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Editor: Roger Mulvihill

Private Equity

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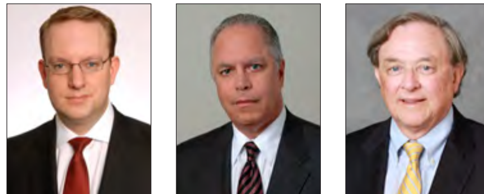
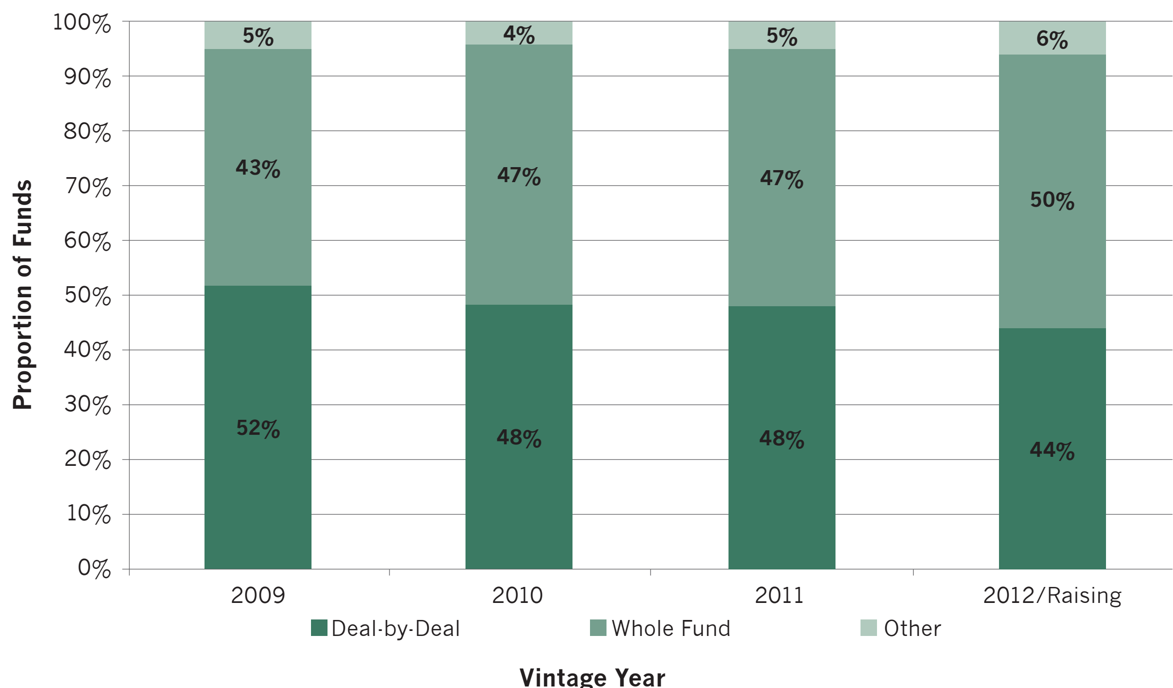
ILPA Guidelines Have Noticeable Impact



by **Gus Black**, **Carl A. de Brito** and **Roger Mulvihill**

Every private equity fund formation is unique, but after more than three years of the ILPA Guidelines (the Guidelines) and one comprehensive revision (the Revision) which reflected the views of many industry participants, some preliminary observations are relevant. These observations are based on a collaboration with Preqin and the results of their survey in June 2012 of 2400 funds across fund types and vintage years (the *2012 Preqin Private Equity Fund Terms Advisor* cited herein as the Preqin Study), and Dechert's own experiences in representing sponsors and limited partners in similar funds.

The Guidelines have clearly had an impact on sponsors and limited partners, although not in all cases, and not with respect to all of the" best practices" recommended in the Guidelines. One of the largest U.S. pension funds, on the one hand, announced in February 2012 that it would require all private equity funds in which it is invested to comply with the ILPA terms on capital calls and distributions. On the other hand, many GPs have suggested that the Guidelines need to be modified in many cases to reflect their specific circumstances.



Source: *2012 Preqin Private Equity Fund Terms Advisor*

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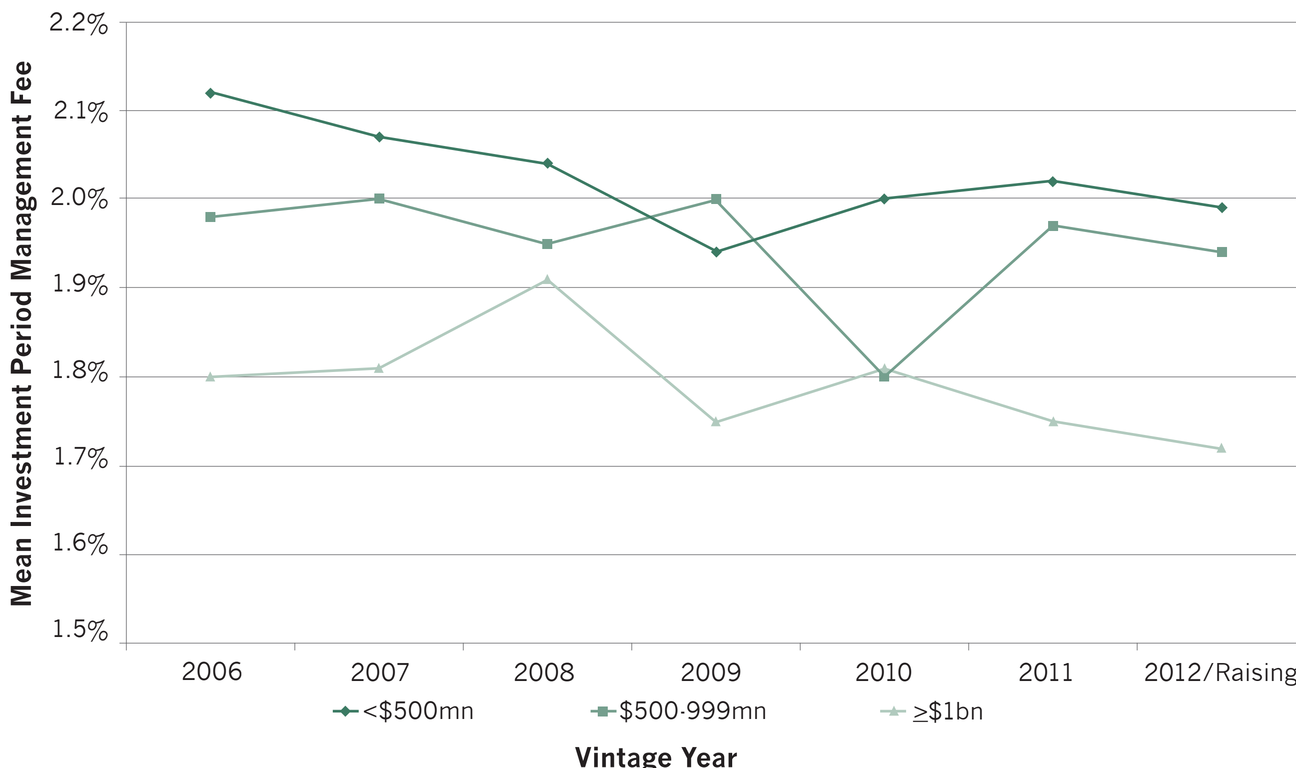
From our experience, in both the United States and Europe, the best performing PE funds were the least likely to adopt the more significant recommendations in the Guidelines. The Preqin Study seems to confirm this observation. For instance, one of the more far-reaching suggestions in the Revisions directly affecting LP/GP economics was a definite preference for the European style waterfall where LPs receive priority distributions of all their capital contributions and any preferred return before any carried interest is distributed to the GP. The Preqin Study indicated that only 50% of North American focused buyout funds raised in 2012 adopted a so called "whole fund" distribution approach instead of the deal by deal format.

Of course, there are several reasons why successful funds might persuade investors to support the traditional waterfall structure. For one thing, many funds had already adopted modifications which softened the impact of the classic deal by deal waterfall provisions. Limitations on distributions, such as net asset value coverage tests or carry escrows, which have been widely adopted by even top tier funds, and interim clawback provisions, effectively create a hybrid waterfall which in some cases has an impact similar to a whole fund approach. (The Revision itself suggested several such restrictions on GP carried interest distributions, as a fall back approach). Then, too, the most desirable PE funds — generally those that have long-standing top quartile track records, and can point to a "prior vintage" position on key fund terms — often had the leverage to push back on fundamental changes to their distribution structure. This was also the case in Europe, where some sponsors — albeit a minority — continue to use a deal by deal model to be consistent with earlier fund vintages, even though the "whole fund" basis of calculation is more prevalent overall in Europe.

It seems clear that the vast majority of investors, both institutional LPs and others, were very familiar with the Guidelines and the Revisions. In our experience, LPs cited provisions in the Guidelines in support of their preliminary investment positions even if they were more marginal investors in highly successful funds and would not have expected to have much practical impact on the terms. Indeed, the less established investors used the Guidelines as a form of due diligence checklist, with some adopting a "comply or explain" approach. Our impression, however, is that more experienced investors have their own checklist of key issues and positions, and for them the Guidelines will have been less helpful as a due diligence resource, albeit that it may have helped those investors' overall negotiation position.



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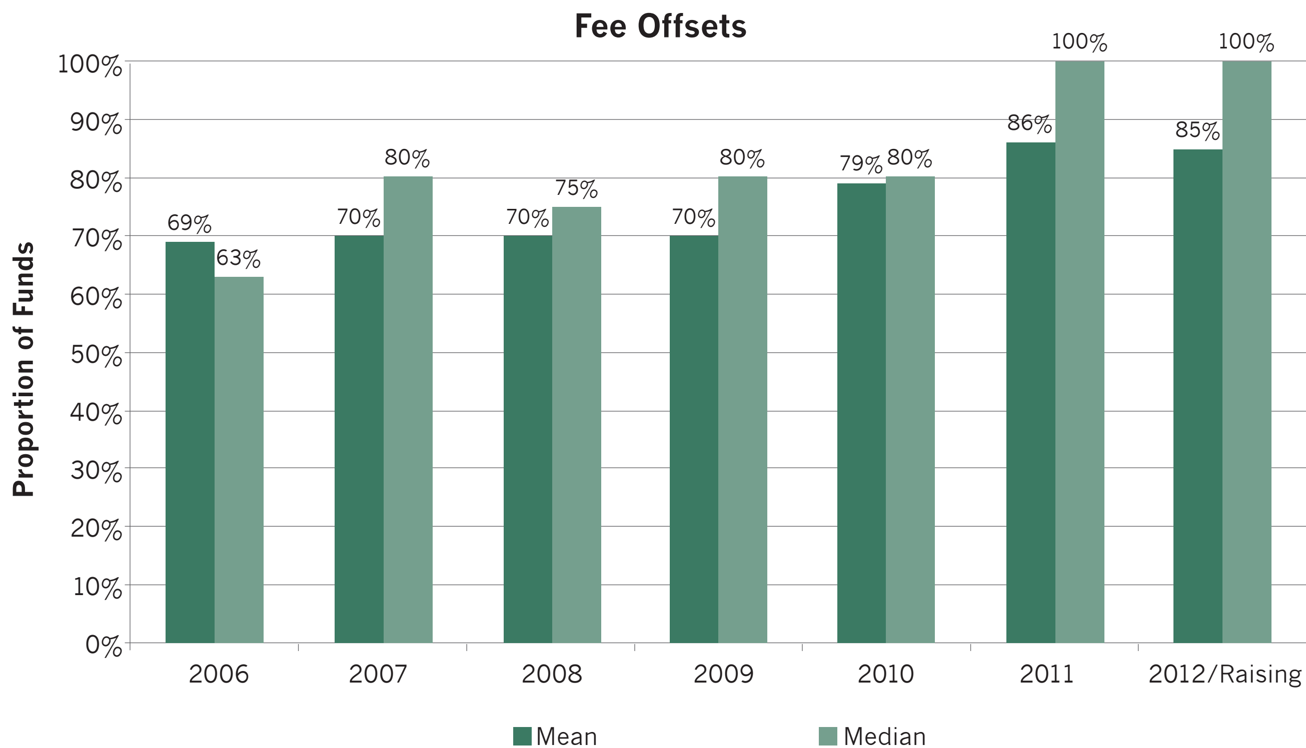

Source: *2012 Preqin Private Equity Fund Terms Advisor*

Less established fund sponsors and new funds, even those being formed by sponsors with impressive track records elsewhere, almost always incorporated most of the Guideline suggestions in their initial offering materials. Sponsor lawyers were frequently asked to compare the sponsor's proposals at an early stage against the Guidelines even before any contact with prospective limited partners. We understand that several placement agents routinely advise new funds to adhere to the Guidelines (or to be able to justify convincingly why they are deviating from the Guidelines) and avoid potentially contentious debates with investors except on terms the sponsors consider vital.

In the area of fee income offsets, the Guidelines seem to have had a significant impact on PE terms, even for many PE funds. On average, 86% of new funds in 2011 and 85% of new funds in 2012 in the buyout fund sector rebated all transaction fees. (While the 2009 Guidelines recommended a 100% offset, the Revisions did not suggest a specific rebate percentage). In the Preqin Study there did not seem to be a significant difference on average in the treatment of fees (i.e., whether transaction, monitoring, directors, breakup or other). Deal terms had been trending in this direction for several years but the Guidelines no doubt provided additional impetus.

Other proposals in the Guidelines may have had a more indirect impact on actual deal terms. The Guidelines recommended that management fees be set based on sponsor provided budgets or expense models in order to tie fees to a more realistic estimate of operating expenses. In earlier years it was suggested that a good many funds profited handsomely from the management fees even if the portfolio performance was substandard. We do see more limited partners requesting management company information, including management fee budgets as well as management professionals compensation criteria. Although we are not aware of any established sponsors who have provided detailed budgets to prospective investors for the purpose of setting management fees, those fees have generally declined since vintage 2010 funds in all size categories. For instance in funds under $500 million, fees have declined from 2% to 1.99% in 2010 and 2012, respectively; in funds from $500 million

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to $999 million fees have declined in 2011 and 2012 to 1.97% and 1.94%, respectively; and in funds over $1 billion fees have declined from 1.81% in 2010 to 1.75% in 2011 and 1.72% in 2012, respectively. The Guidelines also encouraged limitations on investment concentrations and, although such provisions were generally common before the Guidelines, it is likely that the recommendations had some favorable impact. Thus, in vintage 2011 and 2012 funds, 38% of the funds restricted a single investment to 15% of capital and 44% limited it to 20%. There has also been a noticeable increase in requests for tightening of overall investment focus so that sponsors are not able to "creep" away from the fund's core geographic, industry or other focus.

The Guidelines emphasized that the general partners should have substantial cash equity investments in their funds. It is hard to generalize from the Preqin Study since sponsor contributions in 2011 and 2012 were widely dispersed. In general, most buyout funds averaged between 1% and 3% of aggregate commitments although some GPs (particularly in foreign funds) made substantially higher contributions. The Guidelines and the Revision disapproved of management fee waivers which appear to be less popular in the Preqin Study and in our experience as well.

The Revision recommended that fund extensions should be limited to one year increments after LP or LP Advisory Board approval. However, the Preqin Study found that most extensions were for two year periods, normally in two one-year increments, with about a third providing for Advisory Board approval. Sponsors generally followed the Revision on recommended no fault divorce percentages however. The Revision suggested a three quarters vote of the LPs in interest to terminate a fund. The Preqin Study found that most funds adopted a 75% vote with a few outliers at 80% which is also consistent with our own experience.

The Preqin Study found other developments which were not explicitly covered in the Guidelines but were consistent with the overall spirit of aligning the interests of sponsors and limited partners. The number of limited partner members on the advisory board averaged between four and six, depending on the size of the fund, which reflected a workable size board in light of the increased responsibilities of the advisory board contemplated by the Guidelines and the Revision. The vast majority (72%) of vintage 2011 and 2012 funds under the Preqin Study restricted the final close to one year after the first close which limited the complications for LPs if values of portfolio companies changed during an extended fund raising term. Organizational expenses also seemed consistent with the spirit of alignment in that they are generally influenced by the size of the fund.

Last year the ILPA uploaded to its members-only website a software tool that allows limited partners to quantify limited partnership adherence to its principles. It is not clear yet what impact the Guidelines scoring tool will ultimately have on compliance with the Guidelines once it is made public, probably later this year. At least one large pension fund has instructed its analysts to use the tool when reviewing new fund agreements. Generally, the Guideline scoring mechanism includes any measurable ILPA principle in the software program which asks users to rank their partnership terms with the specific principles outlined in the Guidelines. Each ILPA principle is weighted based on its perceived importance, so that the waterfall structure, for instance, would presumably have greater weight than certain advisory board matters. A full breakdown of each principle's weighting however is not yet available to non- ILPA members. While many GPs will argue that one size doesn't necessarily fit all, GPs with a less impressive ILPA scores should be prepared at a minimum to discuss why the tool is less of a factor in their particular case.

Gus Black
+44 20 7184 7380
gus.black@dechert.com

Carl A. de Brito
+1 212 698 3543
carl.debrito@dechert.com

Roger Mulvihill
+1 212 698 3508
roger.mulvihill@dechert.com

Extracting Tax Value in Debt Refinancings and Modifications

by **Daniel M. Dunn**, **Kenneth C. Wang** and **Steven J. Lorch**

The years since the financial crisis have seen a large number of debt amendments in the market, including debt re-pricings and issuers “amending-and-extending” their loans. This activity has continued at a high level in recent months. Although these debt amendments often involve small changes to the parties’ commercial deal, they may have significant U.S. federal income tax consequences.

This article highlights certain tax benefits and planning opportunities that issuers should consider when amending their debt instruments.

Deduction of Unamortized Debt Issuance Costs

Generally, upfront fees or similar costs paid by an issuer to a lender will reduce the issue price of the debt instrument and, in effect, be treated as original issue discount (OID). As a result, the issuer will have been amortizing (deducting) these costs over the life of the debt instrument.

However, case law and IRS authorities permit an issuer to deduct its unamortized costs associated with a borrowing at the time of certain refinancing transactions. This includes deemed debt-for-debt exchanges resulting from an amendment that alters the legal rights and obligations of the issuer and holder to an economically significant degree — the tax result is a “significant modification” of the debt, which is treated as a taxable exchange of hypothetical “old” debt for hypothetical “new” debt.

In a refinancing, as well as when a significant modification occurs, an issuer may be able to accelerate the tax benefit associated with its previously unamortized costs. An issuer generally is able to write-off these unamortized costs if the refinancing debt instrument is considered to be “separate and independent” from the existing debt instrument. Favorable factors include the extension of the new loan by a different lender, materially different terms from the existing loan, the fact that the revised loan was bargained for separately and apart from the existing loan, and the issuer having a separate business purpose for entering into the loan amendment. Thus, in a number of refinancings (for example, to facilitate a leveraged distribution), it will often be possible to deduct immediately any unamortized financing costs. In addition, the Tax Court has indicated that these rules should apply equally to debt amendments that result in a deemed debt-for-debt exchange for U.S. federal income tax purposes, even though there may not be an actual refinancing. In other words, a “significant modification” of a loan under income tax regulations may allow an immediate deduction of previously incurred unamortized lender fees.

An issuer should consult its tax advisors as to whether it may deduct any unamortized upfront costs in connection with a refinancing or debt amendment under these rules.

Acceleration of Interest Deductions

Recently, new Treasury regulations were adopted expanding the definition of "publicly traded" debt for purposes of determining the issue price for debt instruments issued on or after November 13, 2012. The determination of the issue price of a debt instrument can have significant effects on both the issuer and the holder, and is particularly important in the case of a deemed debt-for-debt exchange resulting from a significant modification of a debt instrument (as described above). In such a constructive exchange of debt, the issue price of the "new" debt instrument is used to determine whether (and to what extent) an issuer has cancellation-of-indebtedness income (CODI) resulting from the exchange and whether (and to what extent) there is any OID associated with the debt instrument.

Under the new Treasury regulations, the issue price of any amended debt instrument that is considered to be "publicly traded" is determined by reference to the price at which the debt is sold or the price at which the debt is quoted from brokers, dealers or similar services during the 31-day period ending 15 days after the effective date of the amendment (the trading price). These new rules have created potential pitfalls for issuers because adverse tax consequences (such as CODI) may result if the "new" debt is considered to have a trading price that is lower than its face amount.

However, an issuer-friendly result may arise if the amended debt instrument is treated as having a trading price that is higher than its principal amount – that is, if the debt is "trading" at a premium. In that case, an amendment could accelerate a portion of the issuer's interest deduction. The amount by which the issue price of the "new" debt exceeds the issue price of the "old" debt (the premium) would be treated as interest paid by the issuer at the time of the amendment and result in an increased deduction for U.S. federal income tax purposes. This amount would then be offset by reductions to future interest deductions, with the total reduction generally equal to the premium amount spread over the term of the amended debt in the same manner as OID.

An issuer that is amending debt currently should also ask its tax advisors whether these rules would apply to accelerate a portion of its future interest deductions.

For further information or advice on how to take advantage of these possible tax benefits and planning opportunities, please contact the authors or any member of Dechert's Tax Practice.

Daniel M. Dunn
+1 212 698 3857
daniel.dunn@dechert.com

Kenneth C. Wang
+1 212 698 3564
kenneth.wang@dechert.com

Steven J. Lorch
+1 212 698 3614
steven.lorch@dechert.com

Private Equity and Venture Capital Investing in China: Exit Strategy and Circular 698

by **Paul Wang** and **Amy Yang**

Exit Strategy and Circular 698

The State Administration of Taxation (SAT) issued the Notice on Strengthening the Management of Enterprise Income Tax Collection of Proceeds from Equity Transfers by Non-Resident Enterprises Guoshuihan [2009] No. 698 on December 10 2009, targeting capital gains from equity sales. As a result, offshore holding companies in the PRC may face more challenges. In accordance with Circular 698, if an intermediate offshore company directly or indirectly holds an interest (assets, subsidiaries, or business operations) in the PRC, foreign companies and PE/VC funds, which are non-resident enterprises, are required to pay taxes in the PRC when they sell or transfer equity of such intermediate offshore company.

Circular 698 has two major points in relation to an aforesaid equity sale:

Reporting Obligation

If a non-resident enterprise disposes of a PRC enterprise via an indirect transfer of an offshore

holding company, the investor shall report the matter and make a filing with the SAT within 30 days of signing the equity transfer agreement, provided that the offshore holding company is located in a jurisdiction with an effective tax rate lower than 12.5%, or that it does not tax its residents on overseas income. Circular 698 applies to all foreign investors which have indirectly transferred shares of a PRC enterprise.

Taxation on Indirect Transfers

If a non-resident enterprise indirectly transfers a PRC enterprise through a business entity which lacks a reasonable commercial purpose in an aim to avoid paying PRC taxes, the PRC tax authorities can ignore the existing structure for the purpose of calculating taxes. Basically, the tax authorities will review relevant documentation, with the main consideration being whether the indirect share transfer has reasonable commercial substance, and if the transfer is regarded as having an abusive business structure, any capital gains resulting from such transfer will be treated as PRC-sourced income, and PRC taxes will be imposed accordingly.

Conclusion

PE/VC funds invest in China through offshore holding companies, and exit from China by transferring these offshore holding companies without paying PRC taxes. However, Circular 698 may make this structure problematic, and SAT may consider taking further actions to enforce tax collections in offshore equity transfers.

In view of practical considerations and the aforementioned regulatory development, PE/VC funds will need to make many difficult choices in their existing investment and holding structures, and may wish to further review their current structures, assess the potential risks brought about by Circular 698 and consider changes to their exit strategies necessitated thereby.

Paul Wang
+8610 5829 1300
paul.wang@dechert.com

Amy Yang
+8610 5829 1339
amy.yang@dechert.com

BDCs and SBICs Attract PE Sponsor Interest

by **Thomas J. Friedmann**, **Richard Horowitz** and **Roger Mulvihill**

Private Equity sponsors have long wished for a source of permanent capital (particularly in difficult fund raising climates) and attractive long-term leverage. These objectives have encouraged a number of sponsors to explore the possibility of combining a business development company (BDC), which is in essence a registered public company with a permanent capital base, with a small business investment company (SBIC), which is a federally regulated limited partnership entitled to draw-down up to $150 million from the Small Business Administration in the form of ten-year debentures at interest rates only several points above the 10-year U.S. Treasury Note rate on the date the interest rates on such debentures are fixed. This article outlines each program and points out various

advantages and disadvantages, but it is not intended as a comprehensive discussion of the rules and regulations relating to BDCs or SBICs, some of which are complex.

BDCs

A BDC is a type of closed end investment company which elects to be exempt from registration under the Investment Company Act of 1940, as amended (1940 Act), and, as a result of such election, is exempt from some of the rules and regulations under the 1940 Act. BDCs must invest at least 70% of their assets in the securities of U.S. companies that have either (1) have no outstanding securities registered with the Securities and Exchange Commission (SEC) or which have a class of registered and listed equity securities outstanding that have a total market capitalization of less than $250 million. Investments in companies meeting these criteria, referred to as "eligible portfolio companies," may be made in the form of loans, debt or equity securities or hybrid instruments. In order to elect to be treated as a BDC under the 1940 Act, a company must register under both the 1940 Act and the Securities Exchange Act of 1934, as amended, which means that they are subject to a full panoply of ongoing registration and reporting requirements, including required compliance under the Sarbanes Oxley Act. Most BDCs also list their shares of common stock on a national securities exchange although this is not required, and there are a growing number of unlisted BDCs raising capital from public investors on a continuous basis.

Consistent with the objective of improving capital formation for small and middle market U.S. companies, a BDC must offer to make available to its portfolio companies "significant managerial assistance. "Significant managerial assistance means significant guidance and advice concerning the management, operations or business objectives and policies of the portfolio company through directors, officers, employees or general partners. If a BDC is does not have at least 70% of its investments in eligible portfolio companies, it may not make additional investments in non-eligible assets. The BDC itself may issue debt securities, preferred stock and common stock as well as, subject to certain limitations, options, warrants and convertible securities. Issuances of debt and preferred stock securities by BDCs, however, must comply with a 200% asset coverage ratio (equivalent to a 50% debt-to-total capital ratio). While restrictive, this is more flexible than the 300% asset coverage ratio (equivalent to 33-1/3% debt-to-total capital ratio) required of traditional closed end funds and mutual funds generally.

One attractive feature of BDCs to prospective sponsors and their affiliated advisory entities is the fee that BDCs may pay for investment advisory services under the provisions of the 1940 Act. Typically, a BDC pays its adviser (which may be organized as either an external or internal adviser) an annual management fee equal to an annual rate of 1.00% to 2.50% of the gross assets of the BDC (including any borrowings). This management fee is usually paid quarterly in arrears. In addition, unlike other registered funds, the adviser to a BDC may charge an incentive or performance fee of up to 20% of the net investment income and capital gains of the BDC (capital gains are defined for this purpose as realized capital gains net of realized capital losses and unrealized capital depreciation) on a cumulative basis. The income component of the performance fee often includes an annual "hurdle rate" of around 7-8% before performance fees are payable, with a "catch up" provision to bring the carried interest back up to 20% on the full amount of income earned by the BDC in the event that the BDC earns more than the fixed hurdle rate.

BDCs, like other registered funds, are subject to strict rules regarding transactions with affiliates. Subject to limited exceptions, affiliates of a BDC may not sell securities to, or purchase securities from, a BDC or a company controlled by such BDC or borrow money or other property from either without (1) prior approval of the SEC, in the case of transactions with such BDCs' directors, officers and employees, investment adviser and sponsor, or (2) the prior approval of the BDC's independent directors, in the case of transactions with 5% shareholders of the BDC and certain other related parties. Importantly, the BDC or a company controlled by it may not engage in joint transactions, which includes most types of co-investment among funds, with an affiliate except under the limited circumstances spelled out by the SEC without first obtaining SEC exemptive relief. This limitation may have important ramifications for co-investment programs involving sponsors managing multiple funds.

BDCs are generally regulated investment companies (RICs) for U.S. federal income tax purposes. Like a closed end or open end mutual fund, a BDC/RIC is

not required to pay entity-level income tax on that portion of its net investment income that it distributes to its stockholders. In order to qualify as a RIC, a BDC must meet several specific requirements under Subchapter M of the Internal Revenue Code. Among these, some of the most significant are: (1) a RIC must distribute at least 90% of its net investment income (and must distribute between 98% and 98.4% of its income, depending on the source of such income, to avoid paying a federal excise tax on the undistributed portion), (2) at least 90% of a RIC's income must be in the form of interest and dividends on investment securities, and (3) a RIC's portfolio must be diversified, meaning, among other things, that the RIC cannot invest more than 25% of its total assets in any single company and must have at least ten investments in amounts of less than 5% or the RIC's total assets. Stockholders in a BDC receive Form 1099s, and distributions are taxable, like mutual fund distributions, as ordinary income or capital gains, depending on the nature of the income. A BDC stockholder is subject to taxable gain or loss on the sale of his shares.

By comparison with these requirements for BDC/RICs, SBICs (1) may incur leverage up to an asset coverage ratio of 150% (equivalent debt to total capital of 66-2/3%), (2) may not make any single investment in excess of 30% of the SBIC's total capital, and (3) need not make any distributions of taxable earnings. Because of these aspects of the SBIC structure, a BDC sponsor often forms a wholly owned SBIC subsidiary. BDCs may thereafter apply for exemptive relief from the SEC which, when obtained, permits the BDC to treat its equity investment in the SBIC as the full amount of its portfolio investment in the SBIC, with the effect that the higher leverage permitted to be incurred by the SBIC need not be included in the BDC's calculation of its asset coverage (leverage) ratio.

Why are BDCs attractive investment vehicles for some sponsors? For one thing, the investors in a BDC have a public market for their securities and a degree of liquidity, unlike mutual funds in which the investor must be redeemed by the fund, or private equity funds, in which an investor's capital may be locked up for extended periods. More importantly, by

organizing a BDC, a sponsor obtains a stable source of “permanent capital” that does not need to be distributed to its investors after seven to ten years, as in a typical private equity fund. (Indeed, sponsors often cite the possibility of avoiding yet another fund raising round for a new fund as an important consideration in exploring a BDC.) Unlike other types of registered investment funds, the managers of the BDC can charge performance fees in addition to a management fee. As a practical matter, it may be difficult to sell shares of a BDC to the public in today’s market as a “blind pool,” so sponsors often roll a portfolio of existing investments from an affiliate into the BDC to make it more attractive to investors.

SBICs

SBICs are federally licensed investment funds, usually structured like traditional private equity limited partnerships, which are eligible to borrow on a non recourse basis through the SBA at the rate to two dollars of borrowing for each dollar of private capital raised by the fund sponsor. The borrowing is in the form of ten year debentures repayable by the SBIC at maturity with semi-annual interest payments at the 10 year Treasury note rate at the time of issuance plus roughly 200 basis points or less. The maximum borrowing is currently $150 million (up to $225 million for affiliated funds) and is adjusted based on the rate of inflation. Debenture borrowings are taken down as needed for investments and expenses along with the fund’s private capital commitments in somewhat the same manner as customary private equity fund drawdowns once the fund has drawn down $2.5 million in private capital.

Under SBA regulations, the sponsor must raise a minimum of at least $5 million from private sources, although a minimum of $10 million or more is more common and some SBA officials have informally suggested a minimum of at least $17 million since smaller funds are often too small to operate efficiently. At least 30% of the SBIC’s private capital must come from three or more investors who are unrelated to the management or from a single investor satisfying certain institutional qualifications to ensure that an independent investor or investors are also keeping an eye on management. Upon licensing, an SBIC may obtain a borrowing commitment from the SBA for up to two times private capital for five years so that the SBIC is not subject to unforeseen changes in the government funding process. Historically, the SBA has had, and continues to have, ample funds to lend under the debenture program.

In the licensing process the SBA places considerable importance on the practical investment experience of the management team (at least two of whom must be substantially full time) and their collective ability to carry out the SBIC’s business plan and strategy. In the past the SBA has rejected applicants whose investment experience was limited or too unrelated to the SBIC’s proposed investment strategy, although the SBA seems more open recently to considering investment experience that, as one official noted, does not fit “squarely within the box.” While the management expertise standard can be an obstacle for some applicants, most private equity sponsors with existing funds should be able to satisfy the requirement.

The SBIC managers may charge the SBIC a management fee of 2.5% on three times the amount of private capital for the lesser of five years and thereafter 2.5% of the cost basis of loans and investments in active portfolio companies. Management fees are reduced dollar for dollar by any board, consulting, transaction and other fees received from portfolio companies and the permissible management fee declines to 2% when the base exceeds $120 million. The profit split among the private capital investors will typically provide for a carried interest to the manager on the entire SBIC investment portfolio similar to a traditional private equity fund. SBICs are often set up as subsidiaries of BDCs with the private capital requirement satisfied by an investment, in whole or in part, from the BDC.

Consistent with the original concept of the SBIC program as a financing source for small business, the SBA regulations require that SBICs only invest in “small businesses” which are defined as enterprises with a net worth (excluding goodwill) of less that $18 million and average after tax income for the prior two years of less than $6 million or, failing that, enterprises that meet certain sizes tests (typically less than 500 employees). At least 25% of invested funds must be invested in “smaller businesses” defined as enterprises with a net worth (excluding good will) of less than $6 million and average after tax income for the prior two years of less than $2 million. The SBIC may retain investments in portfolio companies that subsequently exceed these size standards. The SBA regulations also restrict an SBIC from investing more than 30% of its private capital

in any single portfolio company without SBA prior approval. SBIC investments in portfolio companies may take the form of debt, debt with equity features or straight equity. Permissible interest rates on debt securities generally range up to 19% and on debt securities with equity features up to 14%. The attractive spreads between the SBICs cost of debenture funding and permissible investment rates has attracted attention from sponsors interested in setting up mezzanine fund vehicles.

Prospective participants in the SBIC program must first receive a license from the SBA. The SBA has streamlined the licensing process to permit applicants to get a sense of whether they will qualify for a license before expending too much time and money. All applicants must first fill out a Management Assessment Questionnaire that covers the background of the sponsors in some detail, including specific information on the investment history of the applicants, their investment strategy, expected deal flow and the like. If the applicants appear qualified, they are invited to meet with the SBA's Investment Committee and, if approved, are issued a so called "go forth" or "green light" letter which can be used in fund raising and are then invited to file a formal application. The whole process can run anywhere from six months (or often more) to a year or so in more extreme cases.

Advantages and Disadvantages of SBICs

As noted, the biggest advantage of the SBIC program is the very attractive leverage which can add significantly to the returns in an investment program. The fact that the SBA has substantial funding available for the program and the availability of five year funding commitments have also appealed to sponsors. The more streamlined licensing process under which an applicant can get a good sense within about three months of filing a Management Assessment Questionnaire whether it will qualify for a license is also a positive.

While the definition of "small business" could limit the scope of potential investments it does not appear to be a significant obstacle for many sponsors whose targeted companies either fall within the test or the alternative standards. The limitation on investment to 30% of private capital could restrict follow on or build out programs, although the SBA has given approval for overline investments in the past. The limitation on the size of the leverage (currently $150 million for one SBIC or an aggregate of $225 million for more than one) has proven a deterrent for some prospective sponsors although many look at the program as one more bucket in an investment platform. Finally, the substantial period to licensing (which could stretch out to eight months or more) has discouraged some applicants.

Thomas J. Friedmann
+1 202 261 3313
thomas.friedmann@dechert.com

Richard Horowitz
+1 212 698 3525
richard.horowitz@dechert.com

Roger Mulvihill
+1 212 698 3508
roger.mulvihill@dechert.com

Recent Developments in Acquisition Finance

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

Several recent legal developments will likely impact acquisition finance. This article will survey some of the more notable ones.

A recent decision of the U.S. Bankruptcy Appellate Panel of the Ninth Circuit (BAP) may give secured lenders pause when funding into a highly leveraged or stressed business that derives significant revenue from property-access fees. This may become an issue even where the lenders have taken an all-assets pledge, at least where there is a substantial services component to the business' generation of the revenues in question.

In *In re Premier Golf Properties, L.P.*,[1] the BAP addressed the issue of whether a secured lender's blanket lien in all real and personal property of a golf club includes a lien on the club's green fees and driving range fees collected after initiation of the club's chapter 11 bankruptcy case. In the case, Far East National Bank (Bank) had provided the secured loan in question to Premier Golf Properties, L.P.

(Club). Following the filing of its chapter 11 petition, the Club continued to operate its business as a debtor in possession, in part by using the ongoing revenues it received from green fees and driving-range fees. The Bank filed a motion with the bankruptcy court to prohibit the Club from using the revenues, arguing that they constituted the Bank's cash collateral.

Property acquired by a debtor during the course of a bankruptcy case generally is not subject to a pre-petition secured lender's lien, even if the underlying security agreement contained an "after-acquired property clause," as it commonly would.[2] Such a provision is used in security agreements to include within the lender's lien property acquired by the borrower after it has executed and delivered the security agreement. An exception to this rule, however, exists for post-petition "proceeds" of pre-petition collateral (assuming the underlying security agreement covered proceeds), which are indeed included within the collateral of the pre-petition secured lender.[3]

In rejecting the Bank's arguments, the BAP held, among other things, that the fees did not constitute proceeds of the Bank's collateral. The Bank had asserted that the fees were derived from non-exclusive licenses the Club sold to its customers (to permit them to use the golf course and driving range), and thus were proceeds of Bank collateral (which included the golf course and driving range). In considering this argument, however, the BAP found that the fees *also* were derived largely from the Club's input, after commencement of its chapter 11 case, of additional labor and operational resources (gardening and mowing of the greens, for example). The BAP held that the exception for "proceeds" discussed above does not include revenues generated "largely [as a] result of the Golf Club's labor and own operational resources, which make the license valuable to golfers."[4] The BAP thus acknowledged that the post-petition green fees and driving-range fees constituted license revenues from the golf course and driving range that were Bank collateral, yet nonetheless determined on the above basis that they were not "proceeds" of the Bank's collateral for purposes of extending the Bank's pre-petition lien to cover them.

The BAP's ruling in this case may impact secured lender valuations of collateral, in light of valuation considerations that may include the potential impact of any future bankruptcy case that may be commenced by the borrower within the Ninth Circuit (encompassing nine western states, including California). This is especially so if there is enough of a labor and services component to revenues to support a finding that post-petition revenues generated by the company were "largely" a result of its input of labor and other operational resources after filing of its bankruptcy petition.

This ruling appears to many to have defined "proceeds" too narrowly, and may have been influenced by there having been no other material source of funding for the Club's post-petition operations and other administrative expenses of its chapter 11 case. In a possible signal that the BAP was trying to limit the applicability of its decision in other contexts, the BAP was quick to distinguish the Club's fees from hotel fees (which it considered "rents," eligible for treatment like that accorded to "proceeds"), on the basis that hotel fees are derived primarily from using real property as shelter, whereas the Club's fees derived primarily from using real property for entertainment. Query how long it will be before an attempt is made to apply the rationale of the decision more broadly within the Ninth Circuit or elsewhere.

On another front, a recent decision by the Eleventh Circuit Court of Appeals[5] could potentially reopen a question that may seem a trifle odd — whether the common practice of coordination among holders of an issuer's debt constitutes collusion and a violation of antitrust laws.

In the District Court decision from which appeal was taken,[6] CompuCredit had initiated an issuer tender offer for up to $160 million in principal amount of its outstanding bonds, at a tender price below par but purportedly at or above market value. A majority in principal amount of the bonds was held by about twenty hedge funds, all of which declined to tender their bonds. They were not satisfied with the tender price and demanded that CompuCredit purchase the bonds back at not less than par value. CompuCredit then initiated the lawsuit, alleging that the hedge funds had conspired to boycott the tender offer and inflate the purchase price for the bonds, in violation of the Sherman Antitrust Act. The District Court dismissed CompuCredit's claim, after which CompuCredit appealed the dismissal to the Eleventh Circuit Court of Appeals, where the appeal was decided by a three-judge panel that affirmed the District Court's ruling.

In its arguments before the Eleventh Circuit panel, CompuCredit asserted that the hedge funds were "horizontal competitors" under antitrust laws, as competitors offering similar services, and therefore should be prohibited from working together in order to influence prices. In a well-reasoned opinion, the three-judge panel held that there could be no Sherman Act violation when creditors act together to collect pre-existing debts.[7] The panel opinion stated, "CompuCredit was not in the same position as a normal buyer of goods or services; instead it wished to pay back the money it already owed (at a price below par value but at or above market value). [The bondholders'] choice to reject this offer and seek full par value is not the same as a boycott intended to raise future sales prices."[8]

CompuCredit then moved for a rehearing before the full complement of judges sitting on the Eleventh Circuit Court of Appeals (rehearing "*en banc*"). For the rehearing, several amicus briefs were filed (including by the Loan Syndications & Trading Association, the Managed Funds Association and the Securities Industry and Financial Markets Association) urging that the earlier decisions be affirmed, on the ground that to do otherwise would threaten to freeze all pre-bankruptcy coordination among lenders and "forbid as per se illegal a long-established, near universal creditor behavior that benefits not only creditors but also borrowers, businesses and the economy as a whole."[9] Two days following oral arguments before the ten judges comprising the full complement of available judges, an evenly-split Eleventh Circuit issued a one-page decision vacating the panel's opinion and affirming the District Court's decision without explanation. Under applicable procedural rules, such an evenly-split vote results in affirming the District Court's ruling and superseding the three-judge panel decision, as though the panel decision had never been rendered.

The split decision could make debtholders in a case within the Eleventh Circuit nervous about engaging in the common practice of coordination and collaboration, whether as public bondholders or as lenders in a widely syndicated loan transaction or club deal. Although antitrust arguments of the nature raised by CompuCredit seem not to ring

true, and seem even a bit odd to those familiar with common practice in debt and loan markets, the fact remains that five of ten judges sitting on the Eleventh Circuit Court of Appeals voted to remand the case back to the District Court in order that it consider the antitrust allegations. Additionally, the well-reasoned opinion of the three-judge panel is now of no legal effect. The split decision increases the likelihood that parties, particularly in the Eleventh Circuit (encompassing Alabama, Florida and Georgia), may raise collusion allegations against collaborating debtholders in the future, which could make it more costly for them to lend and in turn increase the cost of capital.

On the interest-rate front, some changes are afoot in the aftermath of the widely publicized LIBOR rate-manipulation scandal. HM Treasury, the UK governmental department of public finance and economic policy, has published its final report on the independent review of certain aspects of the setting and usage of the London Interbank Offered Rate (LIBOR) undertaken by Martin Wheatley (who will be the inaugural chief executive of the UK's new Financial Conduct Authority).

The report's reform plan included a recommendation to phase out the compilation and publication of LIBOR quotations for certain currencies and tenors, for which there was deemed to be insufficient data for proper corroboration of rate submissions to the British Banker's Association (BBA), which administers LIBOR. Subsequent to the report, the BBA issued a statement acknowledging the lack of regular transactions in certain currencies and tenors, and its resulting intention to phase out some of them through May 2013. As of March 2013, the Danish Krone, Swedish Krona and New Zealand Dollar no longer have LIBOR quotes at all, and beginning in May 2013 the Australian Dollar and Canadian Dollar also will cease to be quoted. Further, although LIBOR rates for the U.S. Dollar, Euro, Swiss Franc, British Pound and Japanese Yen will still be quoted, the following LIBOR maturities for such currencies will no longer be quoted: 2 weeks, 4 months, 5 months, 7 months, 8 months, 9 months, 10 months and 11 months. These changes will impact financings in the affected currencies and may require amendments to existing facilities that feature LIBOR-based rates in these currencies. Although the terminated LIBOR maturity options were used less commonly, borrowers that employed them will lose a measure of flexibility on their LIBOR-based borrowing and interest-rate management options.

We look forward to updating you further on these and other developments in future newsletters.

Jeffrey M. Katz
+1 212 698 3665
jeffrey.katz@dechert.com

Scott M. Zimmerman
+1 212 698 3613
scott.zimmerman@dechert.com

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[1] 477 B.R. 767 (B.A.P. 9th Cir. 2012).

[2] 11 U.S.C. § 552(a).

[3] 11 U.S.C. § 552(b).

[4] *In re Premier Golf Props., L.P.*, 477 B.R. at 776.

[5] *CompuCredit Holdings Corp. v. Akanthos Capital Mgmt., LLC*, 698 F.3d 1348 (11th Cir. 2012) (*en banc*).

[6] *CompuCredit Holdings Corp. v. Akanthos Capital Mgmt., LLC*, No. 1:11-CV-117-TCB, 2011 WL 9753766 (N.D. Ga. June 17), *aff'd*, 661 F.3d 1312 (11th Cir. 2011).

[7] *CompuCredit Holdings Corp. v. Akanthos Capital Mgmt., LLC*, 661 F.3d 1312 (11th Cir. 2011).

[8] 661 F.3d at 1315.

[9] En Banc Brief of Amici Curiae Loan Syndication and Trading Association, Managed Funds Association, and Securities Industry and Financial Markets Association in Support of Defendants-Appellees Akanthos Capital Management, LLC, *et al.* at 2, *CompuCredit Holdings Corp. v. Akanthos Capital Mgmt., LLC*, 698 F.3d 1348 (11th Cir. 2012) (*en banc*) (No. 11-13254-BB).

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