Dentons Private Equity Fund Manager's Report™

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DENTONS

From the Editor

Welcome aboard

Welcome to the initial 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. Those activities encompass a broad array of items including organizing a fund, selecting partners and professionals, raising capital, romancing sellers, incentivizing management, sourcing and closing investments, bringing value-add as a board member and successfully exiting those investments. For service providers, the deal is generally completed upon the acquisition—for the fund manager, it has just begun. We hope that the information we provide will alert you to opportunities to be exploited and heighten your awareness so that you will look before you leap and not waste your limited time on investments that fail and sellers who don't really want to sell. Are you discriminating in your choices before you commit your time (how many wasted plane trips to isolated locations have you taken in your career?) and the money of your

investors? They are the people to whom you owe a fiduciary duty. 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, or if you are seeking to hire investment professionals, need industry experience, or want to dispose of an investment, meet an equity sponsor or a mezzanine lender or hire a CFO, 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 have our interests aligned. Thank you, and let us hear from you!

Stephen M. Fields
Partner, Corporate
New York

In this issue...

Environmental liability - Regulatory compliance - Insurance coverage (or not)

By Jessica Duggan, Kevin Kamraczewski and Stephen M. Fields

After looking at numerous investment opportunities, you bite the bullet, assemble a syndicate of lenders and close on a leveraged buyout transaction resulting in control of the operating company target through the use of a holding company. You were careful in your diligence, having conducted a Phase I environmental investigation, with nothing > Read more on page 2

A preview of articles to come

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Environmental liability - Regulatory compliance - Insurance coverage (or not)

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significantly adverse to report despite the regular use in its business by the target of certain contaminants. Now fast forward, and, five years later, you have received an attractive offer to buy your interest from a strategic buyer. The buyer and its lenders proceed to conduct their own due diligence and, lo and behold, the contamination levels that were previously below reportable levels have, according to the buyer, exceeded permissible levels and have now reached groundwater. What is the consequence of this? How did it happen? Who caused it? What are the issues?

At the outset, is the verbal report from the buyer complete and accurate? Is there a lab report or confirming consultant report, in draft form or otherwise, in existence to support the allegation? What is the remediation cost and how long will it take? Have you violated any federal or state laws and are you continuing to do so? What obligations do you as the majority owner and current indirect operator of the tainted property have and to whom? Do you have any indemnity rights against the former owner? Did the contaminated groundwater migrate from an adjoining property? Will it migrate further into public drinking water? What insurance do you have and does your pollution policy cover the existing situation? In addition, the buyer and its lenders have become nervous about the entire transaction, and, if they proceed, now wish to exclude the tainted facility from the purchase and are requesting a separate escrow, indemnity and insurance coverage.

Lots of questions—lots of uncertainty. What should you do and what are your alternatives?

First, you must ascertain the facts. The buyer has made an allegation which may or may not be true or be as severe as claimed. It hired a consultant which undoubtedly has an economic interest in participating in an expensive remediation effort. Do you want the buyer to control that process? If it proceeds with the purchase, the buyer itself is incentivized to reduce the purchase price and to create as large an escrow and indemnity as possible. Under many state and federal environmental statutes, once an owner or operator becomes aware of an "environmental condition" it has an obligation to promptly report same to the local authorities, which will then undertake their own investigation and make recommendations and/or issue directives as to what is required to remediate the property. The obligation to report an "environmental condition" to the local authorities does not generally arise until a final written report is rendered by someone expert in the field. As a result, a seller will often immediately engage its own expert for such purpose so as to control the process and costs involved and to initially render a draft report. If a pollution insurance policy is in place, in order to preserve coverage, you as the seller should immediately notify the insurer—especially if you wish to be reimbursed for any costs you incur, because the insurance company will want to be responsible for the cleanup and hire those who will do such work because of the discount it receives due to its ability to purchase in volume. It is also recommended that, in collaboration with the buyer, a formal claim be made with the insurer before signing any purchase documents with the buyer so as to preserve such insurance coverage because numerous pollution policies have non-assignment provisions and so-called "contractual liability exclusions" from coverage which are triggered upon entering into indemnity agreements with the buyer. You also need to check whether a change of control is deemed to be an assignment under the policy. In the scenario outlined above, the buyer (which will purchase the entity that previously operated the tainted property) and you as the seller (if you retain the contaminated property in a different entity) will no doubt seek to obtain your own pollution policies. (Note that if you as the seller retain the tainted property as a stand-alone in a separate entity, it is possible that such entity will be treated as a real estate holding company and thus Foreign Investment in Real Property Tax Act [FIRPTA] rules will apply to any foreign limited partners of yours, which may require them to file US tax returns.) Note also that buyer and seller will need to be aware of something the insurers call a "material increase in risk endorsement" provision contained in many pollution policies. Thus, in the example above, if the contaminated groundwater continues to migrate in the future, it is possible that the insurance coverage purchased will be disavowed by the insurer. Another caveat is that some of these policies permit the insurer to cancel the policy for any reason or no reason, usually upon 90 days notice. As is apparent, careful review of the policy is essential.

Assuming an environmental disaster is not covered by insurance and indemnity rights are not available from a creditworthy indemnitor, do you as the private equity fund seller have exposure simply because you are the majority stockholder of, and control the board of, Holdco (a Delaware corporation), which is the sole member of Opco (a Delaware LLC), which previously operated the tainted property? Generally, environmental law respects the limited liability of the corporate form unless specific, unusual circumstances justify treatment of the business as a separate entity. There are two ways in which shareholders may potentially face liability: piercing the corporate veil, or where the shareholder is deemed under the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA) and similar state statutes to be an "operator" of the subject property under environmental regulations. Neither of these doctrines applies solely because a seller is a shareholder. Certain courts (the Fifth Circuit for example) take a narrow view of corporate veil piercing in environmental liability actions. However, if the corporation is formed to perpetuate **> Read more on page 11**

A primer on intercreditor agreements

By Ata Dinlenc

When structuring a complex debt financing, financiers need to consider whether unsecured and structurally subordinated "mezzanine" debt ought to be replaced in the capital hierarchy with secured second lien credit. The relatively lower financing cost for second lien credit is based on the assumption that the second lien lenders might obtain some equity value from the liens on the residual collateral which would not otherwise be available with such "mezzanine" debt. Requests for second lien status also arise when these lenders have their own credit facility and need such liens to increase their borrowing base. In exchange for such status, senior lenders often require such liens to be a "silent second" with minimal or no enforcement rights. A properly drafted intercreditor agreement among the parties to the transaction is necessary to ensure that their relative rights and obligations are enforced in a distress or bankruptcy situation.

Defining lien priority as between two secured creditors is necessary when both have security interests in the same collateral. The reason is that the senior lender will seek to be repaid first from proceeds of collateral upon enforcement of the lien, while the junior lender will expect to collect only from any remaining proceeds. If the collateral proceeds are not sufficient to repay the senior lender in full, then both secured creditors and all other unsecured creditors would rank equally in their right to repayment of remaining indebtedness from the other assets of the debtor. Payment subordination provisions in the intercreditor agreement mitigate this result in favor of the senior creditor. Payment subordination allows the senior creditor the right to be paid first from all assets of the debtor or any other obligor of the debtor, regardless whether such assets constitute collateral security. The amount owed to the senior lender drives payment subordination terms, not the value of the pledged collateral. Provisions in the intercreditor agreement typically require all parties to pay-over to the senior creditor or its agent any proceeds obtained from shared collateral.

Setting forth lien priority in intercreditor agreements also serves to mitigate against the risk of the senior creditor not being "first in time" in filing a lien. The intercreditor agreement should require something to the effect that, notwithstanding the date, time, method, manner or order of grant, attachment or perfection of liens securing the senior or junior obligations, etc., the lien in favor of the senior creditor shall be senior in all respects and prior to any lien on collateral securing the junior obligations. Both creditors' counsel should nonetheless diligently observe all perfection requirements during the closing process to protect collateral from unsecured claimants. Finally, the intercreditor agreement should require that parties will not challenge each other's lien and payment priority as set forth in the agreement.

Given their respective lien priorities, a second lien creditor's prospects of recovery from common collateral may significantly decrease if there is an increase in the amount of the first lien creditor's obligations. To avoid this "cram down," junior creditors typically seek explicit limits on the types and amounts of senior obligations that may be secured by the first lien on the common collateral, which terms are heavily negotiated. A second lien creditor may seek to entirely exclude items such as unaccrued original issue discount, that portion of interest accruing at the incremental default rate and certain fees and expenses. In addition, the second lien creditor typically seeks to impose a dollar-defined cap on the overall principal amount of the first lien obligations. Hedging obligations which are part of the senior obligations may vary dramatically and may increase the dollar-defined cap. For cross-border deals or transactions with collateral foreclosure in different countries, currency exchange and fluctuation should be addressed in the intercreditor agreement. Incremental credit facilities such as refinancings or increases in credit extensions (e.g., "accordion" facilities), and priming loans and debtor-in-possession (DIP) loans in a bankruptcy context may also be subject to the overall cap. Similarly, interest and various fees, costs, indemnities and other expenses may also be subject to a different cap or put into the same basket. A way to allow the senior creditor to have sufficient room to extend additional credit to a debtor in distress is to permit such additional obligations to about 10 to 15 percent of the initial principal amount of the senior debt, with perhaps a second, additional cushion if bankruptcy proceedings have commenced and a DIP loan is being extended by the senior creditor. The cap on the principal amount of senior obligations should be automatically and irrevocably reduced upon repayment of principal to the senior creditor under its facilities.

The purpose of these limitations is to subordinate to the lien of the second lienholder that portion of first lien obligations which are in excess of the cap, which results in third lien priority for such excess obligations of the senior creditor. Similarly, any right of the second lienholder to buy out the first lien creditor's debt would be limited to amounts up to the first lien cap, not the excess. First lien creditors would want to impose a corresponding cap (and related terms) on the second lien obligations for the same reasons. In doing so, the **> Read more on page 6**

Anti-corruption due diligence: a key component of mergers and acquisitions

By Randy Bregman, Michelle J. Shapiro and Peter Feldman

The increasing focus on enforcement of the US Foreign Corrupt Practices Act (FCPA), Canadian Corruption of Foreign Public Officials Act and UK Bribery Act, as well as similar anti-corruption laws around the globe, has made conducting pre-acquisition anti-corruption due diligence an essential element of any cross-border merger or acquisition, especially if the target does business in a jurisdiction where local officials may expect to be compensated for simply doing their job. Although some may view their payments to "government officials" (the definition of which is very broad) as merely a cost of doing business or a necessary evil to expedite the granting of a license or permit, in addition to running afoul of applicable laws such payments can wreak havoc with an open and accurate economic analysis of the true costs of doing business, particularly since they tend not to be readily apparent in financial statements relied upon by buyers and lenders worldwide.

As a result, the failure to conduct pre-acquisition anti-corruption due diligence can lead to severe legal and financial consequences, as well as reputational damage, for both buyers and sellers. For buyers, anti-corruption diligence can be especially critical because, under US principles of successor liability, a buyer may be held liable for pre-closing FCPA violations by the target. And if illegal conduct by the acquired company continues post-closing, the buyer can be held directly liable, even if it had no knowledge of or participation in the violation. For sellers, putting aside any individual liability (which would survive a transfer of ownership or control), concerns about potential pre-closing violations can strongly influence a deal's value, if not threaten the entire transaction. Moreover, sellers may be asked to provide specific representations—or even fundamental representations—and warranties as to anti-corruption compliance that are backed by broad indemnification provisions and hefty escrow amounts.

The two US government agencies responsible for enforcing the FCPA, the Department of Justice (DOJ) and the Securities and Exchange Commission (SEC), have endorsed a risk-based approach to conducting pre-acquisition anti-corruption due diligence. As explained in greater detail below, such an approach requires an initial evaluation of the target's risk profile, followed by the creation and subsequent implementation of a work plan that incorporates review procedures specifically tailored to and commensurate with the risks identified. Even if pre-acquisition anti-corruption diligence does not reveal evidence of bribery (after all, the professionals conducting the exercise lack badges and subpoena power, and must to some extent rely on the target's personnel to provide accurate and complete information), conducting such a review can help to identify "red flag" indicators of corruption and potential control weaknesses. Once armed with that information, a prospective buyer can address the issues with the seller and, ideally, convince the seller to remediate and voluntarily report any violations to the relevant authorities before the deal is closed. At a minimum, the results of the review can be factored into the deal terms and pricing, as well as taken into consideration by the buyer when designing plans to integrate the target into its operations. The exercise could also prove useful in demonstrating to law enforcement the buyer's commitment to anti-corruption compliance, should violations come to the government's attention post-closing. Stated another way, if you **> Read more on page 5**

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do not devote sufficient time and resources to try to detect corrupt practices pre-closing, arguments that you were an "innocent purchaser" may fall on deaf ears.

The important role of pre-acquisition FCPA due diligence

In their November 2012 Resource Guide to the FCPA, the DOJ and SEC caution that in the M&A context, they may pursue FCPA charges utilizing theories of successor liability as well as direct liability.[1] Successor liability means that a buyer can be held liable for pre-closing violations committed by the target company (or its agents), so long as the target was subject to FCPA jurisdiction at the time of the conduct. Notably, if a target was not subject to the FCPA pre-transaction, the mere fact of the acquisition will not create successor liability. On a direct liability theory, the DOJ and/or the SEC could pursue FCPA charges against a buyer for any post-closing FCPA violations committed by the acquired company (or its agents).

In light of this legal framework, the DOJ and SEC "encourage companies to conduct pre-acquisition due diligence[,]" as well as to enhance compliance programs and internal controls post-acquisition. As described in the Resource Guide, conducting pre-acquisition FCPA diligence can provide a range of benefits to both buyers and sellers, including:

(1) Enabling buyers to more accurately value the target company

(2) Laying the foundation for a buyer to rapidly and successfully integrate the target company into its operations post-closing, including by reducing the risk that the target company, once acquired, will continue to engage in any conduct that violates the FCPA

(3) Allowing the parties to handle any potential FCPA violations uncovered by the diligence in a more orderly and efficient manner

(4) Demonstrating a genuine commitment to identifying and preventing FCPA violations

The DOJ and SEC also note that pre-acquisition due diligence can be a crucial mitigating factor in their decisions on whether to bring an FCPA enforcement action and, should they nonetheless decide to proceed, it will factor into the calculation of any penalty that may be imposed. According to US regulators, "[i]n a significant number of instances, DOJ and SEC have declined to take action against companies that voluntarily disclosed and remediated conduct and cooperated with DOJ and SEC in the merger and acquisition context." Moreover, they note that "DOJ and SEC have only taken action against successor companies in limited circumstances, generally in cases involving egregious and sustained violations or where the successor company directly participated in the violations or failed to stop the misconduct from continuing after the acquisition."

Tips for conducting risk-based anti-corruption due diligence

Pre-acquisition anti-corruption diligence procedures should be aligned with the particular risk profile of the potential acquisition target. In the Resource Guide, the DOJ and SEC advise that "the degree of appropriate [FCPA] due diligence may vary based on industry, country, size and nature of the transaction[,]" and recommend a "thorough risk-based" approach when determining how to allocate pre-acquisition diligence resources.

A potential buyer (or a potential seller who wishes to conduct a compliance assessment in advance of marketing the company, particularly to US buyers) should consider the following non-exhaustive list of risk factors:

- **Geography**: the perceived corruption risk of each jurisdiction in which the target or its subsidiaries or affiliates operates, either directly or through third parties (e.g., countries with low scores on the Transparency International Corruption Perceptions Index, which is a widely recognized barometer for corruption risk based on information from independent institutions that specialize in the analysis of governance and business climates)

- **Industry**: the perceived corruption risk of the industry or sector in which the target does business, particularly industries that have been the focus of heavy anti-corruption enforcement, such as oil and gas, medical devices, pharmaceuticals and freight forwarding

- **Government business**: the extent to which the target's revenues rely on government contracts and/or government concessions, including licensure, permits or other authorizations

- **Government interactions**: the target's level of interaction with government officials, including the importance of licenses and permits to its operations, the degree of government oversight and inspection and the significance of goods and personnel clearing customs and immigration

- **Business development and sales strategy**: the target's business development program, including any travel, gifts or entertainment provided or received > Read more on page 6

[1] *See US Dep't of Justice & US Sec. Exch. Comm'n, A Resource Guide to the US Foreign Corrupt Practices Act*, 28–30 (Nov. 14, 2012).

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- **Third-party intermediaries**: the target's reliance on third-party agents, particularly in dealing with government officials (including officers or employees of state-owned enterprises) or for business development efforts
- **M&A activity and JV arrangements**: the appropriateness of the target's diligence in connection with mergers, acquisitions and joint ventures
- **Compliance program**: whether the target has adopted and implemented anti-corruption policies and procedures, and if so, whether the anti-corruption program is adequate for the risks presented
- **History**: the target's compliance history, including allegations or suspicions of corruption

Informed by an assessment of the target's risk profile, a pre-acquisition anti-corruption due diligence plan should be tailored to the transaction and then implemented. Typically, but not always, anti-corruption diligence can be performed alongside standard commercial due diligence, using many of the same materials and methods for obtaining information. For example, anti-corruption diligence procedures might leverage an electronic or physical data room, financial analyses already prepared for other purposes, opportunities to interview key personnel and certain publicly available information about the target, its owners and/or key personnel. Throughout the process, anti-corruption diligence should be focused on identifying "red flags" requiring heightened scrutiny and follow-up procedures, possibly including expanded requests for information or data.

To enhance the effectiveness and efficiency of anti-corruption diligence, it is often helpful to integrate US counsel experienced in this area with local counsel in the relevant jurisdictions. This allows the review to incorporate local laws and practices, for example "customary" per diem payments to traveling government regulators or the provision of hospitality to potential customers. Similarly, integrating US and local counsel can help ensure that diligence procedures are targeted to higher-risk areas and nomenclature, such as by focusing on relevant local language search terms (e.g., *chaqian* ["tea money"] in Chinese; *pod stolom* ["under the table"] in Slovak).

Conclusion

Given the regulators' ongoing focus on compliance with global anti-corruption legislation, conducting targeted anti-corruption due diligence is increasingly critical for any cross-border corporate transaction, particularly those involving US companies or US nationals doing business outside the US. Ideally, implementing the type of risk-based review suggested by the DOJ and SEC will uncover any evidence of corruption before a deal is inked, but even if it does not, the exercise can provide a range of significant benefits, not the least of which is identifying "red flags" and other weaknesses that can be addressed in the deal documents and incorporated into the buyer's integration plans so that any questionable practices cease prior to closing.

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parties typically draft "waterfall" provisions to capture the priority levels.

Another basic principle of intercreditor arrangements is that the senior creditor is typically entitled to control the maintenance and disposition of common collateral while the junior creditor is required to waive certain statutory rights that would otherwise entitle the junior creditor to challenge the enforcement and foreclosure process. A "standstill period" is typically imposed, which grants to the senior creditor the exclusive right to enforce and exercise remedies over the debtor for a defined period of time. The number of standstill periods allowed during the lifetime of the loan is usually the subject of negotiation between the senior and junior creditors. Each standstill period is usually 90 to 180 days during the lifetime of the loan, with extensions of additional periods so long as enforcement actions are being diligently pursued. To expedite and streamline collateral realization, the grant of exclusivity in favor of the senior creditor may be subject to specific conditions, such as a requirement that the senior creditor select and retain the services of a qualified independent appraiser for valuation of the collateral or an experienced investment banker to run an auction process for the efficient sale of collateral. The same conditions may apply to the junior creditor if and when it takes over the process at the expiration of the standstill period in respect of unrealized common collateral. The second lienholder typically retains only the right to file a claim and to demand and accelerate its loans so as to preserve its status ahead of (or at least no worse than) all unsecured claimants. Whether the second lienholder is granted the right to consent to dispositions of common collateral under the bankruptcy process is usually hotly negotiated. A comprehensive intercreditor agreement which provides sufficient clarity around the collateral realization process and reasonable limitations on the senior creditor's rights is often sufficient to keep the junior creditor in the fold.

Underfunded pension plans - private equity fund liability

By Michael R. Maryn

On July 24, 2013, the First Circuit Court of Appeals determined that a private equity fund that was actively engaged in the management and operations of its portfolio company, and was compensated for its services, was a trade or business that could be held jointly and severally liable for US$4.5 million in pension withdrawal liability incurred by the portfolio company. *Sun Capital Partners III, LP v. New Eng. Teamsters & Trucking Indus. Pension Fund*, Case No. 12-2312, 1st Cir. July 24, 2013. The decision rests on the basic principle that, for purposes of determining liability for pension underfunding under the Multiemployer Pension Plan Amendments Act of 1980 (MPPAA), the definition of "employer" is extremely broad and "extends beyond the business entity withdrawing from the pension fund, thus imposing liability on related entities within the definition, which in effect, pierces the corporate veil and disregards formal business structures." (Id.) The ruling is a reminder that funds must be on the alert in both structuring their investments and managing their portfolio companies for this potential liability.

The appellees in the case, private equity funds Sun Capital Partners III, L.P., Sun Capital Partners III QP, LP, and Sun Capital Partners IV, LP, (collectively, the Sun Funds) sought a declaratory judgment in the District Court of Massachusetts that they were not liable as an employer to the New England Teamsters and Trucking Industry Pension Fund for the payment of pension withdrawal liability arising from the withdrawal from the multiemployer pension plan and subsequent bankruptcy of Scott Brass, Inc., one of the companies in which the Sun Funds were invested. The district court ruled in favor of the Sun Funds. *Sun Capital Partners III, L.P. v. New Eng. Teamsters & Trucking Indus. Pension Fund*, 903 F. Supp 2d 107 (D. Mass 2012).

The issues on appeal to the First Circuit were whether the Sun Funds were "trades or businesses" under the Employee Retirement Income Security Act of 1974 (ERISA) and whether the investment transaction was structured with the primary purpose of evading or avoiding withdrawal liability. The First Circuit ruled against one of the Sun Funds on the first issue and remanded the case to the district court to determine the "trade or business" issue with respect to the other fund.

The facts of the case with respect to the Sun Funds' control of the portfolio company management were determinative.

The Sun Funds are limited partnerships to which individuals and institutional investors contribute capital for investment purposes. The stated purpose of the funds is to invest in underperforming but market-leading companies at a discount, with the goal of turning them around and selling them for profit. Accordingly, the Sun Funds' controlling stakes in the portfolio companies are typically used to implement restructuring strategies.

The Sun Funds created a Delaware limited liability company to act as the investment vehicle for Scott Brass and invested US$3 million in the LLC for 100 percent of the membership interests; this investment was split 70/30 between the Sun Capital III and IV funds. The split between the funds was admittedly calculated to minimize the chances of incurring withdrawal liability. The LLC invested the US$3 million in a holding company in exchange for US$1 million of the holding company stock and US$2 million of debt. In 2006, the holding company then purchased the stock of Scott Brass for US$3 million in cash and an additional US$4.8 million of borrowed funds. Each of the Sun Funds' general partners has both a committee that makes the investment decisions for the fund and, significantly, a management company that is designed to provide managerial and consulting services to the holding company or the acquired company for which it would be paid management fees. In fact, the holding company signed an agreement with the GP of Sun Capital IV to provide management services to the holding company and its subsidiary, Scott Brass.

Under the MPPAA, members of a commonly controlled group of trades or businesses are jointly and severally liable for withdrawal liability. In determining whether the Sun Funds constituted a "trade or business" within the meaning of the statute, the court turned first to the two-prong test of the Supreme Court in *Commissioner v. Groetzinger*, 480 US 23 (1987): (1) the primary purpose of the activity must be income or profit, and (2) the activity must be performed with regularity and continuity. The purpose of the Sun Funds was undeniably profit. For the second prong of the *Groetzinger* test, the First Circuit relied on its own version of the "investment plus" test derived from a Pension Benefit Guaranty Corporation (PBGC) Appeals Board ruling. The PBGC's ruling looked to the fund's activities with respect to the portfolio company that were over and above its passive investment.

The First Circuit noted that numerous individuals with affiliations to Sun Capital exerted substantial operational and managerial control over the debtor. The stated intent of the Sun Funds in the creation of the enterprise, the Sun Funds' information memoranda to potential investors that explained the funds' involvement in management and operation of the companies **> Read more on page 11**

Capital call loans to SBICs

By Stephen M. Fields and Jane A. Meyer

Although the Small Business Investment Company (SBIC) licensing process has been streamlined and is more efficient than ever, the US Small Business Administration (SBA), which administers the SBIC program, remains hampered by the limited number of experienced personnel in its employ and by the increasing number of funds expressing interest in accessing its long-term, low interest 2-1 matching capital (leverage). Because a delay in licensing prevents timely access to SBA leverage, the only recourse many funds have to implement their investing strategy prior to licensing (and the associated availability of leverage), is to seek private capital from existing or potential investors and co-investors. Unfortunately, accessing private capital is not always possible for licensees, as many institutional and other limited partners have conditioned their commitments to the fund upon the issuance of the SBIC license. However, since nature abhors a vacuum, enterprising and innovative people often find a way to satisfy the business need. Enter capital call loans.

For many years SBA regulations permitted licensees to incur "secured third-party debt," i.e., non-SBA debt secured by the assets of the SBIC, subject to the SBA's consent if the SBIC had outstanding leverage. As a condition to its granting such approval, the SBA had the right to impose whatever conditions or limitations it deemed appropriate on the proposed financing, taking into account the SBIC's historical performance, current financial position and the proposed terms of the debt, as well as the aggregate debt (including leverage) that would be outstanding. Under no circumstances would the SBA favorably consider a request for approval if the proposed indebtedness included a blanket lien on all of the SBIC's assets or a security interest in the fund's limited partner commitments in excess of 125 percent of the proposed borrowing.

The existing regulations notwithstanding, the SBA has recently taken the position (not codified anywhere) that it will no longer permit an SBIC to incur secured debt.

As a result, some lenders have begun to provide an unsecured line of credit for up to 364 days with aggregate availability limited to a percentage of the fund's remaining uncalled limited partner capital commitments, less negotiated reserves. Loan proceeds may generally be used for any SBA-permitted purpose, including to finance qualified investments and management fees. A guarantee from the management company (not the general partner—which the SBA would probably object to) is typically required. As with most capital call loans, the loans are viewed as a bridge facility until limited partner capital is called and/or leverage is drawn under the SBA's commitment to the SBIC. It is from these two sources that lenders expect to be repaid.

Note that in these facilities, the lender has no security interest in the assets of the borrower; no UCCs are filed and there is no lien on the unfunded commitments of the limited partners. In addition, it is customary that no financial covenants are required, although covenants restricting senior secured or unsecured debt are also customary. Note also that the SBA's unsecured claim as a debenture holder against an SBIC is subordinated to third-party lenders but only lenders that are not "associates" of the SBIC or its principals; and only if the SBIC's indebtedness does not exceed US$10 million or 200 percent of the SBIC's regulatory capital. Otherwise, the SBA's claims will be treated pari passu with the claims of other unsecured lenders.

Another possible variation in the evolving structure of these loans is a facility created during the SBIC license process but before actual grant of the license, when an SBIC applicant intends to make a so-called "pre-license" investment. Such investments are permitted by the SBA after a "go forth" or "green light" letter has been issued by the SBA and an applicant's license application has been "accepted for filing." Given its limited personnel, the SBA does not process applications unless it believes that the applicant has raised sufficient funds to indicate that the targeted capital raise and stated investment thesis will be achieved. The SBA generally does not inform an applicant what that minimum financing threshold is until after it has examined the application fully, but as a rule of thumb, the SBA seems to believe that the less money raised, the less likely the applicant will be to succeed. Recent SBA activity seems to indicate that a minimum of at least US$20 million to US$25 million (and sometimes more) in limited partner commitments is the current standard to be "accepted for filing," which is the pre-condition to permitting these pre-license investments.

In this pre-license structure, the lender would no longer have the benefit of two sources of repayment, as only partner capital would be available. Consequently, in these circumstances, the lender is likely to seek a traditional security interest in the applicant's partner capital commitments, which would be required to automatically terminate upon issuance of the SBIC license.

The SBA has permitted such pre-license secured loans because during the time of the security interest it has no money at risk and doing so furthers the main purpose of the SBIC program, which is to make capital available to the deserving small businesses which create jobs in the US.

The availability of the SBA's low-cost capital in an era of tight credit has incentivized many in the investment community to take a new look at an old program. A little creativity and flexibility by lenders and funds alike seem to be allowing access to this funding while complying with the SBA's complex rules and regulations.

How fund managers are affected by antitrust reporting requirements and interlocking officer and director rules

By Renée Eubanks and Stephen D. Libowsky

The Hart-Scott-Rodino Act (HSR) provides a federal regulatory scheme to notify the Federal Trade Commission (FTC) of large transactions involving the acquisition of voting securities and assets so a decision can be made to seek more information about the transaction or to seek to enjoin the transaction based on likely anticompetitive effects in the marketplace. Section 8 of the Clayton Act has interlocking director/officer rules that may affect fund managers who seek to appoint directors or officers to portfolio or other entities who compete with one another (except banks, banking associations and trust companies). This article summarizes some basic principles contained in this regulatory scheme.

When does an acquisition have to be reported under the HSR Act?

Effective February 24, 2014, all acquisitions involving the voting securities or assets of a United States entity need not notify the FTC or the Department of Justice (DOJ) (together known as the Antitrust Agencies) if the acquisition is valued at less than US$75.9 million, unless the transaction is deemed a continuation of a prior transaction of stock or assets of the entity or would give the acquirer certain levels of control of the entity. Therefore, if a fund sought to acquire a position of US$75.9 million or more of the voting securities or assets of another entity, or if a certain acquisition will result in the fund holding US$75.9 million or more, the acquisition must be reported to the Antitrust Agencies before the acquisition can be completed. Unless extended by agreement, once the acquisition is reported, the Antitrust Agencies have 30 days to review and decide whether or not to pursue immediate further investigation. If the Antitrust Agencies grant early termination of the 30-day waiting period, or if the 30-day waiting period expires without any action taken by the Antitrust Agencies, the acquisition may then be completed. The parties are notified if early termination is granted. The parties are not notified if the 30-day waiting period simply expires.

Early termination

In order to expedite the review process, both parties to the transaction may request "early termination" of the 30-day waiting period so that the transaction may proceed without further inquiry. Granting early termination is totally discretionary and cannot be counted on to occur. It should be noted, however, that when the Antitrust Agencies grant a request for early termination, the grant is published in the Federal Register, making the general public aware of the existence of some type of pending transaction between the parties, but not the specific nature of the deal. The HSR notification process is not a clearance process. The fact that the Antitrust Agencies allow the waiting period to expire does not preclude those agencies, state agencies or private parties from later challenging the transaction or filing any other type of antitrust action.

Further governmental inquiry

Granting early termination typically occurs within 10 business days after a filing is deemed complete, but the time frame for granting early termination depends upon the backlog of filings at the Antitrust Agencies and the complexity of the transaction and the issues involved. That complexity could result in further inquiry by the Antitrust Agencies (the agencies divide transactions needing further inquiry up by industries, with certain industries handled by the DOJ and others handled by the FTC), ranging from a mere telephone inquiry to a full blown investigation. Buyers and sellers generally agree to cooperate to take all necessary actions to obtain HSR approval, agree to inform each other of any oral or written communication with the Antitrust Agencies regarding the HSR filing and agree not to participate in any meeting or discussion absent advance notice to the other side when permitted by the Antitrust Agencies. The HSR Form requires submission of a signed purchase agreement or a term sheet with sufficient detail to describe the transaction. The parties typically do not share the information to be supplied on the HSR Form, other than the description of the transaction, the name of the ultimate parent entity and the North American Industry Classification System (NAICS) codes of each party.

The parties, at times, negotiate their respective obligations involving the cost of responding to governmental inquiries. The HSR filing fee, which ranges from US$45,000 to US$280,000 depending on the size of the transaction, is required to be paid by the buyer, although parties can divide that cost any way they desire by agreement. Both parties usually covenant that they will use commercially reasonable efforts to respond to any requests for additional information and to resolve objections, if any, that are or could be raised by the Antitrust Agencies with respect to the contemplated transaction. Since a request for additional information or directives by the Antitrust Agencies could take many forms and may cost a substantial amount of money to comply, the parties at times negotiate specific duties and obligations and at other times simply agree to decide how to respond when and if necessary.

The parties ultimately may need to decide duties and obligations related to (i) litigating or contesting in any manner any administrative **> Read more on page 10**

How fund managers are affected by antitrust reporting requirements and interlocking officer and director rules

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or judicial proceeding or any court order; (ii) paying any amounts (other than the payment of filing fees and expenses and fees of counsel); (iii) commencing or defending any litigation; (iv) agreeing to any limitation on the operation or conduct of the business acquired or as consolidated; (v) waiving any of the conditions of closing contained in the purchase agreement; or (vi) making any proposal, executing or carrying out any contract or submitting to any court order providing for (A) the sale, license, disposition or holding separate of any of the assets of the seller or any of the properties or assets of the buyer or any of its affiliates or (B) the imposition of any limitation or regulation on the ability of the buyer or any of its affiliates to conduct freely their respective business or exercise full rights of ownership of the seller. Each of these items is usually the subject of intense negotiation.

The Clayton Act

When a fund holds equity positions in more than one company within the same industry and seeks to participate in the management of those companies by appointing officers or directors, specific care must be taken to make sure that the appointments comply with interlocking director/officer rules specified in Section 8 of the Clayton Act. The act addresses whether an individual may serve simultaneously as a director or officer of two companies considered competitors. Specifically, Section 8 of the act states:

"(a) 1. no person shall, at the same time, serve as a director or officer in any two corporations (other than banks, banking associations, and trust companies) that are -- A. engaged in whole or in part in commerce; and B. by virtue of their business and location of operation, competitors, so that the elimination of competition by agreement between them would constitute a violation of any of the antitrust laws,... ." (Emphasis supplied.)

In order for Section 8 of the act to apply, both subsections A and B listed above must exist. Although there is a safe harbor with regard to amount of commerce needed to trigger subsection A (each competitor must have in the aggregate, capital, surplus and profit of not less than US$29,945,000, except that such companies will not be covered if competitive sales are less than US$2,994,500), most major businesses will be considered as engaging in commerce under the act. Therefore, the most relied-on safe harbor is in subsection B—that any agreement between two entities not to compete would not violate the antitrust laws.

The test to determine whether or not any agreement not to compete would violate the antitrust laws turns on whether the two entities with overlapping officers or directors compete for business with one another. Having overlapping officers or directors of a parent and a wholly owned subsidiary will not cause a violation since those entities are deemed a single entity for antitrust purposes. In situations where a parent company owns more than 50 percent, but less than 100 percent of the subsidiary, courts have reached different results on whether the parent and subsidiary are capable of conspiring to fix prices or allocate markets. Some courts look at a variety of factors (above and beyond parent's percent of ownership) in determining whether they are separate persons capable of entering into an antitrust conspiracy. Those courts look at a variety of factors above and beyond ownership to decide whether an agreement not to compete among those companies will violate the antitrust law. In addition to looking at recent court decisions for guidance, it is possible to obtain informal, non-binding advice from the FTC's Pre-Merger Notification Office, using a hypothetical example to describe the nature of the competition between the entities along with the ownership structure. Whether having officers or directors on companies that have no common ownership will violate Clayton Section 8 will be determined by a fact-specific determination of the markets in which each company participates. Accordingly, it is important for fund managers holding interests in companies operating within the same industry to determine whether those companies compete with one another before appointing officers or directors to work on behalf of the fund and participate in the management of those companies.

Conclusion

The HSR rules and Section 8 of the Clayton Act rules are complex. The failure to file an HSR notification with the Antitrust Agencies when applicable is a violation of federal law and subjects the acquiring party to fines of up to US$16,000 per day until the filing is deemed completed. The Antitrust Agencies may also institute civil proceedings for a failure to file and for violations of Section 8 of the Clayton Act. Whenever possible, legal counsel should be consulted in the early stages of a proposed transaction so that a full analysis of the transaction can be made in order to determine whether an HSR filing is required. Lastly, when a fund manager takes positions in multiple companies operating in the same industry, a thorough review should be done to determine whether the companies may be considered competitors so the fund can decide whether to appoint directors or officers to manage the companies.

Environmental liability - Regulatory compliance - Insurance coverage (or not)

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a fraud or where the shareholder's activity resulted in the liability, a shareholder could be held liable. While the rules of veil-piercing limit derivative liability for the actions of another entity, CERCLA's "operator" provision is primarily concerned with direct liability for one's own actions. As a result, an officer, employee or shareholder could potentially be liable if "they themselves actually participated in the wrongful conduct prohibited by the Act." *Riverside Mkt. Dev. Corp. v. International Bldg. Prods., Inc.*, 931 F.2d 327, 330 (5th Cir. 1991). Liability does not extend merely because management had authority to operate or make day-to-day decisions. Board control does not change this analysis. "Operator" liability extends only to those "persons" (including corporations and other entities) who "managed, directed or conducted operations specifically related to pollution, that is operations having to do with the leakage or disposal of hazardous waste, or decisions about compliance with environmental regulations." *United States v. Bestfoods*, 524 U.S. 51, 66-67 (1998).Partner,

Underfunded pension plans - private equity fund liability

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in which they invest, pre-acquisition restructuring and operation plans, the service agreements and fees, and the funds' involvement in management decisions and operations were all factors which satisfied the court's "investment plus" test for what constitutes a business or trade.

The Sun Funds purposely divided their investment in Scott Brass to fall below the 80 percent parent-subsidiary common control threshold under ERISA and related Treasury Department regulations to avoid incurring withdrawal liability. The First Circuit remanded the case back to the district court to determine whether the Sun Capital Funds satisfied the second prong of control group liability standard, the "ownership test." A trade or business is not liable under ERISA for the withdrawal liability of another entity unless the ownership test is satisfied. In general, a parent-subsidiary relationship will trigger controlled group status under the ownership test if one trade or business owns, directly or indirectly, 80 percent or more of the equity of the other trade or business. Thus, unless the district court determines that Sun Capital Fund III and Sun Capital Fund IV should be aggregated and treated as a single entity under some form of alter ego theory or through constructive ownership rules, it appears that the Sun Capital Funds may still avoid withdrawal liability through the use of a multiple funds investment strategy designed to keep any single fund from owning 80 percent or more of the equity of Scott Brass. However, the *Sun Capital* decision highlights that private equity funds cannot continue to rely solely on passive ownership of portfolio companies to avoid withdrawal liability. The inquiry into a fund's controlled group status calls for a fact-intensive inquiry in each case with respect to the degree of a private equity fund's control and involvement in the affairs of a portfolio company to minimize the risk of incurring control group liability as a trade or business.

The issues raised by the case are likely to be revisited in many other situations. According to a recent study of the US Government Accountability Office, multiemployer pension plans cover more than 10 million employees and retirees. As a result of investment declines, increased employer withdrawals from the plan and demographic changes, many multiemployer plans have had large funding shortfalls. Private equity investors may well become targets of the pension funds and others as they seek to make up the underfunding of pension plans.

Thanks to the following lawyers at Dentons who have contributed to this publication:

Randy Bregman
Partner, Public Policy and Regulation practice
D +1 202 408 9164
randy.bregman@dentons.com

Ata Dinlenc
Partner, Corporate practice
D +1 212 768 5314
ata.dinlenc@dentons.com

Jessica Duggan
Managing Associate, Energy / Environment and Natural Resources practices
D +1 415 882 0369
jessica.duggan@dentons.com

Renée Eubanks
Counsel, Capital Markets practice
D +1 212 768 6996
renee.eubanks@dentons.com

Peter Feldman
Managing Associate, Public Policy and Regulation practice
D +1 202 408 9226
peter.feldman@dentons.com

Stephen M. Fields
Partner, Corporate practice
D +1 212 768 6935
steve.fields@dentons.com

Kevin P. Kamraczewski
Partner, Litigation and Dispute Resolution practice
D +1 312 876 8922
kevin.kam@dentons.com

Stephen D. Libowsky
Partner, Litigation practice
D +1 312 876 2529
stephen.libowsky@dentons.com

Michael R. Maryn
Partner, Pensions, Benefits and Executive Compensation practice
D +1 202 408 6436
michael.maryn@dentons.com

Jane A. Meyer
Partner, Corporate practice
D +1 212 398 5279
jane.meyer@dentons.com

Michelle J. Shapiro
Partner, White Collar and Government Investigations practice
D +1 212 398 4877
michelle.shapiro@dentons.com

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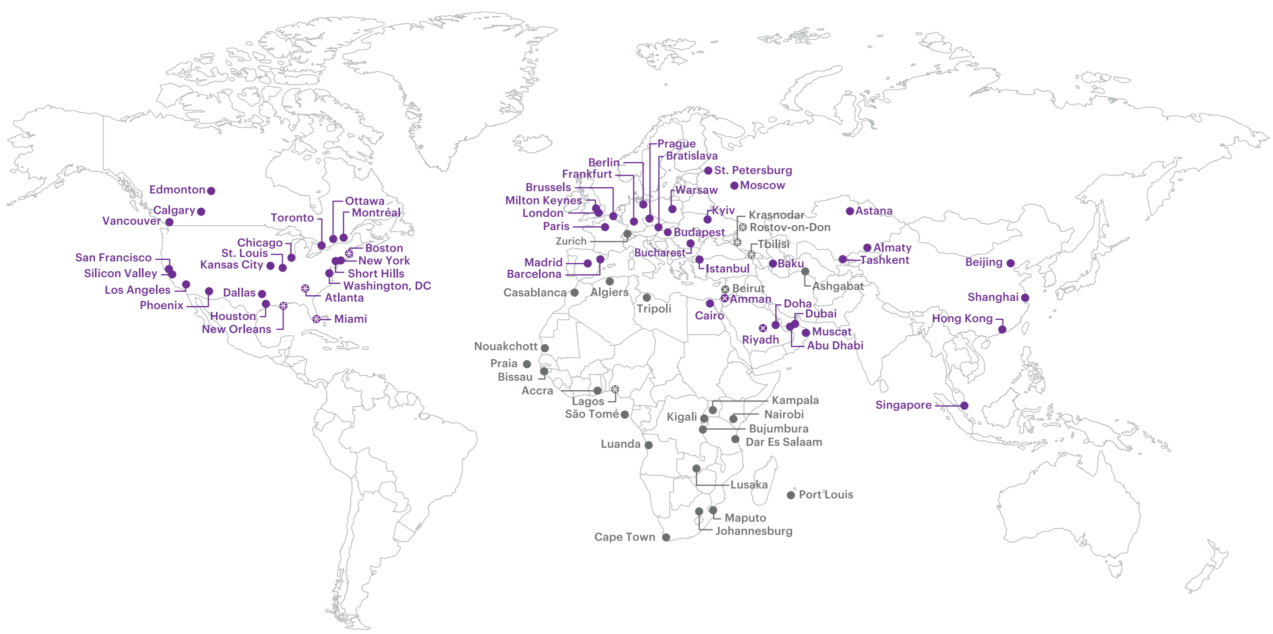

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