LATHAM & WATKINS

No. 6, May 2008

SmartCapital

US Edition — Current Legal Issues for Private Equity Investors

Bruce J. Prager
Partner
Litigation Department

Howard A. Sobel
Partner
Corporate Department

E. Marcellus Williamson
Partner
Litigation Department

Consortium Deals May Move Forward: US Federal District Court Dismisses Antitrust Challenge to Private Equity Funds' Consortium Deal

By Bruce J. Prager, Howard A. Sobel and E. Marcellus Williamson

In February 2008, in *Pennsylvania Avenue Funds v. Borey*, No. C06-1737RAJ (W.D. Wa. Feb. 21, 2008), a US federal district court in the Western District of Washington dismissed an antitrust action against two private equity firms (Vector and FP) that jointly acquired WatchGuard Technologies Incorporated (WatchGuard). While parties contemplating acquisitions should continue to seek counsel as to the antitrust implications of particular joint-bidding arrangements, the decision represents another favorable legal development for private equity firms and other financial institutions that enter into bidding consortia.

Private equity consortia are generally comprised of two or more private equity funds and may include strategic partners. Bidding consortia enable private equity firms to share the risks associated with acquiring a large target company and facilitate the funding of the required equity financing. Indeed, recent consortium deals have been instrumental in executing multibillion-dollar acquisitions in cases where no single private equity fund could have funded the entire equity required for the transaction or was willing to risk doing so.

Subject to the terms of the confidentiality agreement negotiated with the target in any given auction, private equity firms can create consortia at different points during the bidding process and under various circumstances: (i) firms can join together at the beginning of the auction process; (ii) firms can form consortia shortly before or after the bid is submitted, but before executing definitive documentation; (iii) firms can join a winning bidder which is seeking to syndicate a portion of its equity commitment after executing definitive documentation; or (iv) occasionally, sellers may select which firms can join together to bid and acquire a target.

Bidding consortia recently have been subject to heightened public scrutiny as a result of lawsuits that have questioned

Inside This Issue

Consortium Deals May Move Forward: US Federal District Court Dismisses Antitrust Challenge to Private Equity Funds' Consortium Deal 1
US Enacts New Law to Strengthen Review of Foreign Investments 3
SEC Reduces Restrictions On Resale of Restricted Securities 5
Private Equity Deal Highlights 8
S&P Takes a Negative View of Preferred Equity 10
Industry Focus - PBGC Deems Private Equity Funds Members of Their Portfolio Companies' Controlled Group; Imposes Joint and Several Liability for Pension Underfunding 11
European Highlights - Schemes of Arrangement: The Current Structure of Choice for Acquisitions of UK-Listed Companies 13
Latham News 15

the legality of their joint-bidding practices under the United States antitrust laws. At issue in these cases, in part, is whether consortium bidding may harm the sellers in competitive auctions by reducing the number of participants in the auction and the ultimate price to the seller.

In *Pennsylvania Avenue Funds*, the plaintiff—a former shareholder of WatchGuard, the target company—alleged that the interrelated activity by Vector and FP constituted an illegal bid-rigging scheme. Vector and FP were originally just two of numerous potential purchasers that expressed an interest in acquiring WatchGuard. Indeed, the "[p]laintiff admitted at oral argument that as many as 50 suitors expressed some level of interest" in the transaction. As the WatchGuard auction proceeded, however, the field narrowed considerably.

According to the complaint, although both Vector and FP initially submitted competitive bids to acquire WatchGuard, the competitive bidding process came to a halt when Vector and FP allegedly "entered into a contract, combination, or conspiracy to artificially fix the price, refrain from bidding, or rig the tender offer bids for WatchGuard shares." The plaintiff alleged that the conspiracy played out in three phases: first, "Vector agreed to stop pursuing WatchGuard, and stand aside while FP made a lower bid." Next, FP lowered its bid from $4.60 per share to $4.25 per share. Finally, less than one month after WatchGuard's board of directors accepted FP's lowered bid, Vector announced an agreement to fund half of FP's acquisition of WatchGuard in exchange for a 50 percent interest in WatchGuard after the merger.

The complaint alleged that FP and Vector entered into a horizontal agreement to "rig the tender offer bids for WatchGuard shares." The plaintiff alleged that such an agreement was *per se* illegal under Section 1 of the Sherman Act, 15 U.S.C. § 1. Under that standard, the joint-bidding arrangement, whereby FP and Vector allegedly agreed not to bid against one another and to reduce the price being offered, would be illegal irrespective of its purpose or effects. In the alternative, the plaintiff alleged that the purported agreement violated Section 1 of the Sherman Act under the rule of reason, which deems unlawful only those agreements whose adverse effects on competition outweigh any potential procompetitive justification. The court disagreed with the plaintiff on both scores.

First, as to plaintiff's *per se* claim, the court held that "[a]nalysis of Defendants' agreement to acquire WatchGuard under the *per se* rule is presumptively inappropriate." As the court explained, "*[p]er se* liability applies to 'agreements that are so plainly anticompetitive that no elaborate study of the industry is needed to establish their illegality.'" The court noted that "no court has applied the *[per se]* rule to a price-fixing agreement in a contest for corporate control," and that, in any event, it would be inappropriate to apply the rule given that "[p]rice fixing among rival bidders in a contest for corporate control is not, in general, anticompetitive." The court observed that joint-bidding by private equity firms plausibly has several pro-competitive aspects, including (1) allowing "poorer contestants" to "gain access to the contest" by "combining resources" with "well-heeled bidders," and (2) allowing "bidders who join forces" to "spread risk between themselves . . . " The court concluded that joint-bidding encourages bids that might otherwise exceed a sole bidder's "resources or risk tolerance" and dismissed the plaintiff's *per se* claim.

Second, the court likewise rejected the plaintiff's rule of reason argument. Under the rule of reason, the court explained, the "plaintiff must allege both the existence of a relevant market and 'that the defendant has power within that market.'" Beyond that, the plaintiff also "must show that the defendants control enough of the market that their anticompetitive conduct actually injures competitors or consumers." It is well established that without market power arising from control over a substantial part of the relevant market, any anticompetitive impact of the complained of action is improbable.

The court stated that it was not pursuaded by the plaintiff's claim that "the market for corporate control of WatchGuard" constituted a "relevant market" because the market for control of a single target company appeared to be an inappropriately narrow market definition as a matter of law. Even if the plaintiff's proposed market definition was sufficient, however, the court rejected the plaintiff's rule-of-reason claim because the plaintiff's allegations failed to demonstrate that Vector and FP possessed market power. Although the plaintiff argued that Vector and FP had market power because they were the only bidders left standing at the auction's end, the court found this characterization of the bidders as having market power misleading: Vector and FP's role as the two remaining bidders did not prove that they had market power, but instead, the court opined, indicated that WatchGuard "was not an attractive asset." In other words, "Vector and FP had an apparent stranglehold on this submarket… but only because dozens of other suitors who expressed interest in WatchGuard refused to make bids."

The court found the reality to be that "[a]ny acquirer who believed that WatchGuard was worth more than FP's bid could have made a topping bid" and that the WatchGuard shareholders retained the power to vote down the merger if they believed that the bid was too low. Thus, because the plaintiff failed to establish that the defendants in fact possessed market power, the court

held that the plaintiff could not survive a rule-of-reason analysis and dismissed the Section 1 claim. Inasmuch as virtually all acquisition agreements involving the sale of a public company contain "fiduciary outs" which enable the target company to entertain competing bids until the required shareholder vote is conducted, the court's reasoning suggests that joint-bidding arrangements with respect to auctions for public companies should survive a rule of reason analysis. Of course, there can be no assurance that other courts will adopt the court's approach to the rule of reason analysis.

Pennsylvania Avenue Funds represents another positive development in antitrust law for private equity firms that participate in bidding consortia.[1] Nonetheless, it is important to recognize that the court's analysis in *Pennsylvania Avenue Funds* was fact-specific and, standing alone, this decision does not create a bright-line rule that all consortium deals are immune from antitrust challenges. Instead, the decision supplies participants in consortium deals with yet another compelling precedent that they can use to ward off future antitrust challenges to their agreements.

Endnote

1 *See, e.g., Finnegan v. Campeau Corp.*, 915 F.2d 824, 827-32 (2d Cir. 1990) (in a case presenting facts similar to Pennsylvania Avenue Funds, the Second Circuit held that the federal securities law (specifically, the Williams Act) precludes application of the antitrust laws to rival bidders that ultimately joined forces to acquire a target company); *Kalmonivitz v. G. Heileman Brewing Co., Inc.*, 769 F.2d 152, 156-57 (3d Cir. 1985) (affirming grant of partial summary judgment against antitrust plaintiffs in similar circumstances because "the sale of stock of a single company within the context of a takeover battle for that one company does not fall within…" the definition of "trade or commerce" and, therefore, "[t]he antitrust laws simply were not designed to regulate this type of corporate power struggle…"). ■

US Enacts New Law to Strengthen Review of Foreign Investments

By Teresa D. Baer and Philip J. Perry

Teresa D. Baer
Partner
Corporate Department

Philip J. Perry
Partner
Litigation Department

On October 24, 2007, a new law took effect to govern the review of transactions involving foreign investment in the United States.

The law, known as the Foreign Investment and National Security Act of 2007, is the culmination of the controversy that arose from the 2006 effort by the state-owned Dubai Ports World to acquire container terminals at US ports. In the aftermath of that transaction, the Committee on Foreign Investment in the United States (CFIUS) has come under intense scrutiny, and the process for government approval of foreign acquisitions has become more rigorous. The new law codifies this greater scrutiny and rigor. It is critical for transaction parties whose deals involve foreign investment—particularly where that investment is from countries that may raise political or other sensitive concerns or involves so-called "critical infrastructure"—to understand and prepare for the US national security review process.

Background

In 1988, Congress enacted the Exon-Florio Amendment to the Defense Production Act of 1950, giving the President the authority to review the national security effects of foreign acquisitions of US companies. The President delegated much of his authority under the statute to CFIUS, an inter-agency committee that had been established by Executive Order in 1975 to monitor foreign investments in the United States. Since then, CFIUS has cleared nearly 2,000 foreign acquisitions.

Transaction parties voluntarily submit their transactions to CFIUS for review on a confidential basis. CFIUS completes its review of most transactions within a statutorily provided 30-day review period. A small number of transactions are subject to investigations that by statute may last up to an additional 45 days, after which time the President has up to 15 more days to determine whether to suspend or prohibit the deal. The key advantage of obtaining CFIUS review is that, if CFIUS has not previously reviewed a deal, it retains

jurisdiction to do so at any time, including after closing (when it could potentially require even divestiture), although post-closing reviews are rare.

Recent controversial transactions before CFIUS—particularly the Dubai Ports World transaction, but also deals such as the 2005 effort by China National Offshore Oil Company to acquire Unocal—have focused significant negative attention on the CFIUS process. The resulting scrutiny has led CFIUS to tighten its own procedures, among other things requiring decisions to be made only at the highest levels of the member agencies, referring more cases than ever before to 45-day investigations and increasingly requiring parties to enter into agreements to mitigate national security concerns. Fearful that their deal could become the subject of public scrutiny, transaction parties have been notifying CFIUS of their deals in record numbers.

> **"The new law mandates a very high level of scrutiny of many foreign investments for the foreseeable future."**

The New Law

The new law codifies CFIUS and attempts to strengthen the review process in a number of key respects. In particular:

- **Membership**. The law retains the Secretary of the Treasury as Chair and includes as members the Secretary of Homeland Security, Secretary of Commerce, Secretary of Defense, Secretary of State and Attorney General, among others. The law also adds the Secretary of Energy, the Secretary of Labor and the Director of National Intelligence to CFIUS (the latter two as non-voting members). In addition, the Secretary of the Treasury must designate a "lead agency" for each transaction.
- **Process**. The 30-45-15 day timing and the voluntariness of the process are unchanged. The law specifically requires the involvement of high-level appointees in the various agencies. It also adds new factors for CFIUS's consideration, including whether a transaction involves a country that poses a potential regional military threat to US interests, the potential national security impact on US critical infrastructure and critical technologies, whether the transaction involves state ownership, the adherence of the country to nonproliferation control regimes, the country's cooperation with US counter-terrorism efforts; and the potential for diversion of technologies with military applications. Pursuant to a January 23, 2008 amendment to an Executive Order, communications with transaction parties must occur only through, or in the presence of, the lead agency, or the chair if there is no lead agency.
- **Critical Infrastructure**. The law mandates increased scrutiny of transactions that may affect US critical infrastructure or other sensitive assets. "Critical infrastructure" is defined as "systems and assets, whether physical or virtual, so vital to the United States that the incapacity or destruction of such systems or assets would have a debilitating impact on national security." While the term likely includes ports, power, telecommunications, defense and the chemical industries, among others, its scope is unclear.
- **Government-Owned Purchasers**. The law calls for 45-day investigations for transactions involving foreign government-owned buyers. Investigations will not be required, however, if the Secretaries of the Treasury and the lead agency determine that the transaction will not impair US national security.
- **Mitigation Agreements**. The law specifically provides for a mechanism for clearing transactions with "mitigation agreements" intended to address national security concerns and continuing CFIUS oversight to ensure compliance with those agreements.
- **Evergreen Provision**. The law provides for an "evergreen" mechanism, explicitly permitting the government to reopen cleared transactions if a company misrepresented material facts in its CFIUS filing or materially breached a mitigation agreement. Thus, years later, CFIUS could impose new, more burdensome conditions on a long-closed transaction, including divestiture.
- **Political Oversight**. The law requires CFIUS to report on its actions to over a dozen members of Congress. Thus, CFIUS will expect significant congressional scrutiny and may be sensitive to transactions that could spur political controversy.
- **Implementing Regulations**. The law calls for the adoption of implementing regulations by April 21, 2008, including regulations providing for the imposition of unspecified civil penalties for violations of the law or of mitigation agreements. CFIUS has missed the statutory deadline, however. Instead, the Treasury Department issued draft regulations on April 21, calling for comments within 45 days.

The Impact on Foreign Investors

The new law mandates a very high level of scrutiny of many foreign investments for the foreseeable future. The increased reporting to Congress, moreover, will no doubt lead to some level of ongoing congressional involvement, and thus continued politicization of

the process. For the most part, however, the rigorous scrutiny and political oversight have already been in place for more than a year, and during this time investors from most countries generally have fared well in the process. Indeed, most foreign investors—especially those from Western European countries, Canada, Australia and certain other countries closely allied with the United States—may not feel a significant additional impact from the enactment of the law, other than the need to follow a process that has become, and will remain, somewhat more cumbersome and a bit more confusing than it used to be.

This is not necessarily the case for all investors, however. Investors with links to a foreign sovereign (including not just enterprises with state ownership or control, but also sovereign wealth funds) and investors that seek to acquire critical infrastructure may face greater hurdles. Investors from certain countries—*e.g.*, China, Russia and Middle Eastern countries—are likely to continue to face particularly intense scrutiny, with this heightened sensitivity making it difficult for CFIUS to clear many such deals (especially deals involving critical infrastructure) without the imposition of potentially significant conditions, if CFIUS clears the deals at all.

The continued politicization of the process also means that it is particularly important for investors—and critical for investors whose involvement may raise concerns—to navigate the CFIUS process with an eye to security and any political sensitivities. Investors also should bear in mind that the deliberate nature of CFIUS's review, coupled with additional confusion as CFIUS works to adopt regulations to implement the new law, may add time to the review process and potentially delay desired closings. Investors who are less familiar with the US market or who have little recent experience with CFIUS, and investors whose presence is likely to raise concerns, therefore may benefit from "making the rounds" in Washington, D.C. and introducing themselves to key government officials even before they have a concrete deal to submit to CFIUS. Once a transaction is approved, it is also prudent to develop a robust internal compliance system for any applicable mitigation agreement. With some patience and careful planning, most foreign investors are likely to proceed through the CFIUS process successfully. ■

SEC Reduces Restrictions On Resale of Restricted Securities

By John J. Huber, Robert A. Zuccaro and Aaron M. Singer

John J. Huber
Partner
Corporate Department

The US Securities and Exchange Commission (SEC), has amended Rule 144 under the Securities Act of 1933 in ways that will increase the liquidity of privately placed securities. The amendments shorten the minimum holding period and, particularly for non-affiliates, reduce other restrictions on the resale of restricted securities acquired before or after the changes took effect.

Robert A. Zuccaro
Partner
Corporate Department

Aaron M. Singer
Associate

If you are a non-affiliate and hold restricted securities that were acquired before the amendments became effective on February 15, 2008, you may now be able to resell those securities sooner and subject to fewer restrictions than before.

In summary, the amendments:

- reduce from one year to six months the holding period for restricted securities issued by reporting companies;
- remove the volume limitation and other conditions for resales by non-affiliate holders of restricted securities issued by reporting companies once the holding period is satisfied;

- remove all restrictions on sales of restricted securities, including those of non-reporting companies, for non-affiliates once a one-year holding period is satisfied;
- remove the manner-of-sale condition for all debt securities;
- codify eight staff interpretations relating to Rule 144; and
- retain most of the requirements applicable to resales by affiliates.

The following table summarizes the key aspects of Rule 144 as revised.

Conditions to Resale of Restricted Securities under Revised Rule 144

Seller	**Affiliate**		**Non-Affiliate (at resale and three months before)**		
Issuer	Reporting	Non-Reporting	Reporting		Non-Reporting
Minimum Holding Period	6 months	1 year	6 months	1 year	1 year
Other Requirements	1. Current public information 2. Volume limits 3. Manner of sale (only for equity securities, not debt) 4. Form 144		Current Public	None	None

Rule 144 and the Amendments

Background

Generally, offers and sales of securities must be registered with the SEC unless an exemption from registration is available. Rule 144 provides a safe way for holders of *restricted securities* (meaning securities acquired directly from the issuer in a transaction exempt from registration) or *control securities* (meaning securities held by affiliates of the issuer) to resell those types of securities without registering them. The amendments make it even easier than before to resell those types of securities.

The Amendments

The amendments to Rule 144 are intended to increase the liquidity of securities sold in private placements and thereby decrease the cost of capital for all issuers. The amendments will substantially streamline the process by which "restricted securities" sold in private transactions can become "unrestricted" for Securities Act purposes. The amendments also codify eight staff interpretations.

Holding Period Applicable to Sales of Restricted Securities by Non-Affiliates

Prior to the amendments, Rule 144(d) required restricted securities to be held for at least one year before any Rule 144 sales could be made. After a one-year holding period, non-affiliates that satisfied manner of sale, volume limitation and Form 144 notice conditions could sell restricted securities of a company that satisfied current public information requirements.[1] Non-affiliates who held the restricted securities for at least two years were permitted to sell the securities without limitation, even if the issuer did not satisfy the current public information reporting requirements. To satisfy the one-year or two-year holding periods, non-affiliates could add, or tack, their own holding periods to those of other non-affiliates from whom they bought the restricted securities.

Under the amendments, a security holder who has not been an affiliate of the issuer for three months and holds restricted securities of a reporting company[2] that is current in its SEC filings may resell these securities without any restriction after satisfying a six-month holding period. A non-affiliate security holder, moreover, may resell restricted securities of a reporting company after satisfying a one-year holding period even if the reporting company is not current in its SEC filings. A holding period of one year will apply to a non-affiliate's sale of restricted securities of a non-reporting company; however, sales made after the one-year period will not be subject to any of the Rule's requirements.[3] Tacking holding periods of non-affiliates continues to be permitted.

Holding Period Applicable to Sales of Restricted Securities by Affiliates

Prior to the amendments, Rule 144(d) required affiliates to hold restricted securities for one year before any Rule 144 sales could be made. After the one-year holding period, affiliates that met the current public information, manner of sale, volume and Form 144 notice requirements could make sales of restricted securities.

Under the amendments, the rules are now different for

affiliates reselling restricted securities of a reporting company and a non-reporting company. Affiliates must hold restricted securities of reporting companies for six months and must comply with the current public information, manner of sale, volume limitation and notice requirements in order to make Rule 144 sales. Affiliates must hold the restricted securities of a non-reporting company for one-year and thereafter must still comply with the information, manner of sale, volume limitations and notice requirements in order to make Rule 144 sales.

Manner of Sale Requirements Amended for Equity Securities

Under the amendments, manner of sale requirements no longer apply to resales of equity securities by non-affiliates. The manner of sale requirements still apply to affiliate sales of equity securities.

The amendments also make it easier for broker dealers to be involved in Rule 144 transactions. Those details, however, go beyond the intended scope of this article.

Rule 144's application to Debt Securities

Under the amendments, manner of sale requirements no longer apply to resales of debt securities, without regard to affiliate status, which should provide more flexibility in how debt securities can be resold. "Debt securities" now includes non-participating preferred stock[4] and asset-backed securities. In addition, the amendments relax the volume limitations with respect to debt securities by allowing resales of up to 10 percent of a tranche of debt securities in any three-month period.

Form 144 and Form 4 Reporting Requirements

Under the amendments, both Form 4 and Form 144 still need to be filed. Now only affiliates of an issuer are required to file a Form 144, however, and the filing thresholds have been increased to trades of 5,000 shares or $50,000 within any three-month period. There will likely be fewer Form 144 filings due to this increase in the filing thresholds.

Amendments to Regulation S

Regulation S creates a distribution compliance period for issuers, distributors or their affiliates complying with the Rule 903 safe harbor. That safe harbor allows certain offshore transactions. Regulation S's compliance period prevents the "flow back" of securities sold in Rule 903 transactions into the United States.

To conform the distribution compliance period for offerings of equity securities by Category 3 issuers (US reporting issuers) to the new six-month holding period for reporting companies of Rule 144(d), the SEC amended Regulation S to reduce the distribution compliance period for securities by US reporting issuers from one year to six months.

Possible Market Impacts

- Reduction of illiquidity discounts for privately placed securities.
- Reduction in use of or less onerous registration rights in private offerings.
- Impact on issuers' determination to become Securities Exchange Act reporting companies.

Conclusions

The amendments to Rule 144 will substantially streamline the process by which "restricted securities" sold in private transactions can become "unrestricted" for Securities Act purposes. These amendments are likely to improve the liquidity for privately placed securities and to reduce the needs for registration rights in private placements. We have separately published a *Client Alert* addressing the impact of these amendments on registration rights for debt securities. It can be found under the Publications section of our Web site, www.lw.com.

Endnotes

[1] Current public information under both the prior rule and the amended rule is deemed available for reporting issuers if the issuer has been subject to the Exchange Act reporting requirements for at least 90 days and has filed all required reports (excluding Form 8-Ks) during the 12 months preceding the sale (or such shorter period that the issuer was required to file such reports). Rule 144(c)(2) sets different requirements for non-reporting companies.

[2] For purposes of Rule 144, a reporting company is a company that has been subject to the reporting requirements of the Exchange Act for at least 90 days prior to the sale of the security.

[3] We expect the one-year holding period would also apply in the case of unsold restricted securities held by non-affiliates of a reporting company that for any reason ceased to be current in its SEC filings in the year following issuance.

[4] Non-participatory preferred stock is defined in amended Rule 144(a) as "non-convertible capital stock, the holders of which are entitled to a preference in payment of dividends and in distribution of assets on liquidation, dissolution, or winding up of the issuer, but are not entitled to participate in residual earnings or assets of the issuer." ■

Private Equity DEAL HIGHLIGHTS

Our comprehensive experience in all aspects of private equity investment enables us to service the full array of legal needs of fund sponsors and investors alike, from fund formation to investment acquisition, structuring, financing and disposition.

The following is a selection of US deals.

Abu Dhabi National Energy Company PJSC (TAQA)

Acquisition by TAQA North Ltd., a wholly owned subsidiary of Abu Dhabi National Energy Company PJSC (TAQA), of PrimeWest Energy Trust, an oil and gas exploration and production company.

2008

$5,000,000,000

Apollo Management LP

Acquisition by Apollo Management of International Paper Co.'s coated-paper business to CMP Holdings LLC.

2006

$1,400,000,000

BC Partners Ltd.

Acquisition by BC Partners of Intelsat Ltd, a provider of fixed satellite services.

2008

$16,900,000,000

Carlyle/Riverstone Global Energy and Power Fund, LP

Acquisition by Carlyle/Riverstone Global Energy and Power Fund III, L.P. of Titan Specialties, Ltd.

2007

$265,000,000

Guitar Center, Inc.

Acquisition of Guitar Center, a musical instrument retailer, by Bain Capital.

2007

$2,100,000,000

Harrah's Entertainment, Inc.

Unsolicited leveraged buyout offer by Apollo Management and Texas Pacific Group to acquire Harrah's Entertainment.

2008

$28,000,000,000

Kohlberg Kravis Roberts & Co.

Acquisition of Biomet, Inc. by a private equity consortium led by Kohlberg Kravis Roberts & Co.

2007

$11,600,000,000

Leonard Green & Partners, LP

Acquisition by Leonard Green & Partners of The Container Store.

2007

Not Public

Leonard Green & Partners, LP

Acquisition by Leonard Green & Partners of Brickman Group.

2007

Not Public

LS Power Equity Partners, LP

Acquisition by LS Power Equity Partners of six US natural gas-fired plants from Mirant Corporation.

2007

$1,407,000,000

Macquarie Bank Limited

Acquisition by a consortium led by Macquarie Bank of Spirit Finance Corporation.

2007

$3,500,000,000

Macquarie Infrastructure Partners

Acquisition by a Macquarie Infrastructure Partners led consortium of Puget Energy, a regulated utility providing electric and natural gas service to the Puget Sound region of western Washington.

2007

$7,200,000,000

Maguire Properties, Inc.

Acquisition by Maguire Properties of Equity Office Properties assets in Orange County and Downtown Los Angeles, from The Blackstone Group.

2007

$2,875,000,000

Odyssey Investment Partners, LLC

Acquisition by Odyssey Investment Partners of Ranpak Inc., a manufacturer of paper-based protective packaging.

2007

Not Public

One Equity Partners Westcom Holdings

Sale of Westcom Holdings by One Equity Partners to IPC Systems, Inc. and Silver Lake Partners.

2007

Not Public

One Equity Partners

Acquisition by One Equity Partners of a 13 percent interest in Clipper Windpower plc, a manufacturer of advanced wind turbines and developer of wind energy projects.

Pending

$150,000,000

Sabre Holdings Corporation

Acquisition of Sabre Holdings Corporation by Silver Lake Partners and Texas Pacific Group.

2007

$5,400,000,000

The Carlyle Group

Acquisition by The Carlyle Group, Bain Capital and Clayton, Dubilier & Rice, Inc., of HD Supply, a distributor of construction, industrial and maintenance supplies in North America, from Home Depot.

2007

$8,500,000,000

The Carlyle Group Onex Corporation/Onex Partners LP

Acquisition by The Carlyle Group and Onex Corporation of Allison Transmission, a producer of transmissions and related parts for military vehicles and heavy equipment, from General Motors Corp.

2007

$5,600,000,000

The Carlyle Group

Acquisition by The Carlyle Group of Manor Care, a provider of skilled nursing and assisted living services.

2007

$6,300,000,000

The Goldman Sachs Group Cogentrix Energy, Inc.

Sale by The Goldman Sachs Group and Cogentrix Energy, Inc. of interests in a portfolio of 14 power generation facilities, to Energy Investors Funds.

2007

Not Public

Joshua A. Tinkelman
Partner
Corporate Department

S&P Takes a Negative View of Preferred Equity

By Joshua A. Tinkelman

On August 10, 2007, Standard & Poor's published an article entitled "LBO Equity Hybrids: Too Good To Be True," which announced that S&P intends to treat preferred stock as debt for credit rating purposes. This change in policy has the potential of significantly altering how private equity clients use equity to capitalize their portfolio companies.

Background

For years, many private equity firms have capitalized their portfolio companies with both common and preferred equity. While the terms of the preferred equity vary from deal to deal, they typically:

- are perpetual;
- accrue a fixed dividend, which is typically payable-in-kind (or PIK'd); and
- are redeemable at the option of the issuer or are mandatorily redeemable upon a change of control of the portfolio company at par, plus any accrued PIK'd dividends.

The terms of the debt incurred to finance an acquisition customarily limit cash dividends on the preferred (or any other) equity. As such, sponsors typically expect to get paid on their preferred equity upon an IPO or a change of control.

Using preferred equity provides a sponsor a guaranteed return on a portion of its equity investment, before anything gets paid to the common stockholders. It also provides the holders of the common stock (including management) a greater portion of any "upside" after all required payments on the acquisition debt and preferred equity are made.

S&P Concerns

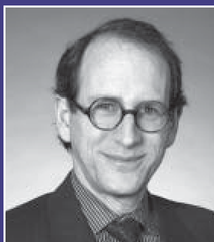
In its August 10th article, S&P stated that it "is skeptical about the benefit of [such preferred stock] for the company's long-term credit quality." Significantly, S&P went on to state that it would "not assign it any equity credit—and treat it as debt in calculating credit ratios."

The articulated reasons for S&P's skepticism centered on the perceived incentives that such preferred stock create (a) to pay dividends in cash on the preferred stock where possible and (b) to orchestrate a change of control in order to recapitalize the portfolio company. S&P's view was that in such a recapitalization, the preferred equity would likely be replaced with debt and, accordingly, the preferred equity should be treated as debt when calculating credit ratios.

Conclusion

Although we question the assumptions upon which the S&P position is based, it is our experience that S&P is adhering to the positions set forth in the article when assigning ratings to debt that is used to finance an acquisition.

If preferred equity will be used to finance an acquisition, a private equity sponsor should discuss the terms of the preferred equity with its financing source as early in the process as possible to assess how the terms of the preferred equity will affect the overall ratings given to the acquisition debt. ■



Jed W. Brickner
Partner
Tax Department

Meredith L. O'Leary
Associate
Tax Department

Industry Focus

PBGC Deems Private Equity Funds Members of Their Portfolio Companies' Controlled Group; Imposes Joint and Several Liability for Pension Underfunding

By Jed W. Brickner and Meredith L. O'Leary

The Pension Benefit Guaranty Corporation (PBGC), the federal pension plan insurer, recently ruled that a private equity fund (Fund) was liable for the underfunding of the terminated pension plan of its bankrupt portfolio company under a theory of controlled group liability. Under the facts of the actual case, the Fund was held liable for $3.2 million, the amount by which the pension plan was underfunded upon its termination, plus applicable interest.

Under the controlled group theory on which the decision relies, not only investment Funds, but also other portfolio companies of such Funds could be held similarly liable. Although the decision did not reach this question because of an insufficiently developed factual record, the clear implication of the decision is that, given an appropriate record, any portfolio company could be held liable for the pension underfunding of any other portfolio company in the same Fund.

Controlled Group Liability Generally

Under the Employee Retirement Income Security Act of 1974 (ERISA), if a company terminates a defined benefit pension plan and such plan, at termination, has unfunded liabilities, all members of the company's "controlled group" (as defined by ERISA) may be held jointly and severally liable for the unfunded liabilities. A company's controlled group generally consists of all incorporated or unincorporated entities engaged in "a trade or business" that are under "common control" with the company.

The basic common control case is that of a parent and a subsidiary. When a parent company owns 80 percent or more of a subsidiary company, the parent company and the subsidiary company are under common control. Where a parent owns multiple subsidiary companies, each subsidiary company in which the parent company has an 80 percent or more ownership interest (whether direct or indirect) is deemed to be under common control with the parent company and all other 80 percent or more owned subsidiary companies. For example, if a parent company owns at least 80 percent of Company A and at least 80 percent of Company B, then the parent company, Company A and Company B are under common control and are in the same controlled group. If Company A has an underfunded, terminated pension plan and Company A is unable to satisfy this liability, the PBGC can turn to the parent company and to Company B to secure additional assets to satisfy the unfunded liability.

PBGC Appeals Board 2007 Decision

On September 26, 2007, the PBGC Appeals Board (the Board) ruled that an unnamed private equity Fund was a member of the controlled group of its unnamed portfolio company and, as such, was jointly and severally liable for the unfunded liabilities of the portfolio company's pension plan, which was terminated during the company's bankruptcy.

The decision, which was released in December of 2007, is the first published decision by the Board and is the first piece of guidance on this question. Although many practitioners have long been concerned about the issue, prior to the decision, it was unclear whether Funds would be considered to be within their portfolio companies' controlled groups because it was uncertain whether Funds would be deemed to be engaged in "a trade or business" as is required by ERISA for an entity to be considered part of a company's controlled group.

The Fund argued to the Board that the Fund was a passive investor in the portfolio company and that, under previous case law, as a mere investor, the Fund should not be considered engaged in "a trade or business." If the Fund was not engaged in a trade or business, it argued, it could not be within the portfolio company's controlled group and therefore could not be held liable for the underfunding of the portfolio company's terminated pension plan. The Board rejected this argument, distinguishing the previous case law on the grounds that such cases covered only individual

investors and did not apply to incorporated entities that continuously and regularly invested, did so primarily for income or profit and were actively involved in the day-to-day business of the companies in which they invested. The Board further ruled that an agency relationship existed between the Fund and the Fund's general partner (which had hired a management company to be responsible for the day to day management of the Fund), that the actions of the Fund's general partner should therefore be imputed to the Fund, and that such actions went beyond mere passive investment. As such, the Board rejected the argument that the Fund was a passive investor, held that the Fund was engaged in a trade or business through its agency relationship with the Fund's general partner, and held the Fund jointly and severally liable per ERISA for the unfunded liabilities of the portfolio company's terminated pension plan.

It is worth noting that the Board's decision is subject to judicial review and that, should it appeal, the Fund might yet persuade a court that it is a passive investor not engaged in a "trade or business" and, as such, is not within the portfolio company's controlled group.

Implications of the PBGC Appeals Board 2007 Decision

While the decision's joint and several liability holding only specifically applies to Funds themselves, its reasoning would also cover other portfolio companies invested in by a Fund, if the Fund owned at least 80 percent of such companies. As such, given appropriate facts, under the decision, the PBGC may also turn to these other portfolio companies to satisfy any unfunded defined pension plan liability. Funds should review their holdings and investments to determine whether controlled group liability exists within their structure.

Further, a Fund that has any portfolio companies with any defined pension plan liability should review credit or other financing agreements relating to all of its portfolio companies, as many of these agreements require representations regarding the existence and level of controlled group defined benefit pension underfunding. For example, if Portfolio Company A has $100 million in defined benefit pension underfunding but Portfolio Company B has no defined pension liability, Company B would still need to consider carefully any representations made in its financing agreements concerning pension underfunding if the representations cover not only Company B but also members of its controlled group. Many practitioners have long expressed concerns to Funds and their portfolio companies regarding such representations.

In sum, a Fund which has significant ownership interests in any entity with an underfunded defined benefit pension plan should consult with a benefits specialist to review the potential implications for the Fund and each of its portfolio companies.

Practical Effects PBGC Appeals Board 2007 Decision

There are at least two possible changes in structure that Funds may wish to consider in light of this decision. One possibility is for Funds to organize their investments in portfolio companies in a way that would keep the Fund's total investment in each portfolio company (and the structure that directly or indirectly holds each portfolio company) below the 80 percent ownership threshold required for controlled group liability. This can be accomplished by splitting the investment between more than one vehicle in the same Fund family or by bringing in co-investors.

"Although the cure might be worse than the disease, another possible way for Funds to better insulate their other portfolio companies from controlled group exposure to the liability of a single portfolio company is to return to the practices of the 1980s. . ."

Although the cure might be worse than the disease, another possible way for Funds to better insulate their other portfolio companies from controlled group exposure to the liability of a single portfolio company is to return to the practices of the 1980s and set up a separate vehicle for each investment, rather than having a master Fund which makes multiple investments. Properly structured, if each separate vehicle invests in one portfolio company, the PBGC would only be able to turn to the assets of the investing vehicle to satisfy any unfunded defined pension plan liability (and not to other vehicles or the additional portfolio companies the Fund family may hold). (Note, though, that because ownership is assessed on both a direct and an indirect basis, a Fund could not avoid the 80 percent threshold merely by setting up several different vehicles all held by a master Fund to invest in entities because this indirect ownership will be imputed to the master Fund.)

Ironically, one of the practical effects of the Board decision may be that Funds become more hesitant to invest in companies which have underfunded defined benefit pension plans (even though such investment may cause the company to improve its performance and therefore make it more likely that the company is able to financially support such liability).

If you have any questions or would like further information regarding the topics covered in this article, please contact Jed Brickner at (212) 906-1294 or Meredith O'Leary at (212) 906-1665. ■

Peter Myners
Associate
Corporate Department

Schemes of Arrangement: The Current Structure of Choice for Acquisitions of UK-Listed Companies

By Peter Myners

The scheme of arrangement is the current structure of choice for purchasers acquiring large, UK-listed companies, and there have been recent, significant developments in market practice as well as welcome changes to the legal and regulatory regimes applicable to schemes.

What is a Scheme?

A scheme of arrangement is a court-based arrangement between a target company and its shareholders, and an alternative to the standard contractual offer made by an offeror direct to target shareholders. Schemes are governed by the City Code on Takeovers and Mergers (the Takeover Code), but structured, procedurally, in-line with court rules and the court timetable. A scheme will require the approval of 75 percent of votes cast at the general meeting convened at the direction of the court for the purposes of approving it, and a majority in number of those attending. Once approved by shareholders and sanctioned by the court, however, a scheme will bind 100 percent of target shareholders.

The majority of recent "mega-mergers" in the UK have been structured by way of scheme, and a consensus is building among principals and their advisers that the advantages associated with schemes generally outweigh the disadvantages.

Why Structure a Deal by Way of Scheme?

There are two principal advantages associated with schemes when compared with contractual takeover offers: (i) probable stamp duty tax savings of 0.5 percent of the total consideration payable; and (ii) speed and certainty of acquiring 100 percent of the target's shares. The latter will be of real importance in the context of hostile minorities, highly leveraged deals and public-to-privates.

It is also possible that an acquisition structured by way of scheme will reduce some of the complexities associated with offers to overseas shareholders.

So Why Isn't Every Public Takeover Structured as a Scheme?

Traditionally, schemes have been viewed as inflexible, time-consuming and costly structures, relative to contractual offers, and on smaller deals the stamp duty saving may be outweighed by the extra cost associated with preparing the necessary documentation (which will be more extensive as compared to a contractual offer) and engaging counsel to assist with court procedures.

There are detailed rules regarding the composition of separate classes of shareholders (with uncertainty in relation to the impact of so-called "hard" irrevocable undertakings), each of which will need to approve the scheme, as well as the ability to vote at the relevant meetings. The latter will impact the balance of power at the court-convened meeting, as well as the tactical decision as to whether or not to build a stake in the target.

Historically, due to the fact that schemes are largely target-controlled and the target board is able to withdraw a scheme at any time prior to the final court order being granted if it considers this to be in the best interests of shareholders (for example, in the event of a higher bid), schemes have offered appreciably less deal protection than is available on a contractual offer.

Perceived Inflexibility in Competitive Situations

In the context of competing bids, the ability to increase the price offered to target shareholders and otherwise improve the terms on which an offer is made is essential.

The issue on a scheme is the extent to which a court will permit a bidder to alter the terms of its scheme once the court process has commenced, and whether a further meeting of the target's shareholders will be required if the initial meeting of target shareholders has already taken place by the time the revised terms are announced. Historically, a bidder in such a scenario would seek to exercise its reserved right to switch to an offer, and abandon the scheme of arrangement, to allow it to be more responsive and to operate independently of the target board. Recent changes to the Takeover Code have, however, clarified the offeror's ability to amend the terms of a scheme under the rules of the Code.

Competing Schemes

The traditional view had been that it would not be appropriate for a competing bidder to structure its offer by way of a scheme in circumstances where an original offer has already been structured as a scheme and the court process in relation to that scheme has already commenced.

Recent deals, however, have prompted a debate about the ways in which competing schemes could be structured. There are, theoretically, two principal structures that could be used for competing offers made by way of scheme: the "parallel" scheme (involving separate scheme documents being posted to target shareholders) and the "dual-option" scheme (where the target sends to shareholders a scheme document containing both schemes and convening both schemes' respective court meetings and EGMs for the same day). Complex timetabling and procedural issues are likely to arise, and advice from counsel will be needed as to the possibility of either scheme being struck out for abuse of process.

Implementation Agreement

It is now market practice for the general imbalance between the offeror and the target as regards control of the scheme process to be addressed in an implementation agreement. Market practice has developed in relation to the level of comfort obtained, with the agreement typically including a break fee and non-solicit and increasingly a "matching right" in the event of a competing bid.

What Has Prompted Recent Market Practice?

The main drivers behind the recent trend toward more innovative use of schemes appear to have been a shift in the attitude of the courts, and the flexibility of the Panel. There is evidence (for example, in their sanctioning of so-called "hybrid" schemes which contain both transfer, in respect of loan note elected shares, and reduction elements) that courts are prepared to be more flexible provided the terms of the scheme are clear and the manner in which those terms are put to shareholders is fair and reasonable.

And Will the Trend Continue?

Market practice had developed over time and been reflected, albeit on an informal basis, in the approach adopted toward schemes by the Panel, but it had never formally been reflected in the Takeover Code. Welcome changes to the Takeover Code took effect on January 14, 2008, and these have clarified the application of the Takeover Code to takeovers implemented by way of scheme.

The changes to the Takeover Code provide a more certain framework within which acquisitions of UK public companies can be implemented by way of scheme and are likely to further increase confidence in schemes of arrangement as a means of structuring takeovers.

In addition to the changes to the Takeover Code, new practice directions came into force on October 1, 2007 with the aim of streamlining the court-based procedures applicable to schemes.

So Schemes Are Here to Stay?

It remains to be seen whether the increased and more innovative use of schemes and the associated procedural complexity will overload and give rise to a backlash from the courts, or whether a general decrease in the number and relative value of highly leveraged bids will give rise to a reduced need to structure takeovers by way of scheme. In the meantime, however, the current trend is set to continue.

For further information, please contact Peter Myners at peter.myners@lw.com. ■

Firm Continues to Expand Its Global Footprint

Latham & Watkins Expands Into Middle East

We are pleased to announce Latham & Watkins' expansion into the Middle East with the opening of our newest office in Dubai. The firm will also be opening offices in Abu Dhabi in the United Arab Emirates and Doha, Qatar in the following months. Corporate partner Rindala Beydoun, who joined Latham & Watkins from Vinson & Elkins LLP, will serve as the Office Managing Partner for the three offices. Ms. Beydoun has extensive experience advising on M&A and private equity deals and real estate projects in the region. A number of Latham & Watkins partners and associates will transfer to the region in a move that reinforces Latham's commitment to its Middle East expansion plans.

Our Middle East offices will focus on M&A, private equity, project development and finance, structured finance, leveraged finance and capital markets and will significantly bolster our practice in one of the most dynamic markets in the global economy. While we already have substantial experience advising companies and financial institutions operating in the Middle East, having a physical presence in the region is strategically very important for our continued global expansion. The region's significant M&A and investment work—including both cross-border and regional deal activity—present significant opportunities for our Corporate and Finance practices.

Latham & Watkins has worked on a number of high-profile deals in the Middle East region, including the groundbreaking Nakilat liquefied natural gas (LNG) ship financing in the State of Qatar. In what is the largest ship financing ever completed, Latham represented Qatar Gas Transport Company Limited (Nakilat Inc.) in connection with its US$7.3 billion project financing of more than 20 LNG vessels to transport LNG produced from Qatar's North Field, the world's largest non-associated gas field with approximately 15 percent of the world's total proven natural gas reserves, to established gas markets throughout the world.

Latham has also advised TAQA, a global energy company listed on the Abu Dhabi Securities Market, on major North American acquisitions, including: the C$5 billion acquisition of PrimeWest Energy Trust, a publicly traded oil and gas royalty trust; the US$2 billion acquisition of Northrock Resources Ltd. from Pogo Producing Company; and the US$540 million acquisition of Pioneer Natural Resources Canada Inc. from Pioneer Natural Resources Company. In addition, over the years, Latham has done extensive M&A work for the Qatar Investment Authority.

Italian Practice

A team of five leading Italian partners have joined Latham & Watkins, expanding the firm's Italian practice with the launch of a local Italian law capability. Their focus will be on mergers and acquisitions, private equity, capital markets, banking and finance, insolvency and restructuring, and real estate.

The team, together with a number of associates, joins Latham's existing Italian practice operating out of the firm's Milan office, which represents Italian companies and investment banks on the international aspects of their capital markets transactions, mergers and acquisitions, acquisition and leveraged financing, and other corporate transactions, and also provides to Italian and international clients general corporate and antitrust advice.

Currently Latham's Italian practice in Milan and Rome houses 30 lawyers and full support staff.

The arrival of the team and the addition of the new office in Rome enhances Latham's significant presence as a premier full-service firm operating in all of the major European economies, with more than 400 lawyers resident in 11 offices across the continent.

Contact

LATHAM & WATKINS

SmartCapital is published by Latham & Watkins as a news reporting service to clients and other friends. The information contained in this publication should not be construed as legal advice. Should further analysis or explanation of the subject matter be required, please contact the attorneys listed below or the attorney whom you normally consult. A complete list of our publications can be found on our Web site at www.lw.com.

If you wish to update your contact details or customize the information you receive from Latham & Watkins, please visit www.lw.com/LathamMail.aspx to subscribe to our global client mailings program.

If you have any questions about this edition of *SmartCapital*, please contact David S. Allinson or John Giouroukakis in our New York office at +1.212.906.1200, or any of the attorneys listed below.

Office locations:

Barcelona
Brussels
Chicago
Dubai
Frankfurt
Hamburg
Hong Kong
London
Los Angeles
Madrid
Milan
Moscow
Munich
New Jersey
New York
Northern Virginia
Orange County
Paris
Rome
San Diego
San Francisco
Shanghai
Silicon Valley
Singapore
Tokyo
Washington, D.C.

www.lw.com

Barcelona
José Luis Blanco
+34.93.545.5000

Brussels
Andreas Weitbrecht
+32.2.788.6000

Chicago
Mark D. Gerstein
Thomas E. Keim, Jr.
Richard S. Meller
+1.312.876.7700

Dubai
Rindala Beydoun
+971.4.704.6300

Frankfurt
Hans-Jürgen Lütt
Dirk Oberbracht
+49.69.6062.6000

Hamburg
Christian E. Edye
Götz T. Wiese
+49.40.41.40.30

Hong Kong
John A. Otoshi
David T. Zhang
+852.2522.7886

London
Michael A. Bond
Bryant B. Edwards
+44.20.7710.1000

Los Angeles
Jeffrey L. Kateman
Scott P. Klein
Paul D. Tosetti
W. Alex Voxman
+1.213.485.1234

Madrid
José Luis Blanco
+34.91.791.5000

Milan
Michael S. Immordino
+39.02.3046.2000
(also based in London)
+44.20.7710.1000

Moscow
Mark Banovich
+7.495.785.1234

Munich
Jörg Kirchner
+49.89.20.80.3.8000

New Jersey
David J. McLean
+1.973.639.1234

New York
David S. Allinson
John Giouroukakis
Raymond Y. Lin
Jennifer S. Perkins
Eric J. Schwartzman
Howard A. Sobel
Taurie M. Zeitzer
+1.212.906.1200

Northern Virginia
Scott C. Herlihy
+1.703.456.1000

Orange County
Charles K. Ruck
+1.714.540.1235

Paris
Nicolas Bombrun
Thomas Forschbach
+33.1.4062.2000

Rome
Fabio Coppola
+39.02.3046.2000

San Diego
Scott N. Wolfe
+1.619.236.1234

San Francisco
Scott R. Haber
+1.415.391.0600

Shanghai
Rowland Cheng
+86.21.6101.6000

Silicon Valley
Peter F. Kerman
Anthony J. Richmond
+1.650.328.4600

Singapore
Mark A. Nelson
+65.6536.1161

Tokyo
Satoshi Karashima
Michael J. Yoshii
+81.3.6212.7800

Washington, D.C.
Daniel T. Lennon
William P. O'Neill
+1.202.637.2200

Latham & Watkins operates as a limited liability partnership worldwide with affiliated limited liability partnerships conducting the practice in the United Kingdom, France and Italy. Under New York's Code of Professional Responsibility, portions of this communication contain attorney advertising. Prior results do not guarantee a similar outcome. Results depend upon a variety of factors unique to each representation. Please direct all inquiries regarding our conduct under New York's Disciplinary Rules to Latham & Watkins LLP, 885 Third Avenue, New York, NY 10022-4834, Phone: +1.212.906.1200. © Copyright 2008 Latham & Watkins. All Rights Reserved.