INSIDE THE MINDS

Understanding Legal Trends in the Private Equity and Venture Capital Market

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Legal, Institutional, and Regulatory Trends Affecting the Secondary Private Equity Market

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Introduction

Prior to the summer of 2007, private equity (PE) firms benefited from unprecedented access to credit and outstanding deal values that helped fuel investors' appetite for high returns. PE was the flavor of the day, with record levels of new funds and new firms being established each year. Favorable credit markets and a frenzy of fundraising opportunities provided a huge cache of capital to finance multibillion dollar buyouts across industries, markets, and countries. Carlyle, Blackstone, Providence Equity, TPG Capital, and other leading titans of PE were making record profits, some went public, and confidence in the ability to achieve even higher returns was absolute.

This trend abruptly ended when the mortgage-led debt crisis at the end of 2007 froze credit markets and triggered a global recession, which is still affecting markets today. Banks and debt capital markets reeled under the pressure and stopped lending money to finance leveraged buyouts (LBOs). As a result, even brand name PE firms found themselves unable to service or refinance debt. While there are some signs that the credit markets are now starting to turn a corner, and while some banks have exhibited a renewed willingness to underwrite debt in the LBO markets, the PE industry generally is by no means back to its glory days. Indeed, markets remain volatile, pricing is uncertain, and banks are still timid. Good quality targets are few and hard to find. Investors are demanding higher returns but are still reluctant to commit new funds, while PE firms are under pressure to deploy available cash and put their money to work. In short, the crisis has severely tested the traditional PE business model, and has forced many PE firms to adapt in new ways to confront current market conditions and proposed changes in the regulatory environment.

This chapter briefly discusses the legal, institutional, and regulatory trends affecting the PE market generally since the debt crisis began, and analyzes how these trends have in turn resulted in a renewed and increased volume of secondary market PE deals. Part I describes the general trends defining the current PE market, including increasing and innovative exit options; greater leverage on the part of sellers to negotiate deal protection provisions; challenges in fundraising; and a continuing focus on emerging markets and distressed deals. Part II describes and analyzes the upsurge in secondary market PE deals, including the underlying factors causing the increase in secondary deal volume and the outlook for the secondary PE market. Finally, Part III focuses on changes in the regulatory, legislative, and tax landscape affecting the PE industry and the prospects for PE firms in the future, given the hurdles and challenges confronting them.

A Recovering But Challenging PE Market

While 2010 has shown signs of improvement, PE is still suffering from tight credit markets and reduced exit opportunities, as well as an increased scrutiny on the part of regulatory authorities. According to recent statistics, the average size of PE-sponsored acquisitions is still smaller than in the pre-recession peak years, and the volume of minority investments as a percentage of total acquisitions by PE firms is significantly higher. See *Ernst & Young 2010 Global Private Equity Watch* (2010), hereinafter *2010 Global PE Watch* (stating that the average size of a PE acquisition in 2009 was $100 million as compared to $158 million in 2008 while minority investments as a percentage of total deals rose to 50 percent from 45 percent in the prior year). Moreover, many PE firms have opted to do "all equity" deals in light of the limited availability of debt financing on acceptable terms (with the hope that the target will be refinanced within a short timeframe). The reduced ability to complete large leveraged deals in turn has caused many PE firms to focus on preserving value of existing portfolio companies, including through selective (though smaller) add-on acquisitions and reorganizations, pending the opportunity and their ability to obtain an acceptable return on their investment. These trends have played out time and again in our experience over the last two years, particularly among our middle market PE clients, which have been willing to review and complete acquisition opportunities even if they do not meet the fund's normal investment criteria (such as minimum EBITDA) and to purchase investments solely on an equity basis without any leverage.

Said differently, PE firms have realized that—with limited exit options and reduced leverage—the need to improve core operational efficiencies for their investments is critical to bolstering returns on their portfolio. Over the last couple of years, fund managers have therefore focused less on acquisitions and more on operations with the assistance of experienced teams, including in some cases "operating partners" or "executive managers" that work with portfolio company management to execute strategic initiatives, increase revenue, and implement cost-cutting, supply chain, procurement and working capital improvements. *2010 Global PE Watch* at 2. This trend will likely continue in 2010, thereby ensuring that PE portfolio companies will weather the economic downturn with the aim of exiting some of the businesses in the near term.

Increased Exit Options in 2010 for PE Firms

Exit and liquidity options for PE firms such as secondary buyouts, initial public offerings (IPOs) and the availability of financing for dividend recapitalization have increased in 2010 as compared to the previous two years. Based on transactions completed during the first half of the year, banks generally have shown a renewed, albeit timid willingness to finance PE deals. See The Deal Magazine, *Private Equity Buyout Activity Rebounding,* July 7, 2010. This has been evidenced by increased lending multiples (currently averaging about 4.1x EBITDA) and relaxed restrictions on leveraged loans as compared to prior periods during the recession. *2010 Global PE Watch* at 30. That said, equity contributions for leveraged transactions are noticeably high and likely to remain on average over 50 percent of total purchase price (rather than the historic average of 33 percent or less), which will continue to make it difficult for PE firms to reach their internal targets. Further, it is not clear whether leverage for new acquisitions will continue to be available to drive the market through the remainder of 2010 and into 2011.

As financing has become more available, leveraged dividend recapitalizations are also on the rise as a tool of choice for PE firms. In the first quarter of 2010, lenders provided $6.4 billion in leverage for dividend recapitalization in the United States alone, which reflected a 400 percent increase as compared to the previous two years combined. Practical Law, *2010 Trends in Private Equity Exits*, September 1, 2010, hereinafter referred to as *2010 Trends in PE Exits,* citing *Standard & Poor's, 1st Quarter 2010 Leveraged Buyout Review*. This has allowed PE firms both to leverage portfolio companies with the aim of generating higher returns and to rebalance the capital structures of portfolio companies that were funded by substantial equity well above historical levels.

The relative recovery of the stock market over the past year and a half has also restored initial public offerings (IPOs) as a possible exit option for portfolio companies and as a liquidity source for PE firms. See *Renaissance Capital Global IPO Review: 2nd Quarter 2010*, 1 and 6. This trend has been encouraged in part by looming loan maturities and the concomitant pressure on portfolio companies to refinance or pay down debt. Further, IPOs are well suited to portfolio companies whose operating results have improved due to PE firms' focus on operational efficiencies over the last two years. Nonetheless, while the increased volume in PE sponsored IPOs provides some encouragement, the IPO market—like the credit market—remains fragile and is a long way off from pre-recession levels. It is worth noting that in certain recent IPOs, PE sponsors were not allowed to achieve full liquidity, given the focus and sensitivity by underwriters and investors on high leverage ratios; as a result, while some PE firms have been able to partially exit from their investments through IPOs in 2010, other have been prevented from doing so (until such time the portfolio company has used proceeds from the IPO to pay down indebtedness). For example, in March 2010, Sensata Technologies completed its IPO for $440 million, of which up to $350 million was used to pay down indebtedness owed to bondholders. As a result, Bain Capital was able to sell down only a small portion of its ownership investment in the IPO itself and instead had to rely on the "green shoe" (or overallotment) option to divest itself of 20 percent of its ownership interest in the company. Similarly, in February 2010, Generac Holdings completed its $250 million IPO, but CCMP Capital Advisors were unable to sell any of its position. These constraints in turn have forced some PE firms to look to future secondary offerings—through Rule 144 and follow-on public offerings—for their ultimate exit. Their success, of course, will depend on whether the markets remain sufficiently robust to support such sales at favorable prices—an uncertain prospect given the moodiness and volatility defining the equity capital markets over the last two years. For this reason, many PE firms will tend to prefer an exit scenario through a sale transaction if available (even at a discount) in order to increase their chances of a successful exit.

Recent Legal Trends: Deal Protection Provisions

As a general matter, the global economic crisis has affected the leverage PE firms once hoarded over sellers by asserting their reputation in the market and ability to close deals. In particular, large funds regularly scoffed at sellers' attempts to negotiate contractual provisions enhancing deal certainty. "We never agree to that provision," the argument would go during drafting sessions, "because everybody knows we stand behind our reputation and our word." Today, that argument no longer carries the same sway. The trend in recent deals shows that PE firms are willing to agree to deal protection provisions, particularly in the wake of two high profile litigations in 2007 and 2008 in which a couple of the most prestigious PE firms, Cerberus and Apollo, each sought to back out of significant acquisitions in the midst of the credit crunch.

Despite the concerns over "broken deals," most sellers are still willing to close deals with PE firms, but with added protection. Indeed, sellers are now insisting on, and often successfully negotiating, certainty provisions that were once "off-limits" and that provide greater comfort that the transaction will be consummated after signing. These include, for example:

- Reverse breakup fees, where the buyer pays a termination fee to the seller in the event of certain financing failures or if it otherwise breaches certain obligations prior to closing
- Specific performance provisions giving the seller the right to enforce the obligations of the buyer in the contract (such as, for example, its commitment to obtain financing) rather than seeking only monetary damages for a breach
- Equity commitment letters expressly giving the target company or seller the right to pursue equity financing from the PE fund (rather than the shell company buyer)
- Go-shop provisions, which enable the target company or seller to actively discuss and negotiate an alternative transaction with a third party for a specified period of time (usually thirty to sixty days)
- Detailed financing covenants, whereby the buyer is obligated to comply with strict efforts standards and detailed undertakings to obtain financing

PE firms have thus shown greater willingness to consider specific provisions that increase the certainty of closing from the target's

perspective in order to get the deal done.
In addition, another trend characterizing the LBO market since the economic crisis began is the willingness of PE firms to underwrite deals, at least initially, on an all-equity basis. Although this might have been considered heretical by some in past years, it is becoming more common. From a risk perspective, an all-equity deal presents obvious advantages for the seller, who does not have to worry about a financing contingency as a potential obstacle to closing the deal. From the buyer's perspective, although he assumes the risk of debt, there is a significant advantage for him too: the sponsor will usually have greater leverage to negotiate more favorable terms from different lenders after having acquired an attractive company. In sum, PE firms have shown that their business model too can be flexible, even when access to debt is restricted.

Fund-Raising Challenges Continue

In general, fundraising slowed in 2009 as the economic turmoil deepened. Today, investors remain reluctant to commit more capital to PE funds pending evidence of greater returns. Global PE firms closed 357 funds last year, the smallest number of funds closed in the last five years. *2010 Global PE Watch* at 18. Further, funds took longer to close on average, and some large funds conspicuously failed to meet their targets. As a result, the total value of 2009 vintage funds was $234.9 billion, less than half the $590.3 billion in 2008 funds. Id. While 2010 has shown some signs of improvement, PE fundraising during the first half of 2010 fell to $45.1 billion, down 26 percent from $61.2 billion raised during the same period last year. Id. Despite these trends, the number of funds raising capital was static between 2009 and 2010 (at 198 firms), which some see as a modest sign of recovery. Id.

The challenges in PE fundraising are in part due to the absence of mega buyouts, which largely drove fundraising in years past, as well as the scarcity of good investment targets overall. Ironically, this environment has benefited some smaller buyout and industry-focused funds, which play in the middle market and which have been able to leverage their expertise in specific sub-markets that are more immune to the economic downturn (such as, for example, government defense services firms serving the intelligence community). As PE firms closed 2009 with $500 billion in "dry powder" (i.e., uninvested capital that at the end of a fund investment period cannot be called for new investment), 2010 so far has seen too much capital chasing too few deals. Many funds are feeling the crunch as general partners (GPs) are under extreme pressure to find opportunities to deploy cash, while limited partners continue to weigh alternative investment options. In some cases, GPs are being forced to negotiate extensions to the terms of their funds and to explore other solutions to address the problem of uncalled capital (including in some cases returning uncalled capital to investors, lowering management fees, and allowing investors to reduce their fund commitments). The bottom line is that PE funds have been forced to adapt their traditional strategies in order to retain the trust of their investors and to focus their energies on existing portfolio investments in order to mitigate any hemorrhaging arising from covenant breaches and ballooning loan maturities under the existing debt facilities. In this environment, retaining investor confidence and raising the next fund will remain a challenge.

Focus on Emerging Markets and Distressed Deals

As emerging markets have proved more resilient to the global economic downturn, PE firms are increasing their investments in targeted countries, particularly China, Brazil, and India. This trend reflects the increasing global nature of PE firms and their ability to find investment opportunities in less penetrated markets. Historically, most of the activity in these countries involved foreign PE firms making minority investments in local targets with the goal of injecting growth capital and increasing their equity stakes down the road. Today, domestic acquisitions in each of China, Brazil, and India have increased significantly, and most investors plan to accelerate their new commitments in these emerging economies over the next two years. Coller Capital and the Emerging Markets Private Equity Association (EMPEA), *Emerging Markets PE Survey, 2010*. Asian funds continue to account for more than half of total PE investment, with China as the leading destination for new capital. In sum, investors are drawn to and will continue to invest in markets with strong underlying growth rate driving returns and growing middle classes driving consumption.

In addition to the focus on emerging markets, distressed PE has been very active over the past year and promises to remain robust. In general, distressed or turnaround PE funds focus on those companies that have either filed for bankruptcy or are about to do so; they generally buy the debt of the target company at a discount, in the hopes of making a profit when the creditors are paid back through the bankruptcy process, or often more preferably, they will forgive the debt as part of the company's reorganization in exchange for equity. The pipeline of investment opportunities has been driven in part by a large number of over-leveraged companies conducting business in depressed economies. As companies' revenues and profitability have deteriorated due to tighter wallets and reduced spending, many over-leveraged companies have been forced to deal with liquidity problems, cash flow issues, and covenant defaults under their loan facilities. This in turn has increased the volume of companies facing bankruptcy or reorganization as a way to pay their creditors and continue their operations. Thus, investors have been willing to pump billions of dollars of funds into the distressed markets because they believe that the potential returns are more favorable than other investment options in the current environment. As a result, distressed debt and turnaround funds with operational and industry expertise over their investments have been well positioned to prosper and deliver returns to their investors.

Upsurge in the PE Secondary Market Deals

The liquidity crisis in 2010 has been characterized by a significant increase in the level of activity in the PE secondary market (i.e., PE firms selling to other PE firms). While expectations for a strong increase in secondary activity in 2009 failed to materialize (largely due to the unavailability of credit), the first half of 2010 recorded much more significant deal flow. Tom Fairless, *Financial News, Secondaries Market Comes Back to Life,* July 12, 2010 (hereinafter *Financial News).* Secondary buyouts totalled $13 billion in the first half of 2010, as compared to less than $0.5 billion for the same period in 2009. *2010 Trends in PE Exits* at 2, (citing Dealogic, as of April 6, 2010). Some recent notable examples include:

- Lloyds Banking Group's agreement to sell 70 percent of a private equity portfolio formerly owned by UK lender HBOS to London-based Coller Capital for £332 million
- French bank Natixis' deal to sell its in-house private equity activities for $677 million to the private equity arm of

French insurer Axa

- Citigroup's sale of about $900 million worth of private equity investments to US-based Lexington Partners
- Madison Dearborn Partners' acquisition of BWAY Corporation by Kelso & Company for $485 million
- BC Partners and Silver Lake Partners' agreement to acquire health care provider Multiplan Inc. from Carlyle and Welsh, Carson Anderson & Stowe for $3.1 billion

Confluence of Factors Leading to Secondary Deals Surge

The upsurge in recent secondary deals has been motivated by several factors, including the greater availability of credit as well as time constraints confronting both PE buyers and sellers. On the one hand, buyers need to deploy un-invested capital before the expiration of their funds' investment periods, which generally run about five to six years; on the other hand, sellers are seeking liquidity events to exit their investments and deliver returns to investors. The combination of these factors and the lack of other viable exit options have resulted in intense competition for good quality assets by PE players, which in turn has driven up prices.

The increase in secondary market deals has also been propelled in part by global regulatory pressure to reduce risk in the financial system. As discussed in greater detail below, in the United States, the Dodd-Frank Wall Street Reform and Consumer Protection Act and the Volcker rule have incentivized banks to divest their PE holdings as a way to reduce their balance sheet exposure. Pub. L. No. 111-203, 124 Stat 1376 (2010). Further, outside the United States, global regulatory efforts such as Basel III regulations (which will force banks to boost capital and liquidity requirements) and the Directive on Alternative Fund Managers in Europe will likely continue to stimulate secondary sales activity, as PE players continue to try to cope with the new regulatory landscape which continues to define itself on the heels of the global economic recession.

Challenges and Outlook for Secondary Market Prospects

The financial and regulatory environments discussed above suggest that the secondary PE market for LBOs will continue to grow in the coming year.

Improved prospects in the secondary market are also supported by increasing interest from institutional investors, including pension funds, insurance companies, and endowment plans. Although these investors have been more focused on new avenues for selling their stakes in funds, a growing number are joining the more traditional secondary market players, such as primary and secondary fund of funds managers, in seeking to purchase discounted stakes in private equity funds on the secondary market as part of their overall investment strategies. See *Financial News* at 2.

Several factors support the continued growth of the secondary market at the end of this year and in 2011. Large institutional investors that overcommitted to 2007 and 2008 PE funds will look to sell fund interests and to take advantage of more attractive pricing. Further, demand will remain strong and drive up the prices as funds are looking for opportunities to deploy capital soon. Id. See *The 2010 Preqin Private Equity Secondaries Review* (2010). Finally, market volatility may encourage vendors to sell now rather than wait. Indeed, a second dip in the global economy—which some commentators are predicting—could drive distressed sales and, therefore, a surge in secondary sales.

Despite the upsurge in deal activity, the secondary market is still inherently inefficient and pricing tends to vary widely among bidders—which may somewhat reduce the volume of deals in the short term. This is in part due to the factors described above, including improved access to leverage and the feeding frenzy for quality assets in the current market. The inefficiencies of the secondary market are compounded by the fact that fund managers generally must approve any transfer of a fund's interests, which consent can be conditioned on the buyer's ability to satisfy the fund's commitments as well as other contractual and regulatory requirements. Satisfying these conditions can be difficult and significantly delay a deal. Moreover, most PE interests have no "set" of defined market values and, as a consequence, the price must be negotiated. Unsurprisingly, then, the range between a buyer's and a seller's view of what constitutes fair value—or even between two professional valuation firms—can often be significant and kill a deal. This problem in the secondary market is in the process of being mitigated over time with experience players, as PE firms are working together to manage expectations about pricing (given economic conditions and prospects) and better define market and deal parameters for these kinds of transactions. As a consequence, the increase in volume of secondary market deals will necessarily be accompanied by an increase in the learning curve by the players involved and the market generally, leading to greater fluidity, better definition of market norms, and narrower bid/ask spreads.

Uncertain Climate: Legislative, Regulatory and Tax Changes

Recent and proposed changes in financial regulation are expected to institute additional requirements and restrictions on private equity funds. Today, there is considerable uncertainty about the details of future regulatory changes, which has created significant anxiety in the market. As mentioned earlier, the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act) adopted by the US lawmakers earlier this summer includes new rules affecting fund managers. The Act requires advisors to hedge funds, PE, and real estate funds with more than $150 million in assets to register with the U.S. Securities and Exchange Commission (SEC), officially eliminating the "private investment advisor" exemption existing until then. Beside this new registration requirement, the Act requires investment advisors to maintain certain records regarding each private fund and to make such records available for inspection by the SEC. The Act also expanded the SEC regulatory oversight on financial institutions through the so-called Volcker Rule, named after the former Chairman of the Federal Reserve Paul Volcker. In particular, this rule restricts banks and other financial institutions from engaging in proprietary trading and from sponsoring or investing in PE or hedge funds—a permitted practice in the past which was viewed by Chairman Volcker and Congress as a significant factor leading to the current economic crisis. Specifically, under the Volcker Rule, banks cannot hold more than 3 percent of their Tier 1 capital (a measure of a company's financial strength) in private equity or hedge fund investments. In total, these new regulations and rules will require many PE firms and financial institutions to make significant adjustments to their business models in the coming months. This transition period might stretch even longer as the SEC and the newly created Financial Stability Oversight Council have been tasked under the Act to adopt and recommend the regulations necessary to implement the Act. This ever-changing regulatory environment may slow PE activity as PE firms decide to adopt a "holding pattern." This regulatory reform trend is also ongoing in Europe with a similar chilling effect on the market, as the proposed Directive on

Alternative Fund Managers is expected to bring a number of changes to the regulatory landscape for PE firms, including new disclosure requirements, harmonized governance standards, and limits on leverage.

Another source of anxiety for PE firms in the United States is the proposed reform of the tax treatment for carried interests—i.e., the share of any profits that the general partners of PE and hedge funds receive as compensation. Congress is currently considering legislation intended to tax income earned by investment managers of PE funds, hedge funds, venture capital funds, and real estate investment partnerships at ordinary income rates (up to 35 percent), instead of the traditional capital gain rates (15 percent). The reasons for this proposed change include a consensus among some lawmakers that PE fund managers have unfairly benefited for too long from lower tax rates as compared to other taxpayers by characterizing their "day-to-day" business as a long-term investment eligible for the lower tax rate (which, according to these advocates, was never the intent behind the capital gains tax rate legislation). Politically, the proposed legislation would also offer one avenue for boosting tax revenues for the government at a time when politicians are seeking solutions to reverse the growing spending imbalance and address concerns regarding the national deficit. That said, carried interest legislation has failed to pass a number of times during the past several years, most recently in June 2010. Despite various attempts to soften the bill, industry associations such as the Private Equity Council (PEC)—an advocacy group made up of many of the world's largest PE firms, including Blackstone, Carlyle, and TPG—and some politicians have raised concerns that the tax increase would severely impact innovation and investment in the country. As the election season approaches, there will be few opportunities for carried interest legislation to be adopted this year

In the meantime, across Wall Street, financial firms are embarking on the delicate task of complying with the new rules governing their trading and investments. Morgan Stanley is considering spinning off its $7 billion hedge fund firm, FrontPoint Partners. Citigroup has sold hedge fund and private equity businesses and is discussing paring back its proprietary trading business. Bank of America Corporation has spun off part of its private equity wing Bank of America Capital Investors, which will be managed by Ridgemont Equity Partners.

Regulatory reform therefore remains a major uncertainty that could drastically affect the PE industry's recovery and the prospects for deal activity going forward. In large part, this will be determined by the view of PE firms held by the government and the public perception of PE as a solution rather than a cause of the financial crisis. PE firms are working hard to correct this perception and public relations failure by using the press with the aim of educating the public about the virtues of the PE business. The PEC is also lobbying hard to change the perception of targeted lawmakers about the benefits that PE provides to the US economy and the world. Since the remaining stages of the legislative process are likely to continue into the latter part of 2010, we are currently in a "wait-and-see" period, and only time will tell how successful PE firms will be and how much more they will have to adapt their business models to comply with any new requirements.

Conclusion

Over the last three years, the credit crunch and the unavailability of leverage have drastically affected the PE market. This year, however, has presented signs of recovery, as the credit markets have begun to relax and deal volume has increased. Although a full recovery is still uncertain, the unique circumstances defining the current market have also led to a significant increase in secondary market deals—a trend that is likely to continue. This has been facilitated, in part, by increased regulatory scrutiny of financial institutions, which has caused some investment banks to divest their PE holdings as they assess their future outlook and strategies.

In this complex environment, as PE firms navigate the slalom course of market and regulatory obstacles, it is more vital than ever for investors to work with seasoned advisors and counsel to identify and close deals intelligently and efficiently. PE firms unanimously agree that current conditions still pose a challenging environment for getting deals done; however, they also present great opportunities for those firms that are able to bring flexibility to the process and take advantage of attractive opportunities.

Ultimately, the credit crisis may be a good thing for the PE industry overall. It has forced firms to think outside of the "box," to be more flexible, and to find ways to become more efficient and competitive (rather than relying on cheap debt to fuel their investments). In the end, those firms will survive the current crisis stronger than when they went in, and the industry generally will benefit by becoming more disciplined and contributing to the global economy.

Key Takeaways

- Over the last couple of years, fund managers have focused less on acquisitions and more on operations with the assistance of experienced teams, including in some cases "operating partners" or "executive managers" that work with portfolio company management to execute strategic initiatives, increase revenue, and implement cost-cutting, supply chain, procurement and working capital improvements.
- Sellers are now insisting on, and often successfully negotiating, certainty provisions that were once "off-limits" and that provide greater comfort that the transaction will be consummated after signing.
- Another trend characterizing the LBO market since the economic crisis began is the willingness of PE firms to underwrite deals, at least initially, on an all-equity basis.
- Increasing investments in targeted countries, particularly China, Brazil, and India, reflects the increasing global nature of PE firms and their ability to find investment opportunities in less penetrated markets.

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