INSIDE THE MINDS™

UNDERSTANDING LEGAL TRENDS IN THE PRIVATE EQUITY AND VENTURE CAPITAL MARKET

LEADING LAWYERS ON USING THE LATEST TECHNOLOGY, COMPLYING WITH CHANGING REGULATIONS, AND HELPING CLIENTS ADJUST TO THE NEW ECONOMIC CLIMATE

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INSIDE THE MINDS

Understanding Legal Trends in the Private Equity and Venture Capital Market

Leading Lawyers on Using the Latest Technology, Complying With Changing Regulations, and Helping Clients Adjust to the New Economic Climate

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Private Equity's New Reality in Changing Times

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Introduction

Certainly, members of the private equity community appreciate that the times are changing. The business model that worked so well for private equity firms throughout most of the first decade of the twenty-first century seems as dated as Drexel Burnham's Predator's Ball.

Few observers would disagree that this tsunami of change has caused a rethinking of private equity's traditional business model, including changes responsive to both the new economic environment and a new regulatory regime. And changes continue to flow as financial institutions and other businesses adjust, resulting in winners and losers, with the winners being those firms best able to adjust to the new economic and regulatory realities.

The New Reality affects every aspect of private equity's business model, including the all-important secondary market, which includes liquidity events designed to return funds to private equity investors.

However, to understand the current and future direction of the private equity market, it is important to understand factors affecting the marketplace, some based on the state of the global economy and credit markets and others relating to the regulatory response to the recent financial crisis.

The most severe financial crisis to afflict the world economy since the Great Depression of the 1930s has predictably provoked a governmental response. Although the crisis is most notably associated with the subprime mortgage debacle, it is a crisis that has many parents. In the view of the US Congress and other world governments, among the notable sources for the crisis was a culture of excess fed by the endemic use of leverage without adequate capital to backstop risk, fostered by deregulation and regulatory indifference.

To address this broad-based crisis, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), Pub. L. No. 111-203, 124 Stat 1376, proposes a broad-based resolution. It touches virtually every aspect of the US federal financial regulatory scheme and includes provisions affecting commercial and investment banks, brokerage firms, insurance companies, private equity and hedge funds and other systemically important financial institutions, as well as consumer finance. Although not directly linked to the financial crisis, the Dodd-Frank Act also contains provisions intended to provide the Securities and Exchange Commission (SEC) with additional enforcement tools to address instances of financial fraud typified by the Bernie Madoff scandal.

In 2010, financing has begun to slowly return to transactions, fueling both acquisitions and exits. However, notwithstanding this improved environment, it seems unlikely that, at least for the rest of the decade, buyouts will challenge the pace that culminated in late 2006 and early 2007. This frenzy of buyouts included the agreement by Apollo Global Management (Apollo) and TPG Equity (TPG) to purchase Harrah's Entertainment for $17 billion and the agreement by Kohlberg Kravis & Roberts (KKR) and its partner, TPG, to acquire the Texas utility, TXU, for $45 billion. Notwithstanding KKR's recent exploration of a public offering, in today's environment, managers of private equity funds are unlikely to offer shares of their management firms to the public and receive valuations like those received by Fortress Investment Group and the Blackstone Group (Blackstone), which took their firms public in celebrated initial public offerings (IPOs) when private equity was at its apogee.

After flirting with a 2010 IPO, KKR pulled its proposed offering, citing unfavorable market conditions, notwithstanding that the S&P 500 was up almost 5 percent in the month prior to its decision. KKR's decision says more about the uncertain state of the market for private equity than what it says about the stock market.

In another indicator of the mixed market private equity is facing, on October 15, 2010, Harrah's Entertainment filed a registration statement with the SEC under the Securities Act of 1933, as amended (the Securities Act), to sell $575 million in shares in an IPO. This public offering of shares would be in addition to the sale of $710 million in shares (representing about 9.9 percent of the company) to the hedge fund, Paulson & Company, announced in June 2010 in exchange for Harrah's debt purchased by Paulson at a discount. It is notable that Harrah's private equity owners, Apollo and TPG, will not be selling shares in the IPO and that the primary purpose of the transactions will be to clean up Harrah's balance sheet and provide new capital for the company for growth projects, including completion of previously announced projects. See Amendment No. 1 to Form S-1 Registration Statement of Harrah's Entertainment Inc. (Securities Act registration no. 333-168789).

The Harrah's Entertainment situation is an exemplar of many of the businesses acquired by private equity firms at the top of the market when capital was abundant and cheap. Harrah, like other companies acquired for top dollar at the height of the market, has suffered from a balance sheet burdened by debt that cannot be serviced with the weakened cash flow resulting from the effects of an anemic economy.

As a result, many private equity firms in 2008 and 2009 were required to invest additional funds in their existing portfolio companies to shore up their balance sheets and service debt. Such investments detracted from returns and discouraged new acquisitions, adversely affecting raising capital for new funds. In 2010, an improving economy and credit market has permitted private equity to make some new investments and to exit from some older ones, as well as to raise new capital, but no one would confuse the deal and fund-raising environment of 2010 with that of 2006.

In fact, as private equity firms seek to raise capital for new funds, it is clear that investors have much more leverage than they have had in the past. Terms extended to investors have improved, based at least in part on the economy, but also by the impact of the Private Equity Principals issued in July 2009 by the Institutional Limited Partners Association (ILPA). However, even terms friendlier to LPs are not going to open the spigot of funding to the level seen prior to the financial crisis.

When traditional deal making slows and the economy falters, distressed investors often swoop in, with "vulture" funds preying on the nascent and sparsely capitalized businesses that might otherwise be nurtured by a growing economy. However, the current recession and recovery cycles have not seen the predicted increase in distressed deal making, at least not at the level anticipated.

When structuring distressed asset transactions, the concern is in the abbreviated time and other restrictions, including those related to the payment of "stay" bonuses, imposed under the Bankruptcy Code, as most recently amended. These concerns have dictated that reorganizations and sales are most often done in bankruptcy only when "prepackaged" by negotiations that precede a bankruptcy filing. If agreement cannot be reached with creditors prior to filing (or even if it can), purchase of a creditor's interest is often the most direct path to control of a company, and can provide a means to acquire control of the company and/or its assets at a substantial discount.

An ancillary consequence of the New Reality is a change in transaction structures, underwriting and due diligence, and terms and conditions. Among other things, transactions in the New Reality require more equity, more collateral for debt—including parent guarantees in many cases—and more time spent in verifying the viability of the business model and customer base, contingent liabilities, and negotiation of transaction terms. Welcome to the New Reality.

The New Regulatory Reality

An important factor affecting the secondary markets and private equity generally is the new regulatory regime brought on by the recent financial crisis. Although some commentators argue that private equity was a victim, not a perpetrator, of the financial crisis, the Dodd-Frank Act both directly and indirectly affects private equity. The rationale for this is that private equity is of increasing importance to and has significant impact on the global financial system, potentially having systemic financial significance. The New Regulatory Reality for private equity firms includes new registration requirements, increased scrutiny of operations, including that of the funds they manage, more disclosure to investors and regulators, and additional remedies and enforcement tools for regulators.

The attitude of private equity firms, banks and other affected financial firms to the New Regulatory Reality is mixed, partly because many of the details remain to be determined by rulemaking and the composition of Congress in 2011 and beyond. However, generally, the view of private equity firms is that compliance with the requirements of the Dodd-Frank Act should not be as burdensome as the regulatory changes affected by the Sarbanes-Oxley Act and, in any event, should not materially affect their ability to conduct business. To the extent required, many of the major players have already altered their business models, divesting themselves of certain lines of business and developing new compliance and reporting procedures, and modifying transaction structures.

New Registration and Recordkeeping Requirements

Advisers to private equity funds and hedge funds (collectively, private funds) are subject to substantial requirements under the Dodd-Frank Act. Among these requirements are new registration requirements for advisors to private funds that will force many advisors to register who are not currently required to do so. The Dodd-Frank Act subjects both registered advisors, as well as many advisors not required to register, to recordkeeping requirements concerning certain aspects of their businesses and those of the private funds that they advise. These records and the advisors are also subject to examination by the SEC. The details of the new registration and recordkeeping requirements for advisors for private funds will be set forth in regulations that will be proposed by the SEC sometime in the fourth quarter of 2010 and that are anticipated to be effective in the first quarter of 2011.

The Dodd-Frank Act is not the SEC's first attempt at registering private equity fund managers and forcing disclosure of certain information about private funds. In 2004, the SEC promulgated Investment Advisers Act Rule 203(b)(3)-2, which required certain investment advisors to provide information about the private funds that they manage. However, in *Goldstein v. SEC*, No. 04-1434 (D.C. Circ., June 23, 2006), the D.C. Court of Appeals held that the SEC had overreached its statutory authority and could not require the registration of investment advisors based solely on characteristics of funds managed by them, or the disclosure of information about the funds.

With the Dodd-Frank Act, the SEC has been provided with the statutory authority to require registration of private equity funds having more than $150 million of assets under management and to require disclosure of information about private funds managed by both registered advisors as well as, to a certain extent (subject to final rulemaking by the SEC), unregistered funds.

Prior to the Dodd-Frank Act, many advisors to private funds relied on the exemption for advisors that have fewer than fifteen clients who do not hold themselves out as advisors or advise investment companies registered under the Investment Company Act of 1940, 15 U.S.C. § 80a-1, as amended (Investment Company Act), provided by Section 203(b)(3) of the Investment Advisers Act of 1940, as amended (Advisers Act), as the basis for not registering under the Investment Advisers Act. Under the Dodd-Frank Act, such advisors will be required to register with the SEC, regardless of the number of clients that they advise, provided that they satisfy the $150 million threshold in assets under management (AUM) or $100 million in the case of advisors otherwise required to register under state law. (Pub. L. No. 111-203, Title IV, § 403).

Previously, an advisor generally could not register with the SEC unless it had $25 million of AUM, with advisorsmanaging less being required to register with the states. Dodd-Frank raises this threshold to $100 million (or such higher amount as the SEC may by rule determine) to allow the SEC to focus on larger advisors. The Act also added exemptions from registration for advisors to venture capital funds, family offices, small business investment companies, advisors that operate solely within one state, and foreign advisors (though this exemption has been limited and still subjects foreign advisors to registration and reporting in many cases).

The Dodd-Frank Act requires the SEC to subject advisors to private funds having less than $150 million in AUM to certain recordkeeping and reporting requirements. In particular, the Dodd-Frank Act requires an advisor to maintain records for each private fund it advises about the fund's:

- Amount of AUM
- Use of leverage, including off-balance sheet leverage
- Counterparty credit risk exposure
- Trading and investment positions
- Valuation policies and practices
- Types of assets held
- Side arrangements or side letters
- Trading practices

- Operations, providing such other information as the SEC may deem necessary

(Pub. L. No. 111-203, Title IV, § 408).

In addition, the Dodd-Frank Act requires the SEC to conduct periodic inspections of the records of private funds maintained by registered advisors and to conduct such other examinations as necessary or appropriate in the public interest or the assessment of systemic risk, as well as making available to the SEC upon request copies or extracts of such records to safeguard client assets over which they have custody by, among other things, requiring verification of client assets by independent public accountants. In this regard, it should be noted the SEC's recently promulgated "custody rule" (Rule 206(4)-2) under the Advisers Act may satisfy this requirement.

The Madoff Fallout

The Dodd-Frank Act also addresses concerns epitomized by the Madoff fraud scheme, which highlighted investor protection concerns associated with private funds and their advisers. In part, as described above, it does this by shifting the burden of regulatory oversight for smaller advisors to the states to allow the SEC to focus its resources on larger investment advisors (Pub. L. No. 111-203, Title IV, § 410). In addition, the Dodd-Frank Act increases the threshold for "accredited investor" status, a status that permits issuers to provide a lower level of disclosure when offering securities, and mandates an ongoing review of the criteria for this status. The purpose of this change is to limit investors in private funds to sophisticated investors able to understand and bear the risk of investment in private funds. (Pub. L. No. 111-203, Title IV, § 412).

In addition, the Dodd-Frank Act provides the SEC with new tools designed to detect and deter fraud. The Act (i) requires holders of equity-based swaps to report beneficial ownership, (ii) encourages reporting of fraud by providing whistleblowers with additional protection and cash payments, (iii) expands the authority of the SEC to bring aiding and abetting enforcement actions as well as actions pursuant to the anti-manipulation provisions of Section 9 of the Securities Exchange Act of 1934, as amended (Exchange