

## private equity developments

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### Private Equity Funds Successfully Compete with Strategic Buyers

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Historically, strategic buyers have dominated private equity funds in the buyout landscape. Over the seven-year period from 1999 to 2005, private equity funds accounted for as little as 2% and a maximum of 15% of all U.S. M&A activity.<sup>1</sup> One of the reasons for this dominance is that strategic buyers have typically outbid private equity funds for target companies put on the market in competitive auctions.<sup>2</sup>

The buyout market, however, is changing. Fueled by an unprecedented inflow of capital into private equity funds,<sup>3</sup> financial buyers have become a preeminent force in the market, playing a hand in 27% of U.S. M&A activity last year.<sup>4</sup> In 2006, private equity funds were responsible for seven of the 10 largest leveraged buyouts of all time<sup>5</sup> and five of the 10 largest transactions in the United States.<sup>6</sup> In the first quarter of 2006, private equity funds accounted for 12 out of the 42 deals in the \$1 - \$10 billion range in the United States.<sup>7</sup> Globally, in 2006, private equity funds struck deals worth over \$700 billion, twice that recorded in 2005.<sup>8</sup> The emerging dominance of private equity firms is exemplified by news reports in October 2006 that the U.S. Department of Justice had launched an investigation into the price-setting practices of certain large private equity firms with respect to buyout auctions.<sup>9</sup> In November 2006, a federal class action was brought against certain private equity firms, alleging, among other things, a conspiracy in restraint of trade to artificially fix, maintain or stabilize prices of equity securities of target companies in going private transactions.<sup>10</sup>

There are a number of factors beyond the ability to pay a high price that advantageously position private equity firms when competing for a buyout target with strategic buyers. In addition to the offering price, the management of target companies consider several factors in evaluating bids, including the degree of certainty that the transaction will be consummated, the time frame for consummating the transaction, foreseeable disruptions to the company as a going concern and the business culture of the counterparty. The winning bid is the one that best meets all of the seller's needs and concerns. That means that the winning bidder may or may not be the bidder who offers the highest price.

### Private Equity Fund Value for Target Companies

#### Target Management Benefits, Post-Sale

- Private equity funds usually retain the target's management team after acquisition, while strategic buyers often replace the target's management.
- To ensure that the target's management will remain with the target post-purchase, private equity funds will often offer target management incentives to stay with the target after acquisition,

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including equity in the company and a bonus structure including stock and options.

- Target management can receive as much as a 10% stake in the reorganized company, an equity position that management could not obtain if the target was taken public or purchased by a strategic buyer.

#### Post-Sale Access to Capital and Expertise

- Target management can benefit from the board-level financial and operational expertise of private equity professionals, including acquisition experience, growth assistance and corporate direction.
- Private equity funds can help targets cut excess costs, focus on higher growth products and dispose of underperforming business lines.
- The target may be able to leverage the private equity fund's capital base to expand the target via internal growth or external acquisition.

- Private equity funds utilize their deal-market experience to obtain financing and perform due diligence in an expedited and efficient manner.
- Private equity funds can usually close on a deal in a short period of time.
- The ability of private equity funds to move quickly and efficiently can be of paramount significance if financial problems or regulatory issues are the cause for a target's sale.
- Strategic buyers often rely on staff specialists who may not be as quick, since they have fewer occasions to review companies for purchase, and bureaucracies that may exist in larger strategic buyers may slow the due diligence and deal processes.

#### Limited Antitrust/Regulatory Risks and Delays

- Antitrust and other regulatory concerns may either limit a strategic buyer's ability to purchase a target or slow down the deal process for a strategic buyer, while private equity fund deals are less likely to raise antitrust or regulatory issues.
- In the U.S., most deals that exceed approximately \$50 million in value (the current threshold is actually \$56.7 million, based on periodic adjustments) require a Hart-Scott-Rodino (HSR) filing.
- Some transactions by financial buyers do not require a HSR filing unless they exceed a higher threshold (currently \$226.8 million) if three or more funds each own less than 50% of the acquisition vehicle (this higher threshold is rarely available to strategic buyers due to their structure).
- There will be some delay prior to closing for both private equity funds and strategic buyers, as the HSR filing is prepared and the parties observe the statutory 30-day waiting period; however, it is likely that the Federal Trade Commission and Department of Justice will grant "early termination" of the waiting period within 10 to 20 days for a private equity fund unless the fund has interests in firms that compete with the target.
- In the face of a prospective merger among significant competitors, the antitrust authorities might need to assess the competitive consequences of the transaction; under those circumstances, they would issue a request for additional information which will extend the waiting period until 30 days after the parties certify compliance with this second request, and compliance often can take many months.

- Sarbanes-Oxley has forced public strategic buyers to focus more on implementation of internal controls and developing existing businesses since acquisitions increase the risk of adequate control at the target company.

#### Targets Must Be Wary of Strategic Buyers' Interests

- Targets must be wary of strategic buyers who feign interest in bidding on a target in an effort to learn more about the target's business operations.



#### Minimal Disruption to the Target Company as a Going Concern

- Private equity funds are less likely to change the target's basic management and operational structure, so both rank and file workers and management are less likely to be terminated or relocated.
- Operations and/or headquarters will likely remain where they are situated before the sale.

#### Quick, Efficient and Sophisticated Bidders

- Private equity funds can operate effectively in a bidding environment as a result of their specific abilities, experience, and access to outside experts and capital.

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# Employee Investment in Private Equity Funds

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Employee investment in private equity funds raises a number of structuring issues. This article will explore some of the options that are available, and the considerations in deciding whether to implement them.

## Who Should Participate

Typically, the personnel of a private equity fund consist of a combination of (1) key principals, (2) other professional employees, some of whom are involved in portfolio management and others of whom are involved in back-office functions, and (3) non-professional personnel. The best form of participation for each of these groups may vary.

Often, investors will insist that key principals invest directly in the fund to maximize their alignment of interest with investors. Key principals are typically asked to make an investment that is personally significant to them, either in absolute dollars or as a percentage of their liquid net worth.

These requirements generally do not extend to the remainder of the employee group. For the reasons discussed below, direct participation by the remainder of the employees in the fund is often not the best arrangement.

## Investment Eligibility

Private equity funds are frequently structured under Section 3(c)(7) of the Investment Company Act of 1940 (“Investment Company Act”), pursuant to which all investors must be “qualified purchasers.” To be a qualified purchaser, an employee must either (1) have \$5 million dollars of investment assets (a threshold that is typically achieved, if at all, only by the most senior members of the team) or (2) be a “knowledgeable employee.” The definition of knowledgeable employee covers the senior members of the team, other professionals actively engaged in the portfolio management process, heads of business units (e.g., the general counsel and the chief operating officer) and advisory board members. The definition of knowledgeable employee does not extend to non-professional employees, and also excludes many professional employees who are not heads of business units. In particular, non-portfolio management employees such as marketers, junior counsel and back office, plus junior analysts who evaluate companies but do not substantively participate in the investment selection process, will not qualify.

Because of this eligibility issue, a private equity fund structured under Section 3(c)(7) cannot admit the bulk of its employees directly into the fund. Additionally, junior employees may not qualify as “accredited investors” (i.e., may not have incomes of \$200,000 over the past two years with an expectation of the same for the current year, or \$300,000 per year over the same period with spouse, or \$1 million dollar net worth), and even if a private equity fund is structured under Section 3(c)(1) of the Investment Company Act (which allows up to 100 investors without imposing a net worth requirement), the private equity fund will be privately placed, which means that non-accredited status can be an issue. (Some funds will accept up to 35 non-accredited investors under the “private placement” safe harbor of Regulation D of the Securities Act of 1933, but there is concern that non-accredited investors must receive a heightened level of disclosure). As a result,

employees who are not knowledgeable employees may only be eligible to participate through one of the following structures:

- (i) A fund that runs in parallel with the main fund but relies on Section 3(c)(1) (often, the level of junior employee investment capital is not sufficient to justify forming such a vehicle for employees alone, but this structure may make sense if a 3(c)(1) parallel fund is already being created to accommodate “friends and family”);
- (ii) A feeder fund into the main fund that is not “formed or used” for the purpose of investing in the main fund, and which relies on Section 3(c)(1) (the feeder must have \$25 million dollars of assets and must invest less than 40% of its assets in the underlying private equity fund — as a result, this alternative is typically only practicable for large firms that can allocate the feeder across multiple underlying fund products);
- (iii) An “employee securities company,” that is subject to some of the additional requirements imposed on registered investment funds, but applies for an exemption from the SEC from many of the more stringent requirements (a cumbersome process typically only used by very large firms);
- (iv) Annual co-investment pools (also structured under Section 3(c)(1)) that permit employees to participate through co-investment in deals done by the private equity fund in a particular year; or
- (v) A phantom plan or other bonus plan that offers employees compensation tied to fund performance without actually constituting an investment in the fund.

## Selecting the Best Alternative

In choosing among, and structuring, the options listed, fund sponsors should consider the following issues:

- (i) **Vesting and Forfeiture.** A private equity fund typically has a marketing period that can be one to two years for first time funds, followed by an investment period of three to five years, an investment holding period of five to seven years and investment realizations that cluster toward the back end of the fund term. Over that time span, it is likely that a number of employees will join and leave the firm. The structure for employee investment can provide for incentivization of incoming employees and “golden handcuffs” to discourage voluntary exits and misbehavior. “Bad leavers — those who quit, compete or are terminated for cause — may be required to forfeit a portion of their investment, especially where that investment is subsidized by leverage from the firm. The portion retained by such an employee — or even by a “good leaver” — may be subject to vesting based on years of service.
- (ii) **Satisfaction of Capital Commitments.** Employees who invest in the private equity fund must fulfill the same type of capital commitment obligations applicable to other investors. If an employee who leaves the firm has ongoing capital commitment

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obligations, it may be difficult to pursue them. Additionally, junior employees may need help from the firm in the form of loans to meet their capital commitment obligations.

- (iii) **Nature of the Firm.** Often, a private equity firm is required by its investors to launch only a single fund until that fund is perhaps 75% invested, at which point a second fund can be launched. Other firms (typically more institutional shops with multiple investment teams) may be permitted to run multiple funds simultaneously. The best structure for attracting and retaining employees may include participation in these other vehicles. Once a firm is mature, it may be less important to provide incoming employees with an interest in existing funds, because they can instead be incentivized through slices of future vehicles. For a firm with a more limited number of funds, it will be more important to move investment capacity from exiting employees to incoming ones.
- (iv) **Valuation of Fund Investments.** It is typically difficult to accurately value private equity investments prior to disposition. For this reason, a structure that requires buy-out of a departing employee's interest and buy-in of an incoming employee may not be practicable.
- (v) **Fees.** Typically, employees do not pay incentive allocations or management fees. If they are required to pay fees, higher eligibility requirements may apply.

These considerations may make the annual co-investment pool an attractive option for firms that have a meaningful number of employees who are not qualified purchasers, but who wish to make a direct investment with the fund. An annual co-investment pool can be operated under Section 3(c)(1), eliminating the need of employees to be qualified purchasers. The pool also does not require buy-in or buy-out of employees, and does not require former employees to satisfy continuing capital commitment obligations in subsequent years. The annual co-investment pool also enables the firm to scale the amount of employee investment on an annual basis.

Considerations against the annual co-investment pool approach include the fact that it requires the private equity firm to divide each investment across at least two vehicles. Additionally, there is an extra level of

administration not present when employees invest directly in the fund. Furthermore, sometimes underlying assets may themselves be assessable only to investors who are qualified purchasers or even qualified institutional buyers (a \$100 million dollar threshold), and the annual co-investment pool is unlikely to meet these tests. Finally, junior employees who do not meet the accredited investor requirement may not be eligible to participate in an annual co-investment pool, in which case a firm that wishes to provide for them will need to rely on a phantom or bonus plan. If a firm has more than 100 employees who would participate in the co-investment pool, the Section 3(c)(1) exemption also may be unavailable, forcing the firm to choose a bonus plan for them or to go through the burden of pursuing an employee securities company exemption.

### **Incentives/Management Fees vs. Fund Investment**

Private equity firms may give employees an interest in the incentive allocations and management fees received by the firm either through direct admission of employees into a general partner and management company of the firm or through bonus plans. The incentive allocation is likely to include long-term capital gains. For employees who are U.S. taxpayers, it is desirable to receive those capital gains on a pass-through basis. In order to support tax treatment of an employee as a member of the general partner, the employee must make a minimum investment in the general partner. Employees may make this investment without being qualified purchasers or accredited investors, where the small investment required is necessary to support the best tax treatment of their compensation.

After considering the steps necessary to accommodate direct investment by employees in private equity funds in excess of the amount necessary to support their receipt of carry, many private equity firms conclude that the level of employee interest in additional investments is not sufficient to justify the administrative complexity of implementing one of the other structures described above. For this reason, employees who wish to invest extra amounts may be offered only the option of investing in the fund directly, and the "golden handcuffs" benefits of vesting and forfeiture may be applied against employees' interests in incentive allocations and management fees rather than extending to additional amounts invested in the fund. However, the alternative structures for employee direct investment can be attractive where the level of employee interest is sufficiently high, and can give firms an edge in attracting and retaining junior talent. •

## in the news

### **Veritas Capital to Purchase Pearson Government Solutions**

SRZ is representing The Veritas Capital Fund III, L.P. and its affiliates in connection with their pending \$600 million purchase of the Pearson Government Solutions unit (PGS) of Pearson plc, the international media and education company. PGS designs, builds and operates information technology solutions for government agencies, educational institutions and commercial entities and is a major contractor for the U.S. government, including the U.S. Departments of Defense, Education, Health, Justice and Labor.

SRZ is also representing the acquiring entities on debt financings in connection with the transaction, which consist of a high yield debt offering and a senior secured credit facility.

The transaction is expected to close in the first quarter of 2007.

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- There is a greater degree of risk that information will be improperly utilized or disclosed when disclosing proprietary or sensitive information to strategic buyers, especially if a potential suitor is a direct competitor.
- Strategic buyers may obtain information concerning the abilities and areas of expertise of a target's employees during diligence, and attempt to hire employees away.
- Even if a confidentiality agreement is signed, strategic buyers will still have access to the confidential information, thereby elevating the risk of disclosure or improper use.
- Though similar issues may arise with private equity funds, the likelihood of disclosure and confidentiality issues arising increases with strategic buyers.
- Target companies may disclose sensitive information to a private equity fund more readily than they would to a strategic buyer if the fund's portfolio companies are not direct competitors.
- Private equity funds may have the advantage of being able to bid with better substantive background information, allowing funds to offer a higher bid price based on the additional information.

### Private Equity Funds' Additional Risk Tolerances

- The risk tolerance of private equity funds may allow them to bid more than a strategic buyer would, where bidding prices are typically based on multiples of a target's EBITDA. •

<sup>1</sup> Tim Reason, *A High Water Mark?*, CFO MAGAZINE, Jan. 1, 2006, available at, [http://www.cfo.com/article.cfm/5348114/c\\_5350503](http://www.cfo.com/article.cfm/5348114/c_5350503).

<sup>2</sup> Stephen Fraidin & William Sorabella, *Secondary Buyouts*. 1517 PLI/CORP 235 (2005); *Secondary Buyout*. PLI Pocket MBA, 4 No. 23 PLI-PMBA 1 (2006); Gary M. Cole, *The Sale Process*. 1494 PLI/CORP 131 (2005).

<sup>3</sup> Steve Rosenbush, *Deals of the Year, in a Year of Deals*, BUSINESSWEEK.COM, Dec. 19, 2006, available at, [http://www.businessweek.com/bwdaily/dnflash/content/dec2006/db20061218\\_740232.htm](http://www.businessweek.com/bwdaily/dnflash/content/dec2006/db20061218_740232.htm); Steve Rosenbush, *The Money Behind The Private Equity Boom*, BUSINESSWEEK.COM, Nov. 7, 2006, available at, [http://www.businessweek.com/investor/content/nov2006/pi20061107\\_031256.htm](http://www.businessweek.com/investor/content/nov2006/pi20061107_031256.htm).

<sup>4</sup> Dennis K. Berman, *Can M&A's 'Best of Times' Get Better?*, WALL ST. J., Jan. 2, 2007, Page R5.

<sup>5</sup> Henny Sender & Dennis K. Berman, *In Some Deals, Executives Get a Double Payday*, WALL ST. J., Sept. 8, 2006, Page C1.

<sup>6</sup> Dennis K. Berman, *Can M&A's 'Best of Times' Get Better?*, WALL ST. J., Jan. 2, 2007, Page R5.

<sup>7</sup> Patricia A. Vlahakis, *Takeover Law and Practice*. 1571 PLI/CORP 259 (2006).

<sup>8</sup> Tony McAuley, *Power Play*, CFO EUROPE, Dec. 29, 2006, available at, [http://www.cfo.com/article.cfm/8447667/1/c\\_2984395](http://www.cfo.com/article.cfm/8447667/1/c_2984395); Daniel Gross, *Awaiting Handshakes Worth \$100 Billion*, N.Y.TIMES, Dec. 31, 2006, The Week In Review.

<sup>9</sup> Andrew Ross Sorkin, *Equity Deals Attract Eye of Justice*, N.Y. TIMES, Oct. 11, 2006, Page C1.

<sup>10</sup> David Glovin and Sree Vidya Bhaktavatsalam, *KKR, Carlyle, 11 Others Accused of Rigging Buyouts*, BLOOMBERG.COM, Nov. 15, 2006, available at, <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aKTQ50WmoW6w>.

## in the news

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### Cerberus Acquires Leading School and Transit Bus Manufacturers

SRZ recently represented Cerberus Capital Management, L.P., and its affiliates, in connection with the acquisition, through a newly formed entity, Homerica Investments BV, of three leading bus manufacturers: (i) Blue Bird Corporation (acquired from a group of U.S. and international financial institutions), (ii) Optima Bus, LLC (acquired from American Capital Strategies, Ltd., a publicly-traded buyout fund, and Optima senior management) and (iii) North American Bus Industries Inc. (NABI) (acquired from First Hungary Fund, Ltd., a venture capital fund). Terms of the transactions, including the purchase prices, have not been disclosed.

Blue Bird, a leading manufacturer of school buses founded in 1927, has an extensive network of distributors and service-parts facilities throughout North America. Optima Bus, formerly Chance Coach, has been manufacturing heavy duty, transit quality coaches since 1976 in Wichita, Kansas, including the under 30' Opus low-floor bus, under 35' Opus low-floor bus, and American Heritage Streetcar. NABI, which its headquarters and has manufacturing facilities in Anniston, Alabama, focuses on the sale, assembly and post-delivery support of a full range of heavy-duty diesel, compressed natural gas and liquefied natural gas powered, transit buses.

### Cerberus-led Consortium Acquires Major Austrian Retail Bank

SRZ represented a consortium led by affiliates of Cerberus Capital Management L.P., in its acquisition of BAWAG P.S.K., the fifth largest bank in Austria, from ÖGB, the Austrian Trade Union Association. Through its longstanding distribution and marketing relationship with Austrian Post, BAWAG enjoys the largest retail branch system among Austrian banks.

The Cerberus-led consortium, which includes Austrian Post, Wüstenrot and Generali, agreed to pay approximately €2.61 billion for 100% of the stock of the bank. BAWAG had been pushed to the brink of insolvency by a series of events in late 2005, including involvement with the commodities brokerage RefCo, and concealed currency trading losses by Caribbean entities under the control of the son of the former CEO. Under new management and with the protection of an Austrian government guarantee, the bank stabilized and was put up for auction by ÖGB, in which the Cerberus-led consortium was the successful bidder.

The share purchase agreement was signed on December 30, and the transaction is expected to close in the 2d Quarter of 2007.

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