting requirements to cover side letters granting more favorable rights to investors. This discussion draft has reportedly been the subject of ongoing negotiations, and likely will undergo substantial modifications before a full vote in the Senate. Eventually the House and Senate versions of financial services reform legislation would need to be reconciled prior to passage of a final statute.

If the House version of financial reform legislation is enacted this year as currently proposed, private equity fund managers would not be required to register with the SEC before 2011, based on a one-year transition period. Nevertheless, while the final parameters of financial services reform, and the ultimate burdens that will be imposed on private equity fund managers, remain in flux, it is likely that private fund advisers will become subject to, and should consider preparing for, some form of registration requirement in the future. ■

Richard I. Ansbacher is a corporate partner in Fried Frank's Washington, DC office. He can be reached at +1.202.639.7065 or richard.ansbacher@friedfrank.com.

Jessica Forbes is a corporate partner in Fried Frank's New York office. She can be reached at +1.212.859.8558 or jessica.forbes@friedfrank.com.

Kenneth I. Rosh is a corporate partner in Fried Frank's New York office. He can be reached at +1.212.859.8535 or kenneth.rosh@friedfrank.com.

Shanna M. Cohn is a corporate associate in Fried Frank's Washington, DC office. She can be reached at +1.202.639.7097 or shanna.cohn@friedfrank.com.

Bank Control Rules Evolving to Balance Need for New Capital and Regulatory Policies

(continued from page 8)

FRB, the OCC and the OTS already enforce limitations on affiliate transactions at the 25% ownership level under Regulation W.

Continuity of Ownership (Anti-Flipping)

Private investors in a covered depositary institution may not transfer any of "their securities" for three years without prior FDIC approval, which shall not be unreasonably withheld for transfers to affiliates, if the affiliate agrees to be subject to the conditions applicable to the transferring investor. It is not clear why the FDIC needs to impose this additional restriction, since the FRB, OCC and OTS already have discretion to impose a holding period in connection with approving a new bank holding company, a bank change of control or new savings and loan holding company.

Offshore Secrecy Law Jurisdictions

A private investor may not invest directly or indirectly in a depository organization resulting from a bank or thrift failure through an entity domiciled in a "bank secrecy jurisdiction" unless the investor is directly or indirectly subject to comprehensive consolidated supervision (CCS) as

(continued on page 22)

(continued from page 21)

recognized by the Federal Reserve, and the FDIC will have access to required information. Since private equity investors and their investment vehicles typically are not depository institutions, they are unlikely to be subject to CCS. Thus, this prohibition is likely to prohibit the use of any investment vehicle in a bank secrecy jurisdiction. The Statement's description of such jurisdictions is vague and results oriented, leaving the FDIC with significant discretion in determining what constitutes a bank secrecy jurisdiction. Further, as with other provisions of the Statement that are redundant with existing regulation, the FRB, OCC and OTS already have discretion to impose these restrictions in connection with approving a new bank holding company, a bank change of control or new savings and loan holding company.

Disclosure

While the FRB, OCC and OTS already receive extensive information under existing regulations, the Statement puts private investors on notice, even in non-control positions, that they may be required to provide significant amounts of information to the FDIC, including with respect to entities in the ownership chain, the size of the capital fund or funds, diversification, return profile, marketing documents, management team and business model. Of course, the FRB, OCC and OTS already receive extensive information under existing regulations.

Conclusions

While the FDIC's Statement is less onerous than its original proposal, the FDIC has not explained why so-called "private investors" who do not control a depositary institution should be treated differently from other non-controlling investors. Nor did the FDIC explain why any differences between so-called private investors and other investors justify more onerous restrictions to protect the Deposit Insurance Fund or the banking system generally, or why the existing supervisory structure for bank and thrift holding companies and the chartering of new institutions is inadequate to address the issues raised by the Statement.

The FDIC's Statement has had a short-term impact already, and may have long-term effects as the markets digest the message and the FDIC interprets the Statement on a case-by-case basis. The FDIC has stated that it will review the operation and impact of the statement within six months of its approval date (by the end of March 2010), and make adjustments as it deems necessary. In the meantime, the Statement and evolving FDIC policy seem to be pointing in the following directions:

- Private equity investors will likely be at a competitive disadvantage in bidding against strategic buyers whose investments are not subject to the Statement.
- In situations where there are no strategic buyers for a failed institution, the FDIC will likely be required to provide more assistance to institutions acquired by private equity investors because of the higher capital requirements imposed by the Statement.
- The FDIC is pursuing a strategy of transferring the deposits of a failed bank to a strategic bank acquirer, while selling the "bad assets" to special purpose entities in which partnership interests can be sold to private equity investors.
- A variety of new investment structures will be used where PE investors are non-controlling investors with well respected bankers or investors in established banking organizations which bid for failed banks.
- There will be an increased number of recapitalizations of troubled regional and community banks by private investors that are interested in the financial services space, and see opportunities in bank stocks that are undervalued or where management is top notch. ■

Thomas P. Vartanian is a corporate partner in the Washington, DC office and the chair of Fried Frank's financial institutions transactions group. He can be reached at +1.202.639.7200 or thomas.vartanian@friedfrank.com.

Heightened Manager Concerns for Secondary Transfers

(continued from page 10)

Equivalent Treatment of Investors

Fund managers may be faced with the need to deal with defaulting investors several times over the life of a fund. When considering what action to take in a particular situation, a manager should take care to treat all defaulting investors fairly, to take actions that best fit the particular circumstances, to consider the precedent created by its actions, and to consider the best interests of the fund and investors in evaluating default remedies. While different default situations may warrant different responses, investors may question why the manager handled one situation differently from another, and a manager will want to avoid the appearance of arbitrarily imposing a harsher penalty on one defaulting investor than another. Some default remedies, such as the manager itself acquiring the fund interest from the defaulting investor, may benefit the manager or the principals, and give rise to the appearance of impropriety. The manager must take care to minimize, and appropriately address, any actual or perceived conflicts of interest.

Lessons Learned for Future Funds

While the current pressures on fund managers will soon pass, a similar economic cycle is likely to arise at some point in the future, and managers can take steps now to ensure that the transfer provisions in new fund documents reflect the lessons learned from the current economic situation. Some items to consider for future funds include:

- Allowing the manager greater flexibility to facilitate transfers, including by providing the manager (or an affiliate) with the explicit ability to acquire interests from investors, or to force a sale to a third party, without regard to minimum price or offering the interest to other investors. These provisions should provide the manager with significant discretion in determining a fair price, and explicitly state that an auction or third party valuation is not required.
- Allowing the manager the explicit right to waive or reduce interest charges for delinquent investors. While fund documents entered into in connection with future fundraising may become more onerous on defaulting investors, fund managers will need as much flexibility as possible to avoid an actual default and to help attract potential transferees. In particular, the transfer provisions should be coordinated with any forced sale provisions in the case of a default.
- Including extensive disclosures in the offering memorandum about the potential detriments to non-transferring investors from the sale of distressed interests, such as having to bear interest expenses at the fund level to cover delinquent payments, or having to make additional contributions to cover the defaulted amount.
- Considering transfer logistics when establishing a fund structure. For example, a structure that restricts all tax-exempt investors to selling only to other tax-exempt investors may make it more difficult to market fund interests. If possible, build in the flexibility to transfer commitments between fund vehicles in connection with a transfer.

Richard I. Ansbacher is a corporate partner in Fried Frank's Washington, DC office. He can be reached at +1.202.639.7065 or richard.ansbacher@friedfrank.com.

Kenneth I. Rosh is a corporate partner in Fried Frank's New York office. He can be reached at +1.212.859.8535 or kenneth.rosh@friedfrank.com.

Rebecca Neuschatz Zelenka is a corporate associate in Fried Frank's Washington, DC office. She can be reached at +1.202.639.7260 or rebecca.neuschatz@friedfrank.com.

FRIED FRANK

friedfrank.com

Fried Frank PEP Talk®

Fried Frank Private Equity and M&A Partners

For more information please contact any of the following partners in Fried Frank's Private Equity and M&A Groups

Jeffrey Bagner
+1.212.859.8136

Eric Cafritz
+33.140.62.22.00

Andrew J. Colosimo
+1.212.859.8868

Aviva F. Diamant
+1.212.859.8185

Christopher Ewan
+1.212.859.8875

Arthur Fleischer, Jr.
+1.212.859.8120

Peter S. Golden
+1.212.859.8112

Murray Goldfarb
+1.212.859.8482

Joseph Lee
+852.3760.3636

Brian T. Mangino
+1.202.639.7258

Robert P. Mollen
+44.20.7972.9604

Tiffany Pollard
+1.212.859.8231

Paul M. Reinstein
+1.212.859.8156

Philip Richter
+1.212.859.8763

Sven Schulte-Hillen
+49.69.870.030.200

Robert C. Schwenkel
+1.212.859.8167

David L. Shaw
+1.212.859.8803

David N. Shine
+1.212.859.8284

John E. Sorkin
+1.212.859.8980

Steven J. Steinman
+1.212.859.8092

Richard A. Steinwurtzel
+1.202.639.7120

Dr. Jürgen van Kann
+49.69.870.030.300

Andrew P. Varney
+1.202.639.7032

Jerry C. Walter
+44.20.7972.6265

Fried Frank Private Equity Fund Formation Partners

For more information please contact any of the following partners in Fried Frank's Private Equity Fund Formation Group

Richard I. Ansbacher
+1.202.639.7065

Kenneth I. Rosh
+1.212.859.8535

Edward F. Ughetta
+1.212.859.8409

Fried, Frank, Harris, Shriver & Jacobson LLP

New York
One New York Plaza
New York, New York 10004
Tel: +1.212.859.8000
Fax: +1.212.859.4000

Washington, DC
1001 Pennsylvania Avenue, NW
Washington, DC 20004
Tel: +1.202.639.7000
Fax: +1.202.639.7003

Frankfurt
Taunusanlage 18
60325 Frankfurt am Main
Tel: +49.69.870.030.00
Fax: +49.69.870.030.555

Hong Kong
in association with Huen Wong & Co.
9th Floor, Gloucester Tower
The Landmark
15 Queen's Road Central
Hong Kong
Tel: +852.3760.3600
Fax: +852.3760.3611

Shanghai
40th Floor, Park Place
1601 Nanjing Road West
Shanghai 200040
Tel: +86.21.6122.5500
Fax: +86.21.6122.5588

Fried, Frank, Harris, Shriver & Jacobson (London) LLP

London
99 City Road
London EC1Y 1AX
Tel: +44.20.7972.9600
Fax: +44.20.7972.9602

Fried, Frank, Harris, Shriver & Jacobson (Europe)

Paris
65-67, avenue des Champs Elysées
75008 Paris
Tel: +33.140.62.22.00
Fax: +33.140.62.22.29

A Delaware Limited Liability Partnership

The articles included in *Fried Frank PEP Talk®* are general in nature and are not intended to provide legal advice with respect to any specific situation confronted by our clients or other interested persons. Please consult with counsel before taking any action with respect to any matters discussed in *Fried Frank PEP Talk®*.

IRS Circular 230 Disclosure: Any US tax advice herein was not intended or written to be used, and cannot be used, by any taxpayer to avoid US tax penalties. Each taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor.

If you would like to receive *Fried Frank PEP Talk®* via email, you may subscribe online at friedfrank.com/subscribe.