Dentons Private Equity Fund Manager's Report™

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DENTONS

From the Editor

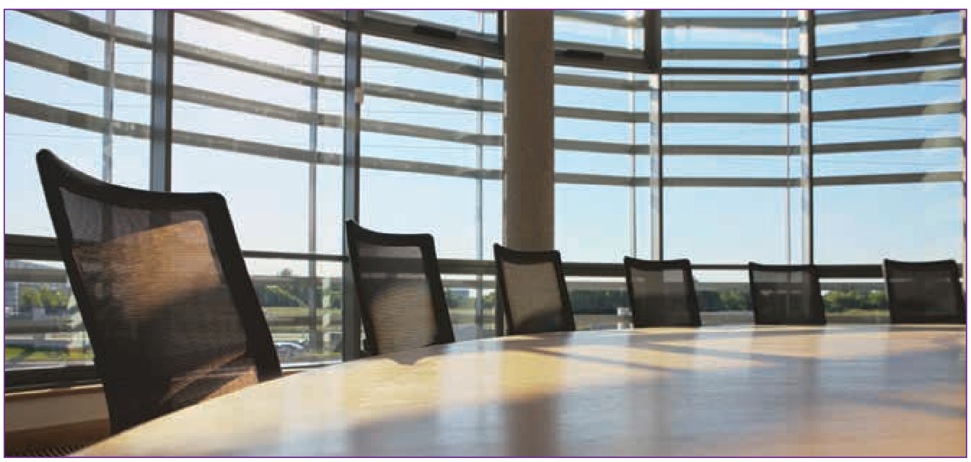
Welcome aboard

Welcome to the second issue of the Dentons Private Equity Fund Manager's Report. It is our intention to periodically provide our friends, clients and others interested in the world of private equity with practical information that can be used by fund managers in the course of their business activities.

In this issue we address certain topics material to the current economic environment, such as the use of accordion features in loan agreements, the current state of play of credit bidding in the world of distressed debt, the use of recently enacted regulations by the IRS and the Treasury Department to effect a step-up in tax basis when structuring private equity acquisitions, and the use of the auction process to maximize value in the sale of portfolio companies. We also review the current use of representation and warranty insurance in merger and acquisition transactions. Finally, we provide some guidance to private equity funds on how to decrease potential liability under the Worker Adjustment and Retraining Notification (WARN) Act in connection with plant closings and layoffs.

We hope that the information we provide will alert you to issues of importance that you can utilize for your benefit. We welcome your input and suggestions about the type of information you want to receive as well as an honest critique of what we have provided. Should you wish to provide "war stories" that would assist others in similar situations, with or without attribution; if you are seeking to hire investment professionals or obtain industry insights; if you want to dispose of an investment, hire a CFO or meet an equity sponsor or a mezzanine lender—we are very active in this marketplace and are pleased to act as a conduit to our readership and to our relationships. We will benefit if you benefit and we seek to align our interests. Thank you, and let us hear from you!

Stephen M. Fields,
Partner, Corporate practice



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Recent Trends in Acquisition Finance - Incremental Loan Facilities

By Elke Rehbock

Recent years have been marked by low interest rates and a highly liquid loan market, creating a very favorable environment for leveraged loans used to fund mergers and acquisitions, sometimes in conjunction with large one-time dividend payouts. As a result, liquidity has increased and borrowers have been successful in expanding the scope of and in adding new features to incremental loan facilities (also called an "accordion").

Generally, an incremental facility allows a borrower to add another term loan tranche or to increase revolving commitments. The benefit to the borrower is obviously the easy access to additional liquidity already pre-approved by the existing group of lenders.

Traditional incremental facilities - typical terms and conditions

Traditional incremental facilities are generally made available to borrowers within the confines of the existing credit agreement and require incremental lenders not already a lender to become a party to the existing credit facility. While these facilities usually have a cap, a very limited number of large-cap facilities provide for unlimited incremental facilities. Typical conditions for these loans include:

- Pro forma compliance with the existing (or adjusted/improved) financial covenants
- A maximum amount of the total incremental debt
- A maximum number of times the incremental facility may be used
- Customary closing conditions
- The absence of a default or event of default, and the accuracy of representations and warranties

These incremental loans typically:

1. Mature at or before the existing maturity date and may share pari passu in the collateral of the existing loans or be junior to them.
2. Contain, as to pricing, a so-called most favored nation clause, effectively tying the pricing of the existing debt to the pricing of the new debt. Thus, if the pricing of an incremental loan is higher than for the existing loan, the interest rate margin on the existing loan will be adjusted. Typically, the adjustment will be expressed in a specified number of basis points (usually 50) less than the rate on the incremental loan.

Traditional incremental facilities - addition of SunGard language

Recently, term sheets providing for incremental facilities, which are permitted to be used for future acquisitions, have added so-called "SunGard" language, effectively allowing the borrower to limit the closing conditions of the incremental loan. Recall that, out of a concern for deal certainty, buyers started requesting SunGard language (also called a "certain funds" provision) at the commitment letter stage. This provision limits:

- The closing conditions to conditions precedent specifically listed, typically in an annex to the commitment papers
- The representations and warranties required to be true at closing to those set forth in the acquisition agreement and a narrow set of additional "specified representations"
- The specified representations typically encompassing corporate governance issues (from existence, power and authority to due authorization), compliance and regulatory issues (anti-terrorism laws, margin regulations and compliance with the Investment Company Act of 1940, for example), as well as validity of the loan and security documents **> Read more on page 3**

Further, with respect to collateral at closing, the certain funds provision allows the borrower to only deliver UCC 1 financial statements for filing, documentation sufficient to enable a stock pledge to be perfected and, under some circumstances, intellectual property filings to be made. All other items needed to perfect the lender's security interest can be delivered post-closing within a specified time period allowing for a smooth closing of the M&A deal concurrent with the financing.

This addition to the conditions of an incremental loan facility effectively turns the accordion feature into a true option for financing a follow-on acquisition, which should be a very attractive feature for sponsor-led deals.

"Sidecar" incremental facilities

Large-cap borrowers have been able to push the envelope and are now sometimes permitted to incur incremental loans outside of the existing credit facility. The obvious benefit of this structure for the borrower is the potential to negotiate better terms with a new lender or new group of lenders.

To make this provision work smoothly in its implementation phase, it is prudent for both the borrower and the agent to draft a form of intercreditor agreement that can be attached to the original credit agreement and that would be required from each incremental lender. While not all facilities with sidecar incremental facilities also have an intercreditor agreement, it is a helpful tool, on the one hand, to manage the increased risk for existing lenders who now have new lenders competing for the same collateral, and on the other hand, for the borrower to ensure the smooth addition of a new incremental lender, thus avoiding the need to negotiate a new intercreditor agreement.

Term sheets providing for incremental facilities have added "Sungard language," allowing borrowers to limit closing conditions contained in the incremental loan used for acquisitions.

Considerations for 2015

A renewed regulatory focus on the leveraged loan industry may have an impact on incremental facilities and other terms in leveraged loans in 2015. The Federal Reserve, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corp revised their 2013 Interagency Guidance on Leveraged Lending, which generally outlines principles of leveraged lending with the goal of avoiding systemic risk to the financial industry.

Some of the requirements contained in the guidance speak to the absence of "meaningful" financial covenants, the fact that leverage should not exceed six times EBITDA or the ability of a company to pay off at least half its debt within five to seven years. While the regulators state that these requirements are not "a bright line," one can expect the market to react in order to respond to the risk factors identified by the regulators.

- First, lenders' and investors' demand for leveraged loans may decrease as today's widespread borrower-friendly terms and higher leverage ratios may come under increased scrutiny in the future.

- Second, that increased scrutiny may lead lenders to reconsider the loan terms they can offer borrowers. One can expect that the bargaining power borrowers have enjoyed in the leveraged loan market in the past will be reduced as banks have to face the renewed regulatory scrutiny.

In particular, provisions impacting leverage are likely to be scrutinized. Incremental loans, for instance, increase leverage and may consequently be the subject of debate in the leveraged loan market. Similarly, regulators' concern regarding a borrower's ability to repay a loan within a certain time frame may push lenders to revisit their repayment terms. This could trigger an increase in scheduled amortization payments, as well as mandatory prepayments with excess cash flow.

Distressed Debt: Loan to Own Investment Strategies After *Fisker*[1]

By Oscar N. Pinkas

In a "loan-to-own" investment, an investor acquires secured debt at a discount to leverage the face amount of the debt in an asset purchase or debt-to-equity swap. For example, if an investor can buy US$50 million worth of debt for US$25 million, it can, in a bankruptcy proceeding, bid on the underlying assets that secure the debt at a 50 percent discount, because the investor can credit bid the face value of the debt as the equivalent of cash in a sale of collateral in bankruptcy, thus creating a competitive advantage over cash or strategic bidders.

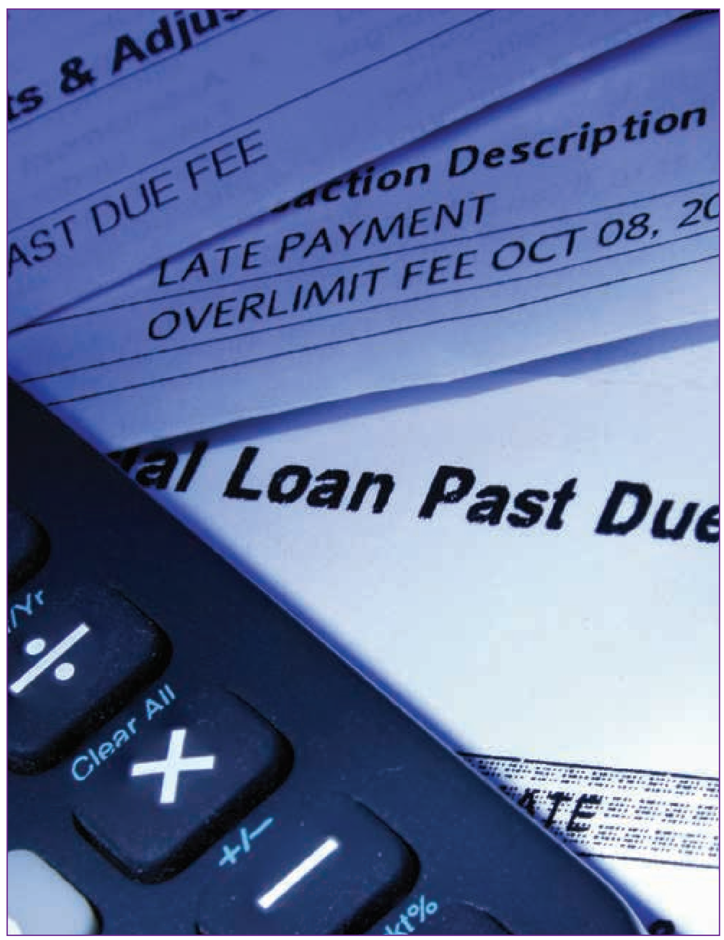
In *Fisker*, an investor's right to credit bid its US$168 million debt claim was capped at only US$25 million, the amount the investor paid for the debt. The US Bankruptcy Court for the District of Delaware reasoned that, in addition to traditional "for cause" bases to cap a credit bid, "[a] court may deny a[n investor] the right to credit bid… *to foster a competitive bidding environment*" [emphasis added]. Broadly construed, this appears to undercut the value proposition for distressed debt investors, since any credit bid in excess of an initial cash bid from a competing bidder might result in a cap on the credit bid to a common floor value among the bidders.

Traditionally, the right to credit bid could only be limited "for cause." That meant (i) procedural irregularities (e.g., failure to comply with bidding procedures); (ii) lien and/or claim disputes; and/or (iii) misconduct (e.g., collusive bidding, or rushing a sale to preclude other bids).
While the reasoning in *Fisker* appears novel, the factual foundation and support for the decision is not, because (i) the investor tried to expedite the bidding process using a drop-dead date, which the court found was "pure fabrication," inconsistent with the notions of fairness; (ii) certain of the investor's liens were not properly perfected, or were disputed; and (iii) the investor tried to credit bid on unencumbered assets, the latter two of which are reasons to limit a credit bid since under applicable law credit bidding is confined to secured debt. These underlying issues thus fall squarely within the traditional "for cause" reasons to limit credit bidding.

The decision expressly states, however, that "the 'for cause' basis upon which the court is limiting [the investor]'s credit-bid is that bidding will not only be chilled without a cap; bidding will be frozen." *Fisker* can, therefore, be read to create a new limitation on credit bidding, a cap that will allow others to bid in order to maximize purchase price at an auction.

Whether this language constitutes a new limitation or not, the decision creates significant uncertainty. However, "loan to own" investors still have the ability to mitigate or even circumvent the *Fisker* limitations. As a general matter, investors can protect against risks of a *Fisker* result by, among other things, selecting commercially reasonable sales procedures and a well-reasoned bidding timeline. Moreover, a prudent investor can try to establish the validity and extent of its claim amounts and liens prior to an auction, whether by stipulation or otherwise, although the compressed timetable for bankruptcy asset sales at the outset of a bankruptcy case may make that difficult or impossible.

An investor can also incentivize a debtor by providing new post-bankruptcy financing **> Read more on page 5**



[1] *In re Fisker Automotive Holdings Inc.*, 2014 WL 210593 (Bankr. D. Del. Jan. 17, 2014).

with priming liens conditioned on the investor's right to credit bid and the debtor's stipulation to the validity of the liens of the pre-bankruptcy debt. Similarly, the investor may want to consider acting as a stalking horse bidder (an initial bidder that offers a floor bid) and including purchase agreement covenants or conditions that require a debtor to defend the investor's liens and any objections to a face-value credit bid. Finally, an investor could offer a debtor a credit enhancement, for example a letter of credit or escrowed cash, to offset any infirmities determined in subsequent litigation over the validity and extent of liens.

If *Fisker* really stands for the proposition that fostering a "competitive bid" process is an entirely independent, stand-alone basis to limit credit bidding, an investor could also voluntarily limit its credit bid. For example, a lower credit bid could be submitted to avoid the objection and thereafter increase it at auction. It could also agree that its credit bid would be increased, but must always trail a full cash bid, thereby limiting any credit enhancement or cash component of a bid required of the investor. While the chosen route will depend on facts and circumstances, an investor may take comfort in higher repayment on its debt as a backstop, on account of competitive bidding.

Loan-to-own strategies remain a viable value proposition for proactive investors prepared with practical solutions.

Other bankruptcy judges may not follow *Fisker* or may find *Fisker* is factually distinguishable. Note also that *Fisker* may not apply in non-bankruptcy court situations, like UCC or real property foreclosure sales.

In summary, "loan-to-own" strategies remain a viable value proposition for proactive investors prepared with practical solutions. Investors that are prepared, and that have considered these and other strategies, will be armed for any dispute raised by "out-of-the-money" constituencies, such as the argument of a creditors' committee (a committee of unsecured creditors selected to act as a check and balance to the debtor) that *Fisker* permits an outright cap on a credit bid so as to permit a competitive auction.

Step-ups in Tax Basis: Utilizing Section 336(e) Elections in Structuring Private Equity Acquisitions

By Timothy J. Santoli

The IRS and Treasury Department recently issued regulations that provide rules for making a "Section 336(e) election." This election is a relatively new tax-planning tool to achieve a step-up in the tax basis of the target corporation's assets for income tax purposes where an asset purchase or a deemed asset purchase under Section 338 of the Internal Revenue Code is not available. A Section 336(e) election combines substantially similar tax consequences as a Section 338(h)(10) election (i.e., a step-up in the tax basis of the target corporation's assets) with a simpler transaction structure.

Specifically, in a Section 338(h)(10) election, the purchaser must be a corporation, whereas a Section 336(e) election may be made where a target corporation is purchased by partnerships, limited liability companies, individuals or a combination thereof. This means that, in acquiring stock of a target corporation, a private equity fund would not be required to incur the cost and complexity in setting up and maintaining a corporation to obtain a stepped-up tax basis in the assets of a target corporation. A consortium of co-investing funds purchasing the stock of a target corporation could also organize their holding company vehicle as an LLC and retain eligibility to cause the target corporation to make a Section 336(e) election where a Section 338(h)(10) election would not be permitted. In addition, the ability of a private equity fund or funds to utilize a partnership or LLC as a holding company allows, in certain circumstances, the management of the target corporation to achieve a tax-free rollover of a portion of their target corporation shares where such tax-free rollover may not otherwise be available.

To make a Section 336(e) election, the seller must make a "qualified stock disposition." For this purpose, a qualified stock disposition means any taxable transaction, or series of taxable transactions, in which 80 percent (by vote and value) or more of the C corporation's or S corporation's (as the case may be) stock is sold, exchanged or distributed, or any combination thereof, within a 12-month period. Any sale, exchange or distribution to a "related person" is not counted towards the 80 percent threshold required to achieve the qualified **> Read more on page 6**

stock disposition. For purposes of a Section 336(e) election, in the case of a C corporation target, the seller generally must be a single corporation. In the case of an S corporation target, the sellers must simply be persons that are eligible to be shareholders of an S corporation. Thus, in order to take advantage of the step-up in tax basis, it is important that the purchaser conduct a level of due diligence to ensure that the S corporation target properly qualifies as an S corporation.

As in the case with Section 338(h)(10) elections, if it is desirable for certain of the management of the target corporation to "roll over" a portion of their target corporation shares, consideration must be given to avoid the transaction from qualifying as a tax-free Section 351 transaction or other nontaxable transaction. This is because neither a Section 336(e) nor a Section 338(h)(10) election applies to nontaxable transactions, such as Section 351 transactions or tax-free reorganizations. In any such latter events, the purchaser would not be entitled to a step-up in the tax basis of the target corporation's assets.

The new Section 336 (e) election enables tax planners to achieve a step-up in the tax basis of the target's assets where Section 338 is not available.

If the Section 336(e) election is made, the seller is not treated as selling the stock of the target corporation; rather, similar to a Section 338(h)(10) election, the target corporation is treated as selling its assets to an unrelated fictional corporation in a single transaction as of the close of business on the disposition date in exchange for the consideration paid for the stock (and taking into account certain of the liabilities of the target corporation) and then liquidating. The purchaser(s) of the stock of the target corporation become the owner(s) of the fictional corporation that now has a tax basis in the assets of the target corporation equal to the then current fair market value.

Unlike the Section 338(h)(10) election, which is a joint election between the seller and purchaser, the Section 336(e) election is made by the seller(s) and the target corporation. Therefore, if the purchaser does not wish for the election to be made (because, for example, the assets

of the target corporation have depreciated), the purchaser should make sure that the purchase and sale agreement requires that no such election will be made unless agreed to by the purchaser at the purchaser's sole and absolute discretion. Similarly, if the purchaser anticipates availing itself of the benefits of Section 336(e), it should make sure that the purchase and sale agreement provides for its ability to cause the election to be made.

Representations and Warranties Insurance in M&A Transactions

By Olga Sandler

Historically, negotiations over representations and warranties (R&W) and the related indemnification in M&A transactions have often been difficult, time-consuming and costly, even where the parties had fully agreed upon the purchase price.

Once the relevant terms and numbers were finalized, parties frequently resorted to escrows and holdbacks to secure sellers' indemnity obligations. Although such arrangements have provided some level of security, they have always had limitations: (i) sellers assumed the risk that they will not be able to receive the remainder of the purchase price or will only receive funds after a significant delay; (ii) buyers assumed the risk that escrowed funds or funds held back would be insufficient to cover all indemnity claims and that funds would be **> Read more on page 7**

released prior to discovery of a breach; (iii) both sellers and buyers carried an additional risk that the other may hold up the release of escrowed funds and that funds may not be released until a court order is issued after prolonged litigation; and (iv) the party that would ultimately be entitled to the escrow or holdback amount gave up opportunity costs by keeping funds in low-interest bearing escrow accounts or only received low interest on the holdback amount.

Over the last few years the availability of more reasonably priced representations and warranties insurance (RWI), the improved process of obtaining RWI (where coverage can be secured in a few days) and better terms and conditions of RWI (with higher limits on liability, longer policy periods and narrower exclusions) have permitted both sellers and buyers to shift a significant portion of the risk associated with breaches of sellers' R&W in sale and purchase agreements (as well as certain other types of agreements) to the insurer, to address some of the shortfalls of the escrow and holdback arrangements and achieve other benefits described below.

Types of insurance

Generally two types of RWI policies are available: seller-side and buyer-side.

Seller-side policies protect a seller against risk of claims against the seller for breach of R&W made by the seller. The policy periods generally match the survival periods in the sale and purchase agreement and sometimes provide for an additional short period of time in order for the insured to make a claim. Policy limits generally match the indemnity cap under the sale and purchase agreement plus an additional amount for defense costs.

Buyer-side policies are the more frequently used and are intended to reimburse a buyer directly for losses arising out of a breach of R&W by the seller. Policy periods in buyer-side policies may extend beyond the survival period of R&W in the sale and purchase agreement (two to four years for general R&W and sometimes even five to seven years for the so-called "fundamental representations," environmental and tax R&W). Buyer-side policies frequently provide coverage in excess of the indemnity cap under the sale and purchase agreement.

Benefits of RWI

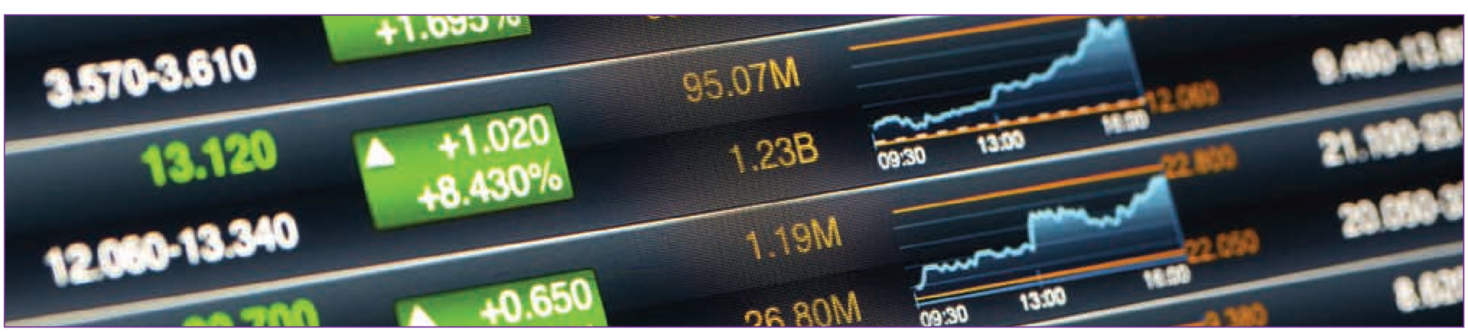
For both sellers and buyers, RWI now allows parties to be more flexible on the scope of R&W and indemnities, including deductibles, caps and survival periods, therefore taking issues off the table in a much more expedited fashion.

RWI now allows the seller to:

- Reduce potential contingent and long-term liability, and negotiate lower deductibles and caps and shorter survival periods in sale and purchase agreements
- Exit "cleaner and faster" from a transaction by reducing or eliminating the amount of funds locked up in escrow or as a holdback, thus enabling a faster distribution of a larger portion of sale proceeds to the seller (and in case of private equity funds, their investors)
- Insist, in an auction context, that buyers rely mainly or entirely on the RWI policy for recourse
- Attract buyers with buyer-side insurance who otherwise would not consider a transaction with a seller of lesser creditworthiness
- Protect itself from liability for breaches of R&W in sale and purchase agreements where the seller has not been actively involved in the management of the target business or in the relevant negotiations
- Expedite the sale process and potentially increase the purchase price by eliminating obstacles to closing, such as indemnity negotiations

RWI now allows the buyer to:

- Supplement indemnification protection offered in the sale and purchase agreement **> Read more on page 8**



Typical premiums in the US for representations and warranties insurance range from 2% to 4% of the amount of insurance purchased. Deductibles typically range from 1% to 3% of the transaction value.

through coverage that may be in excess of the indemnity caps set forth in the sale and purchase agreement, which has become even more important in recent years as the indemnity caps have been sliding from 40–50 percent to 10–15 percent of the purchase price[2]

- Obtain additional time to detect and report problems when policies provide coverage for claims made after the expiration of the survival period in the sale and purchase agreement
- Provide for an effective indemnity in public deals where it is not possible to recover from public shareholders
- Distinguish its bid in an auction by offering lower deductibles, caps, smaller escrows or no escrow, and in some cases offering that RWI be the sole recourse for breaches of sellers' R&W
- Ease its concern about the ability to collect on seller's indemnification due to poor creditworthiness of the seller (including in case of bankruptcy, where escrow arrangements are extremely rare) or from numerous sellers who may be geographically dispersed or otherwise difficult to locate
- Mitigate jurisdiction-specific risk on cross-border transactions, and explore transactions in jurisdictions with which the buyer is not familiar
- Obtain from the sellers additional R&W as long as the buyer's main or sole recourse is the RWI
- Preserve relationships with sellers who may become joint venture or other commercial business partners of the buyer after the closing

Premiums, deductibles and limits

The major insurers offering RWI today include AIG and Chubb. Today, typical premiums in the US range between two percent and four percent of the amount of insurance purchased (compared with five percent to six percent in the early 2000s). Deductibles range typically between one percent and three percent of the transaction value, based, *inter alia*, on the type of business and the nature and the scope of the R&W. Deductibles (in buyer-side policies) often line up with the indemnity cap or size of the escrow in the transaction.

Generally insurers insure up to US$50 million individually, though higher amounts are possible, and parties have also reached higher limits by combining policies from several insurance companies.

Increase in use of RWI

As a result, the use of RWI has become more accepted, especially in middle market deals valued between US$20 million and US$1 billion.

According to Marsh, in the US and Canada the amount of buyer-side RWI used in acquisitions in 2014 increased by 225 percent compared with 2013.[3]

Claims notifications and payouts have also increased in line with market growth.[4]

Limitations and pitfalls

RWI, however, is not an answer to all problems associated with risk allocation in M&A transactions. Parties to M&A transactions should be aware of the limitations and pitfalls of such policies. Some of these include:

- RWI is issued on a claims-made basis only (i.e., claims with respect to a breach must be asserted during the policy period or any reporting period in order to be valid)
- RWI deals with coverage of breaches of R&W; sometimes specific indemnities may be also covered, but such policies rarely apply to breaches of covenants or to post-closing adjustments to the purchase price
- RWI can be structured as a "blanket" coverage for all R&W or only for certain ones; furthermore, the terms of the RWI may not completely **> Read more on page 9**

[2] M&A Market Trends Subcommittee, Mergers & Acquisition Committee of the American Bar Association, Business Law Section, Private Target Mergers & Acquisitions Deal Point Study, 2014.

[3] Marsh, "Competition for Deals Fuels Rapid Adoption of Transaction Risk Insurance Among Global Deal Community: Marsh", November 19, 2014.

[4] *Id.*

mirror the terms of R&W in the sale and purchase agreement, so parties should pay close attention to gaps in coverage

- Although buyer-side policies can essentially provide an extension of the survival periods set forth in the sale and purchase agreement for many representations, in the case of the so-called "fundamental representations" where the survival period is indefinite, the RWI policy will not cover the entire survival period
- Similarly, while RWI policy limits are generally higher than the indemnity cap for breaches of certain R&W under the sale and purchase agreement, "fundamental representations" may not be covered in their entirety since indemnification for breaches of such R&W is generally uncapped

Not all types of risk are covered, and alternative means of protecting against the downside may have to be sought. For example:

Environmental issues: Generally RWI covers costs of the cleanup of unknown pre-existing conditions, including associated permitting, but does not cover new conditions. Consequential losses, such as third-party bodily injury, or long-tail tort claims, such as asbestos, may not be covered. Coverage for non-owned disposal sites and divested properties is also not guaranteed. Coverage may not be available for companies in high-risk industries, such as chemicals. In such cases, the pollution legal liability insurance may be used in tandem with the RWI.

Tax representations: Although the scope of tax representations that insurers now cover has increased dramatically, insurers still tend not to insure certain tax risks, such as taxes in certain foreign jurisdictions.

Foreign Corrupt Practices Act violations: Many insurers tend to exclude such violations from coverage, but it is becoming possible to obtain such coverage in cases where one can demonstrate strong internal compliance programs and control.

Fraud: Sellers may not be able to insure their own fraud, but buyers may obtain coverage against sellers' fraud.

Policies typically exclude claims in respect of matters of which the insured had knowledge prior to the effective date of the policy, though knowledge by the seller would

not normally result in an exclusion under the buyer-side policy. One key consideration is to insist that the exclusion be limited to "actual knowledge" and be defined to refer to several specific individuals on the "deal team." Any coverage for known items would have be to specifically negotiated.

Finally, standard forms of some insurers define "loss" by reference to "actual breach of, or inaccuracy of representation or warranty." References to "actual" should be resisted by the insured, whether in the case of a buyer-side policy or a seller-side policy. In the case of a buyer-side policy, it may be important for the buyer to ensure that a third-party claim alleging facts which are later proven incorrect would nonetheless cover litigation or other expenses related to pursuing the claim. In the case of a seller-side policy, it may be important that the seller will be able to recover costs of defense even if the seller is ultimately vindicated.

Conclusion

RWI offers a valuable tool for structuring M&A transactions more efficiently. While RWI does not negate the importance of negotiating robust R&W in sale and purchase agreements, or eliminate the use of other traditional means of addressing exposure to contingent liabilities in M&A transactions (such as escrows, holdbacks and other types of insurance), RWI does offer greater flexibility in structuring M&A transactions. Furthermore, even though claims and payouts are increasing as the RWI market grows, the expanding use of RWI in M&A transactions is a relatively new phenomenon and the claims-paying history is still in the developing stage.

Maximizing Value in the Disposition of Portfolio Companies

By Stephen M. Fields

The five-year investment period set forth in the limited partnership agreements of many private equity firms have now elapsed, and these firms ("sellers") are now in harvest mode with respect to the portfolio companies remaining in their funds. Achieving attractive return on investment multiples is their highest priority because, among other things, their ability to raise a new fund is significantly dependent upon past performance on a realized basis. As a result, investment banks are being hired to sell these portfolio companies and to create private auctions in order to do so on the theory that such a process will foster competition so as to achieve the highest purchase price and best terms possible.

Investment banks hired to create private auctions generally provide interested buyers with very seller-favorable purchase agreements—does this achieve their goal of best terms possible?

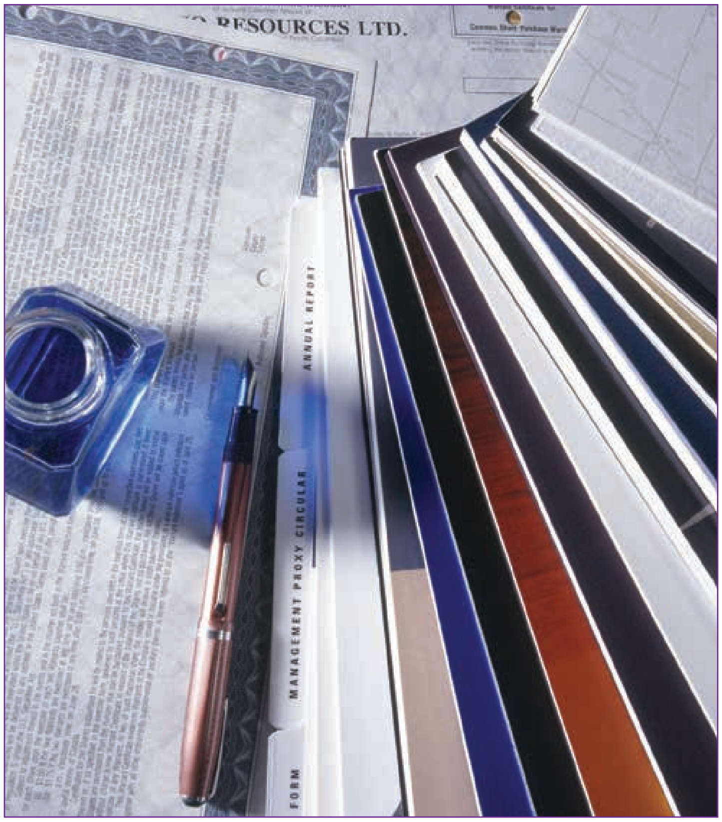
The process is straightforward. A private placement document (PPM) is created, as is a data room. The market of potential buyers is analyzed (strategic versus financial, or some combination thereof), selective potential buyers are contacted and, for those who express interest, confidentiality agreements are drafted, negotiated and executed.

Those expressing interest in pursuing a transaction after review of the PPM ("buyers") are then typically requested by the banker to provide a written "indication of interest" setting forth:

- A non-binding indication of the enterprise value (or range) that the proposed buyers would pay in cash for 100 percent of the outstanding stock of the target, assuming a debt-free, cash-free balance sheet, and what assumptions are being relied upon in arriving at such number (typically a multiple of EBITDA)
- How the proposed buyers intend to finance the subject transaction, including the specific names and interest levels of any third-party financing
- The proposed buyers' views on continuing employment roles for existing management and any "skin in the game" rollover requirements of equity owners who propose to remain as management
- The rationale for the buyers' interest and initial due diligence issues that the buyers would like to address should they have the opportunity to meet with management
- A proposed timeline, including an estimated time to close following the execution of a letter of intent
- The names of external advisors the buyers plan to engage
- The nature of the buyers' approval process necessary to sign a definitive agreement

The indication of interest will usually trigger a dialogue with those potential buyers considered "live ones," whose non-binding submissions are within the sellers' minimum price range expectations, whose financing is deemed credible and whose proposed arrangements with management are deemed acceptable. Such persons are then invited to visit the data room and to have initial meetings with management.

The next step is typically a request from the banker for the remaining eligible buyers to submit proposed, non-binding letters of intent (except for the exclusivity, confidentiality and related clauses). Concurrently, the eligible buyers will often be provided with a draft purchase agreement, which is frequently very seller-favorable, with a request to have the buyers' counsel review it and advise whether they can live with its provisions. Sometimes the banker includes a term sheet in columnar form which lists key points—for example, purchase price, dollar amount of baskets and caps, escrow amount and duration, definition of knowledge and of fundamental representations and warranties, duration and geography of restrictive covenants and similar items. This format then requests the buyers to mark up their purchase agreement and set forth their position in the applicable column of the term sheet opposite the stated position of the sellers. **> Read more on page 11**



The sellers are looking for the bidders to offer the highest price possible, and for buyers that are willing to live with their one-sided terms and conditions. This process creates a dilemma for the buyers. They want to win the bid because they like the target company but do not like the terms set forth in the term sheet or the draft purchase agreement. What will the other bidders do? How many are there? How high a price will they offer and what terms are they willing to live with?

What happens frequently is that buyers will hedge their position, telling the sellers much of what they want to hear (sprinkled with various caveats and "subject to's"). Then, after they have obtained the exclusive right to negotiate a definitive agreement, they will instruct their counsel to substantially rewrite the purchase agreement the way they wanted it in the first place.

So, what have the sellers accomplished? In trying to squeeze the maximum from the buyers, they spent time and money drafting a very one-sided agreement, which the buyers then spent time and money on redrafting what could have been done from inception. Did it result in a higher purchase price and more favorable terms?

Sometimes. In resisting any price reduction proposed by buyers, the sellers will argue that the buyers agreed to the initial terms (including purchase price) in the letter of intent, notwithstanding the non-binding nature thereof. The buyers will often counter that their quality of earnings report had not been completed at that time and that their proposal was subject to those aforementioned caveats and the completion of due diligence, which is ongoing.

Many potential buyers simply refuse to participate in any auction process because the cost in time and money weighed against the odds of being chosen are not very favorable. Some buyers try to avoid this process by making a preemptive bid with which they are comfortable, by offering a purchase price that they have reason to believe will be acceptable to the sellers upon condition that the auction process be suspended during the exclusivity period.

Did the buyers learn from the banker what range of purchase prices and terms will make them the successful bidder? Remember that the banker was engaged and is being paid by the sellers and its success fee is typically based on a percentage of the purchase price, so the interests of the buyers and that of the banker are not aligned. Are the buyers being used as stalking horses to increase a purchase price bid from another buyer? These and others are questions all buyers consider before making a preemptive bid.

Depending upon the sellers' timetable, a preemptive bid may be most advantageous to them. Once they decide to sell, they surely want to conclude the process as quickly as possible. The price offered, meant as a preemptive bid, would normally be within their acceptable price range, although perhaps not the highest bid possible. A single bid is more efficient and less disruptive to the management team and company employees, and lessens the chance of the proposed sale becoming public knowledge to the advantage of company competitors.

Is "a bird in the hand worth two in the bush"? From the sellers' perspective, they can keep the preemptive buyers' feet to the fire by the implied threat of resuming the auction process upon the expiration of the exclusivity period. From the buyers' perspective, one objective will be to whittle down the purchase price upon completion of the diligence process by identifying the weaknesses of the target, increasing the escrow amount and duration, and broadening the representations, warranties, covenants and indemnities. Let the bargaining begin.

WARN Act Liability for Private Equity Funds

By Adam H. Dunst

There is a recent tendency for workers who lose employment at a private equity fund's portfolio company as a result of a plant closing or a layoff to sue the private equity fund for violations of the federal Worker Adjustment and Retraining Notification Act (WARN Act) and similar state statutes. Since it is likely a portfolio company that takes such actions may be failing financially, the terminated employee often looks to the private equity firm as the "deep pocket" source of compensation, claiming that the private equity firm is liable because it made the termination decision with the portfolio company as a "single employer" under the WARN Act. As discussed below, courts will typically apply a test to determine potential "single employer" liability to the specific facts of the case.

Generally speaking, the WARN Act offers protection to employees, their families and communities by requiring employers to provide written notice to such affected employees 60 days in advance of covered plant closings and covered mass layoffs. Such notice is also required to be delivered to appropriate local government units. Below is a brief discussion of the WARN Act, including the legal test generally employed by courts to determine whether "single employer" liability applies. Following this discussion are some practical steps that a private equity firm can take to decrease potential liability under the "single employer" doctrine and increase the chances of a successful motion to dismiss, or of winning a lawsuit if sued by former employees of one of its portfolio companies.

What employers are subject to the WARN Act?

In general, employers are covered by the WARN Act if they have 100 or more employees, exclusive of employees who have worked less than six months in the last 12 months and employees who work an average of less than 20 hours a week (collectively, "exempt employees").

What triggers the notice requirement?

For plant closings, a covered employer must give written notice if an employment site (or one or more facilities or operating units within an employment site) will be shut down, and the shutdown will result in an "employment loss" for 50 or more non-exempt employees during any 30-day period. The exempt employees, however, are also entitled to such notice.

A covered employer must also give written notice if there is to be a mass layoff. A mass layoff is one which results in an employment loss at the employment site during any 30-day period for 500 or more employees, or for 50 to 499 employees if they make up at least 33 percent of the employer's workforce. Again, this is exclusive of exempt employees, though such exempt employees are still entitled to such notice.

An "employment loss" occurs if there is (i) an employment termination, other than a discharge for cause, voluntary departure or retirement; (ii) a layoff exceeding six months; or (iii) a reduction in an employee's work hours of more than 50 percent in each month of any six-month period.

Certain narrow exemptions (such as a natural disaster) may apply, but even in those cases the employer must give as much notice as is practicable.

What are the penalties for violation of the WARN Act?

An employer that violates the WARN Act is liable to each aggrieved employee for an amount including back pay and benefits for the period of violation, up to 60 days. An employer that fails to provide notice as required to a unit of local government is also subject to a civil penalty not to exceed US$500 for each day of violation.

How are private equity firms impacted by the WARN Act?

As discussed above, in many instances, former employees of a private equity fund's portfolio company may sue the fund under a "single employer" doctrine because a portfolio company has not provided the requisite notice of an employment loss. **> Read more on page 13**

Often in these situations, the portfolio company has ceased operations or is on the verge of doing so, and it may be difficult to obtain a meaningful recovery from such company. So, the former employees assert their WARN Act claims against the private equity owner of the failed company looking for "deep pockets." If the "single employer" claim is successful, the former employees will be able to recover from the defendant private equity firm.

The "single employer" test

US Department of Labor (DOL) regulations have set out five factors to be considered when evaluating the "single employer" doctrine with respect to WARN Act liability: (i) common ownership; (ii) common directors and/or officers; (iii) de facto exercise of control; (iv) unity of personnel policies emanating from a common source; and (v) dependency of operations.

> Workers who lose employment at a PE fund's portfolio company as a result of a plant closing or a layoff tend to sue the fund for violations of the WARN Act.

Courts in various jurisdictions, including Delaware courts and the US Court of Appeals for the Second Circuit, have adopted a five-factor balancing test based on the above, and generally apply the same test. Inquiries into the specific facts and circumstances of each case have driven the courts' analysis under the "single employer" test.

The above five factors are meant as a non-exhaustive list so as to allow courts to exercise flexibility. The DOL balancing test is thus not a "mechanical exercise"[5] and is "ultimately an inquiry into whether the two nominally separate entities operated at arm's length."[6] Generally, if only the first two factors are present—common ownership coupled with common management—liability is not established. Typically, the last three factors are the determinative ones. Among these, de facto exercise of control is the most important.

According to the Third Circuit, a "particularly striking" showing of de facto control can warrant "single employer" liability even in the absence of the other factors. The de facto control factor involves a determination as to whether one company "was the decision-maker responsible for the employment practice giving rise to the litigation."[7] A recent Delaware District Court decision held that de facto control is not present where the parent corporation exercises control pursuant to the ordinary instances of stock ownership, but exists only where "the parent has specifically directed the allegedly illegal employment practice that forms the basis for the litigation."[8]

The fourth factor looks to whether there was unity of personnel policies, and is "analogous to a determination of whether the companies had a centralized control of labor operations."[9]

The fifth factor considers whether there was a dependency of operations between the two companies. Courts will look to the existence of arrangements such as the sharing of administrative or purchasing services, interchanges of employees or equipment and commingled finances. This factor cannot be established merely by the parent company's exercise of its ordinary powers of ownership, i.e., to vote for directors and set general policies. Instead, this factor requires that plaintiffs establish the existence of what was known at common law as a master-servant agency relationship.[10]

Finally, it is important to note that the standard for crossing corporate entity boundaries to create liability under the WARN Act is not as high of a standard as is used for "piercing the corporate veil" under traditional law, so it is not prudent to solely rely on "veil piercing" protections in this context.

Protective measures

"Single employer" liability risk can be mitigated with proper advance planning and structuring. **> Read more on page 14**

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[5] *Pearson v. Component Technology Corp.*, 247 F.3d 471, 504 (3d Cir. 2001).

[6] *Id.* at 495.

[7] *Id.* at 504.

[8] *In re Jevic Holding Corp.*, 492 B.R. 416, 426 (Bankr. D. Del. 2013).

[9] *Young v. Fortis Plastics, LLC*, 2013 WL 5406276, at *6 (N.D. Ind. Sept. 24, 2013); see also Hampton v. Navigation Capital Partners, Inc., C.A. No. 13-747-LPS, at *6 (D. Del. Aug. 19, 2014).

[10] *Pearson* at 501; see also *Hampton* at *7.

Below is a non-exhaustive list of some of the protective measures that a private equity fund may want to consider (to the extent practicable) in order to reduce the chances of facing WARN Act liability as a "single employer" in connection with layoffs or plant closings at a portfolio company:

- The portfolio company should have and be responsible for creating its own human resources, labor, employment and personnel policies, rules and procedures; ensure decision-making in this area is independent
- The portfolio company should negotiate its own labor and employment agreements
- Allow the portfolio company to have at least one or more independent directors and independent officers; directors and officers should act on behalf of the portfolio company
- Management-level personnel should not be repeatedly transferred between the fund and the portfolio company
- With board oversight and input from the fund, the portfolio company's management team should strive to control day-to-day operations of the company and decisions as to potential layoffs or plant closures, as well as other major decisions
- Professional advisors to the portfolio company's board and management team should be hired directly by the portfolio company as opposed to relying on advisors to (or hired by) the private equity fund, especially regarding layoff or plant closing decisions
- Each company should maintain its own books and records, have its own bank accounts and prepare its own financial statements

Seeking outside legal counsel as early as possible in the structuring process is advisable to ensure that appropriate decisions and structures are made and implemented in order to protect the private equity fund from WARN Act liability under the "single employer" doctrine. While lawsuits are often inevitable, if proper steps are taken, the private equity fund should have a much greater chance of winning the lawsuit or getting it dismissed.

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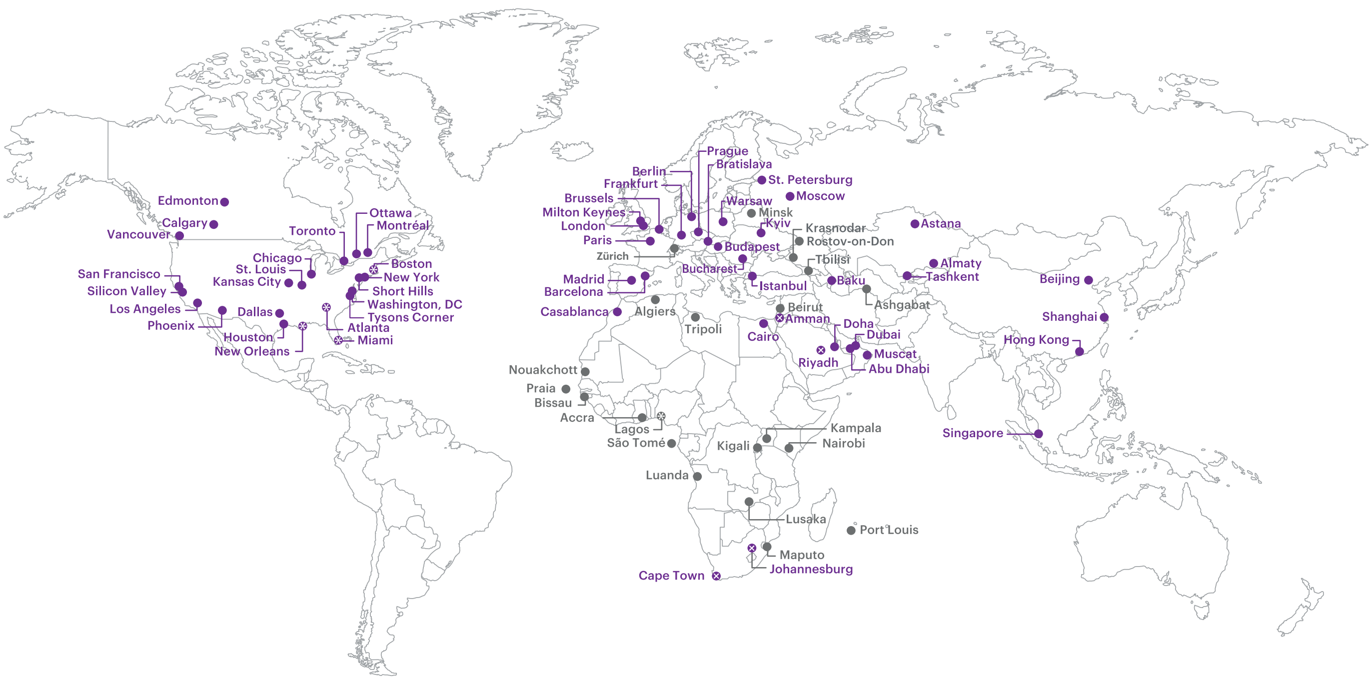

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