

Private Equity

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The Obama Bill: Implications for Private Funds and Unregistered Advisers



by **Kevin P. Scanlan**, **Roger Mulvihill**, and **Joseph J. Muscatiello**

Introduction

The Treasury Department released on July 15, 2009 the Obama Administration's proposed "Private Fund Investment Advisers Registration Act of 2009" (the "Obama Bill") to Congress, which removes the 15-client private adviser exemption under the Investment Advisers Act of 1940, as amended (the "Advisers Act"). The Obama Bill, if enacted, would

require advisers to most hedge funds, private equity funds, and venture capital funds to register with the SEC and to comply with the requirements of the Advisers Act. As a result, all unregistered advisers must now assess the impact that registering with the SEC will have on their business. This assessment should include a complete review of the adviser's policies and procedures to ensure they meet best practice standards and, if they do not, consider what changes can and should be made.

Who is Subject to the Advisers Act Under the Obama Bill?

The Obama Bill will presumably require any U.S. adviser to register with the SEC, although without the repeal of Rule 203A under the Advisers Act, it is possible that the Bill's application will be limited to advisers who have \$25 million or more in assets under management. A limited intrastate exemption will survive for advisers whose only clients reside in the same state as the adviser, but even that exemption will be unavailable for advisers to private funds. A "private fund" is defined as any fund that relies



on Section 3(c)(1) (sold to fewer than 100 investors) or Section 3(c)(7) (sold exclusively to “qualified purchasers”) for its exemption under the Investment Company Act of 1940, as amended (the “1940 Act”), and either (1) is organized under the laws of the United States, or (2) has 10% or more of its outstanding securities owned by U.S. persons. The Obama Bill does not require a “foreign private adviser” to register with the SEC.

Advisers Act Requirements

Adviser Registration

All advisers not prohibited or exempted from registration with the SEC must file and update their Form ADV annually and whenever certain information contained therein becomes inaccurate.

SEC Examinations and Record-Keeping Requirements

Rule 204-2 under the Advisers Act contains an extensive list of the records that registered advisers are required to keep. An adviser’s records are subject to discretionary examination by the SEC at any time.

Development of Compliance Program and Appointment of CCO

Rule 206(4)-7 under the Advisers Act requires each registered adviser to adopt and implement written policies and procedures reasonably designed to prevent violation of the Advisers Act (a “Compliance Program”), to assess its Compliance Program at least annually for sufficiency and successful implementation, and to designate a Chief Compliance Officer (“CCO”) responsible for oversight and management of the Compliance Program.

Personal Trading; Codes of Ethics

When the adviser, its access persons, and/or employees trade for their own accounts, conflicts of interest can arise, and the SEC has brought a number of enforcement actions against advisers and their employees in this area under the antifraud provisions of the Advisers Act. Under Rule 204A-1, registered investment advisers must adopt codes of ethics that address these issues and adhere to the specific content requirements of the Advisers Act.

Presentation of Past Performance

Any adviser presenting a past investment performance record must disclose all material facts necessary to avoid misleading clients or creating any unwarranted inferences. In no-action letters, the SEC staff has provided clarification and detail relating to performance advertising and enforces such guidance under the anti-fraud provisions of the Advisers Act. The Advisers Act imposes numerous

additional restrictions that are specific to the marketing activities of registered advisers. These restrictions and disclosure requirements could be particularly relevant to the fund-raising documentation of private fund advisers, particularly the disclosure in private placement memoranda and other marketing materials.

Requirements for Advisers With Custody of Clients’ Funds or Securities; Surprise Audits

Registered advisers that have “custody” of client assets must maintain those assets (other than certain privately offered securities) with a “qualified custodian” under Rule 206(4)-2 of the Advisers Act (the “Custody Rule”). Under the existing Custody Rule, an adviser must generally have reasonable belief that the qualified custodian sends a quarterly account statement to each client for whom the custodian has custody of funds or securities, or ensure that each private fund that it advises is audited annually and provide investors with audited financial statements within 120 days of each private fund’s fiscal year-end, in order to avoid being subject to an annual surprise audit by an independent public accountant. On May 20, 2009, the SEC issued proposed amendments to the Custody Rule that would significantly increase regulation of advisers’ custody arrangements, particularly self-custody and custody of client assets with an affiliate, by effectively subjecting any adviser with “custody” (defined broadly under the Custody Rule to even include authority to deduct advisory fees from client accounts) to an annual surprise audit, regardless of whether a qualified custodian sends reports to the client or the adviser provides audited financial statements in respect of the private funds it advises.

Requirements for Advisers’ Contracts With Clients

Contracts with a registered investment adviser’s clients must contain some specific terms that are set forth in Section 205 of the Advisers Act. The contract language must convey that advisory services provided to clients may not be assigned to any other person without obtaining prior client consent. Advisory contracts generally cannot include provisions that permit compensation to be based on the performance of a limited partner’s account, unless the performance fee is structured in a way that exposes the adviser to some downside risk, such as a performance fee imposed as a percentage of assets under management, or a “fulcrum fee” that is averaged and fluctuates over a specified period of time. Additionally, the performance fee prohibition generally does not apply to an advisory contract with a private fund relying on the Section 3(c)(7) exemption of the 1940 Act by permitting only beneficial owners who are “qualified purchasers” (for non-U.S. funds, this requirement only applies to U.S.

investors); a private fund relying on the 3(c)(1) exemption under the 1940 Act, but only for those limited partners that are “qualified clients” as defined under the Advisers Act; or advisory contracts with non-U.S. residents. The Obama Bill does not specifically address the applicability of the Bill to various categories of compensated and uncompensated advisers, such as consultants or special advisory boards or panels, who assist in deal flow and/or help to analyze prospective investments.

Requirements for Advisers That Pay Others to Solicit New Clients

Rule 206(4)-3 under the Advisers Act provides that no adviser required to register under the Act may pay a fee to a solicitor who has obtained clients for the adviser unless certain conditions are met. In general, a solicitor must provide any potential client with copies of both: (1) the adviser’s current brochure; and (2) a disclosure statement describing the terms of the solicitation agreement between the adviser and the solicitor (including information as to fees paid and compensation received by the solicitor or the adviser). Recently, the SEC staff has provided no-action guidance that Rule 206(4)-3, by itself, generally does not apply where a solicitor is being paid “solely” to compensate such person for bringing investors into a private fund managed by the adviser. Under such circumstances, a private fund’s adviser is not required to obtain the written acknowledgement as Rule 206(4)-3 prescribes. Nonetheless, advisers should, in those circumstances, consider their general anti-fraud obligations and provide appropriate disclosure to investors regarding the solicitor arrangement.

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PIPEs in Hong Kong



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The Hong Kong stock market, represented by the Hang Seng Index, has risen nearly 40%

since the start of 2009. By comparison, the DJIA has in the same period risen by approximately 8%. Amidst a recovering but still uncertain economic environment in Europe and the United States, coupled with a gradual return of available liquidity, private equity funds have become increasingly interested in China.

Private investments in public equity, or PIPEs, are investments into publicly traded equity securities (including ordinary shares, preferred shares, or convertible securities) by private equity investors. This article explains how PIPEs work in Hong Kong, and the Hong Kong laws and regulations that govern them.

PIPEs Regulation in Hong Kong

In Hong Kong, PIPE transactions must comply with the regulations in Hong Kong relating to the public markets. The relevant Hong Kong laws and regulations governing PIPEs are largely contained in the Securities and Futures Ordinance and its subsidiary legislation (the “SFO”), the Rules Governing the Listing of Securities on the Hong Kong Stock Exchange (the “Listing Rules”), and the Hong Kong Code on Takeovers and Mergers and Share Repurchases (the “Takeovers Code”).

Types of PIPEs

The table on page 4 (**Types of PIPEs**) provides a useful summary of the main characteristics of different types of PIPE transactions that are common in Hong Kong. These include investments in a company before (but close to) its IPO, and during its IPO as a private placement.

Disclosure Obligations and Connected Party Thresholds

An investor in a Hong Kong PIPE transaction is required to disclose its interest in the issuer if its equity holding is 5% or more after the investment. Holdings of shares, or other instruments convertible or exchangeable into shares, are counted for purposes of determining if the 5% threshold has been crossed.

| Types of PIPEs | | |
|--|--|--|
| TRANSACTIONS | ADVANTAGES | DISADVANTAGES |
| <p>Post-IPO – there are three typical methods for a listed company to raise funds through a PIPE investment:</p> <ol style="list-style-type: none"> (1) Private placement – the company issues new shares to investors or to brokers who then place the shares with their clients or to third party investors; (2) Public placing – the company places new shares with an exchange participant who then places or sells the shares to its clients and to the general public; (3) Top-up placing – major shareholder(s) of the listed company place their existing shares with independent third parties and then subscribe for additional new shares. | <p>If the placement constitutes a private placing of shares of a class already listed, a listing document, i.e., prospectus, will not be required.</p> | <ol style="list-style-type: none"> (1) If the placement constitutes a private placing of shares of a class already listed, the listed company is required to publish an announcement containing details of the placement, e.g., the reasons for the placement and the use of the proceeds. (2) If the placement constitutes a private placing of shares of a class already listed, the company will be required to issue and register a prospectus in respect of such placement. |
| <p>Investing before the IPO</p> | <ol style="list-style-type: none"> (1) The investor may be able to invest at a lower price than at the IPO. Investors should take note, however, that the Hong Kong Stock Exchange (“HKSE”) has taken the stance in a number of published listing decisions that the details of the pre-IPO placing will need to be fully disclosed in the IPO prospectus and that in general, a meaningful discount to the IPO price will not be allowed if the shares are issued close to the date of the IPO. (2) The investor is assured an allocation of shares in the company. | <ol style="list-style-type: none"> (1) If the listing is not approved, the investor will be left holding the illiquid shares of a private company. (2) An investment in the form of a convertible security that is converted after listing poses special challenges. A conversion price that implies a discount to the IPO price, or special rights associated with the security that are not available to common shareholders, could be considered unacceptable by the HKSE, which in this situation could force a cancellation or revision of the terms of the convertible security. (3) The Listing Rules require any shareholder holding 30% or more of the voting shares to be subject to a compulsory “lock-up” of six months from the listing date. In addition, the HKSE takes the view that the greater the amount of any discount to the IPO offer price, and/or the greater the proximity in time of the placing to the date of the listing application, the more likely it is that the HKSE will require the shares to be locked-up, regardless of the size of the holding. (4) The identity of the investor and the amount of its investment must be disclosed in the company's listing prospectus. |
| <p>Investing during the IPO in a private placement</p> | <p>If the investment is committed to after the prospectus is issued, and is made on the IPO terms and after the issue of a prospectus, the investment is not required to be disclosed in the prospectus and the investor will not be subject to the compulsory lock-up.</p> | <ol style="list-style-type: none"> (1) An investor will have to pay the full IPO offer price for the shares—there is no discount and therefore no built-in upside. (2) If the IPO is oversubscribed and the shares offered are subject to reallocation, the investor's allocation may be reduced by up to 50%. (3) If the investor is a strategic investor, the listed applicant and the underwriter may request the investor to be subject to a voluntary lock-up of its shares. The investor will be restricted from selling or disposing of any of its shares without the prior written consent of the issuer and the global coordinator for a period of between six and eighteen months from the listing date. |



Furthermore, the Listing Rules impose an array of restrictions on most dealings between a listed issuer and any of its “connected persons” (i.e., a related party). Investors often structure their investments in Hong Kong-listed issuers in order to avoid being treated as connected persons of the issuer.

For example, an investor that holds 10% or more of the voting shares of a listed issuer is a substantial shareholder and therefore a connected person of the issuer. Unlike with the disclosure rules, however, only holdings of voting shares are counted, but not holdings of convertible securities or options. If, for example, the investor holds a bond that is convertible into 10% of a listed issuer’s shares, then it is not treated as a substantial shareholder (and hence a connected person), unless of course it converts the bond into shares.

Takeover Obligations

If an investor acquires 30% or more of the voting shares of a listed company, or holds not less than 30% but not more than 50% of the voting shares of a listed company and acquires more than 2% of the voting shares of the company within any rolling 12-month period, it will be required to make a takeover offer for all the remaining shares of the company. The Takeovers Code prescribes the offer procedure, offer terms, and timetable for the offer.

The Hong Kong Securities and Futures Commission (“SFC”) administers the Takeovers Code. The SFC will aggregate the shareholdings of persons “acting in concert” to determine if the mandatory takeover thresholds have been crossed.

Two or more persons are acting in concert if they act together to obtain or consolidate control over 30% or

more of a company through the acquisition by any of them of voting rights in the company. The Takeovers Code lists nine specific relationships in which a concert party relationship is deemed to exist, but also states that these categories are non-exhaustive—i.e., the SFC retains the right to make a determination of a concert party relationship.

A waiver from the obligation to make a takeover offer (known as a “whitewash” waiver), subject to the consent of the SFC, may be available where the mandatory takeover obligation arises as a result of a subscription of new shares for cash, among other things. This could theoretically apply where a PIPE investor subscribes for more than 30% of a listed issuer’s new shares in cash.

The SFC will usually grant a whitewash waiver if (a) the proposal is approved by a vote of independent shareholders who are disinterested in the transaction; (b) the person to whom the new shares are to be issued, or any person acting in concert with it, has not acquired voting rights in the company, and the company has not repurchased its shares in the six months prior to the announcement of the proposal, but subsequent to negotiations, discussions, or the reaching of understandings or agreements with the directors of the company (which would include informal discussions) in relation to the proposed issue of new shares; and (c) no voting rights have been acquired in the period between the announcement of the proposed transaction and the shareholders meeting. Full details of the potential holding of voting rights must be disclosed in the document sent to shareholders requesting approval of the waiver, together with the competent independent advice of a financial adviser on the transaction that the shareholders are being asked to approve.

A PIPE transaction structured as a purchase of convertible securities (equal to 30% or more of voting shares), however, is unlikely to result in an obligation to make a mandatory offer. This immunity from the mandatory offer obligation will not extend to the time when the investor exercises the conversion. Such conversion may also likely trigger the offer obligation, subject to any discretion of the SFC to exercise a “whitewash” waiver.

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Developing Opportunities for Private Equity in the Healthcare Sector



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Private equity investment strategies involving the healthcare industry, a sector subject to

extensive federal and state regulation, are expected to be significantly influenced by President Obama's still-evolving plans for healthcare reform. The recently enacted American Recovery and Reinvestment Act of 2009 is already impacting how private equity firms focus on the healthcare industry, with renewed attention to areas covered by increased stimulus funding. This includes certain sectors that, until recently, have been out of favor with private equity investors, such as healthcare information technology systems (HIT), non-urban markets, personalized medicine, and wellness initiatives.

The private equity industry will need to be both agile and aggressive in its efforts to capture the opportunities that healthcare reform and stimulus spending provide. From some of the more salient features of the Obama administration's initiatives, investment opportunities likely involve, among other businesses, healthcare providers that are impacted by the proposed expansion of health insurance coverage for all Americans, diagnostic and screening companies that can further the proposed legislation's objectives of personalized medicine to guide the treatment and lower the associated costs for complex diseases like cancer, and businesses that promote wellness products and services that can serve to stave off health problems like diabetes and heart disease that otherwise generate some of the highest costs for both the federally funded and administered health insurance programs, Medicare and Medicaid, as well as their private health insurer counterparts.

In addition, proposals to modify reimbursement levels for healthcare drugs and/or services may shift the revenues associated with the mix of payers for certain public healthcare companies, as some payers, like private insurers, tend to pay at higher levels than do others, like Medicare. Payment reimbursement trends, such as an anticipated reduction in Medicare reimbursement for a certain service a public healthcare company provides, might adversely impact revenue forecasts for such companies, making them more likely candidates for going private or other private equity-type transactions.



Finally, the Obama administration's proposals would cut, for example, some of the payments made to private companies for popular programs like Medicare Advantage—the private insurance option that close to one-quarter of senior Americans have chosen for their coverage under Medicare. Companies that rely heavily on revenue from Medicare Advantage, and so are likely to be impacted, may become targets for private equity buyers.

Despite the upheaval that legislative changes are causing, the prospects for private equity investors in the healthcare sector are attractive due to the basic fact that there is an aging population in need of ongoing healthcare services and support, and there is a general perception that the healthcare industry has longer-term growth prospects than many other industry sectors.

With reference to the unique legal and regulatory issues that the healthcare sector faces, particularly in light of some of the recent legislative acts and proposals, below are examples of healthcare investment opportunities where private equity investors are likely to be able to optimize returns.

Healthcare Information Technology

Until very recently, the HIT sector has not garnered much interest from private equity investors for many years. Healthcare investors have mainly focused on drugs, medical devices, and the provision of general healthcare services, where intellectual property or industry know-how created barriers to entry for competitors. Information technology investors, on the other hand, are often unable to understand the dynamics and complexity of healthcare businesses.

The Obama administration's focus on HIT advances, evidenced by \$19 billion in stimulus funding that includes incentive payments to healthcare providers that implement eligible electronic medical records systems, is likely to enhance interest in companies that provide e-prescribing and HIT systems that can decrease administrative costs, reduce medical errors, and improve health outcomes by applying innovative technological solutions. For instance, private equity firm Insight Venture Partners' recent investment in, followed by the very successful initial public offering for, its healthcare electronic data portfolio company Medidata Solutions is one example of renewed interest in this sector, particularly in this year of a very limited number of IPOs. Medidata employs a proprietary electronic data capture software solution that streamlines the management of clinical trials for large pharmaceutical and small biotechnology companies.

Also consider Wal-Mart's recent decision to enter the world of medical record digitization, announced even before the Obama administration's stimulus package was enacted, where Wal-Mart is seeking to bring the technology to the small physician offices across the country where most Americans receive their healthcare services. Wal-Mart—in conjunction with its Sam's Club division, Dell, and a private company called eClinicalWorks—is working to collectively offer a package of hardware, software, installation, and training to doctor's offices. Wal-Mart believes that this is a large market and that it has the ability to make the technology more accessible and affordable than most other HIT suppliers. Under the stimulus plan, subsidies are granted to those healthcare providers that elect to employ modernized HIT systems, and both stimulus money and legislative efforts offer financial incentives to those that adopt such systems, while imposing penalties on those that do not. Private equity investors are sure to focus on investment opportunities that are perceived as best being able to take advantage of stimulus funds and incentive programs.

Non-Urban Markets

Many of the grassroots hospitals in the U.S. are the sole healthcare providers in their rural communities. In addition, rural areas of America often have a higher population of lower-income residents who qualify for Medicaid. Current legislative proposals seek to expand access to healthcare insurance choices for individuals and could mandate insurance coverage of pre-existing conditions. Moreover, if healthcare reform results in a large increase in Medicaid coverage, as pending legislative efforts suggest, these factors will combine to greatly expand the number of Americans able to obtain health insurance coverage, and rural hospitals stand to significantly benefit

from the higher volumes of patients. The addition of more covered individuals and additional insurance choices will also provide an opportunity for rural hospitals to negotiate and get better terms for their privately insured patients. The revenue growth this may permit could make such hospitals attractive candidates for private equity investors.

Two examples of private equity firms placing big bets on this trend are Warburg Pincus' recent financing of RegionalCare Hospital Partners, and the acquisition of several rural hospitals in the Southwest by GS Capital Partners, the private equity arm of Goldman, Sachs & Co.

Personalized Medicine

President Obama has long argued that personalized medicine must be at the heart of healthcare reform. It is important to note that his administration's proposals would prohibit federal health programs from using data developed during comparative effectiveness research as a reason to deny coverage for treatments and services. Even as a Senator, President Obama sponsored a bill in 2007 (that never came to a vote) called the Genomics and Personalized Medicine Act of 2007 that was supportive of the use of genetic medicine and genetic testing to advance patient care and other national health goals. Companies focused on molecular diagnostics, such as the analysis of DNA, RNA, and the human proteome, are certain to be areas for private equity investors to look. For example, XDx Inc. is a molecular diagnostics company focused on the discovery, development, and commercialization of noninvasive gene expression-based tests. XDx announced recently that it had received Food and Drug Administration approval for one such test and has recently raised funds from private equity and strategic investors such as Kleiner Perkins Caulfield & Byers, New Leaf Venture Partners, and Bristol-Myers Squibb.

Wellness

Legislative proposals now pending are seeking to refocus efforts on the routine care of chronic and sub-chronic conditions, rather than the historic focus on critical, life-saving treatment of acute conditions through innovative drugs, complex medical devices, and highly technical surgical procedures. As a result, investment dollars for private equity firms will track this new reform agenda of controlling healthcare costs by promoting the most efficient, cost-effective, and often earlier-stage treatments.

Diabetes

Afflicting an increasingly large portion of the population, diabetes is at epidemic levels in America. Private equity-backed companies like t+ Medical are focusing on

technologies that will permit a diabetic to use his or her cell phone or personal digital assistant to send blood-sugar readings or blood pressure data directly to their healthcare provider's office so that data can be quickly reviewed and recorded, permitting physicians and care givers to see a problem developing early on and intervene earlier to prevent serious illness.

Behavioral Health

The cost of treating mental disorders rose sharply in the last decade, from \$35 billion in 1996 to almost \$60 billion in 2006. A government report, published in early August 2009 in the "Archives of General Psychiatry," found that antidepressant use in the U.S. doubled between a similar time frame, 1996 and 2005. Spending on mental illness showed a faster rate of growth over this period than costs for heart disease, cancer, trauma-linked disorders, and asthma. Recent legislation mandating parity for reimbursement levels for the provision of behavioral health services versus general medical services has also encouraged patients to seek help for behavioral health conditions. Private equity firms like Crestview Partners have already focused on this sector's trend, having recently purchased ValueOptions, a company that designs and operates behavioral healthcare services, including mental health, substance abuse, workplace services, and employee assistance programs.

Reimbursement Trends

The Obama administration's proposals will seek to continue a trend started under the prior administration of cutting Medicare and Medicaid reimbursement levels for certain healthcare treatments. This, in turn, will provide opportunities for certain sophisticated private equity investors. For example, at the end of last year, the private equity firm Blackstone completed its going private acquisition of respiratory and infusion therapy company Apria Healthcare. With reimbursement levels for its products already under stress, it was difficult for a public company like Apria to keep up with Wall Street's never-ending need to provide accurate revenue guidance. A going private transaction was a solution that made sense for a company like Apria, which has a large and stable customer base, but faces an uncertain future with respect to reimbursement policies applicable to its products.

In early August 2009, a running battle relating to the reimbursement levels Medicare would pay for hospice care was settled, but long term, the Obama administration is still seeking to cut costs in this sector. Public company hospice providers like Odyssey HealthCare, as a result, may become targets for private equity firms to consider a going private transaction.

Medicare Advantage

Healthcare programs that expanded under the prior administration—such as Medicare Advantage, which on average pays private insurance companies and disease management companies approximately 14% more to service Medicare recipients than Medicare fee-for-service beneficiaries—are facing scrutiny under current Obama administration proposals that seek to reduce over all Medicare expenditures. President Obama and many within congress view Medicare Advantage as a wasteful program averaging approximately \$17 billion a year for companies like Humana Inc., which critics contend provide limited benefits beyond regular Medicare. But companies like Humana and their supporters among senior Americans argue that Medicare Advantage permits the private sector to more efficiently manage the Medicare-eligible population, and that the level of care seniors actually receive via Medicare Advantage programs leads to better treatments and disease management that over time reduces overall Medicare costs. Unfortunately, no Medicare Advantage program has been in operation for long enough for such claims to be verified. Given legislative activity and scrutiny on Medicare Advantage, however, private equity firms will likely focus on this sector, as evidenced by MatlinPatterson's recent investment in XLHealth Corporation, a Medicare Advantage company that provides care for chronically ill Medicare beneficiaries who suffer from, among other ailments, diabetes and pulmonary disease.

Conclusion

The Obama administration's legislative proposals for healthcare reform, combined with recent government stimulus plan funding, have refocused private equity interest on healthcare investment opportunities. Although it is still too early to know precisely which sectors of the healthcare industry will be most impacted by recent legislative initiatives, it is clear that private equity investors who are willing to consider some of the complex legal and regulatory issues, and design investment strategies around general trends that legislative proposals appear to be highlighting, stand to benefit financially.

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More Loans Maturing, Fewer Options Available



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The turmoil in the credit markets has given borrowers with maturing debt a tremendous obstacle that they did not account for when they initially incurred such debt—there is little appetite to refinance such debt in the current tight credit markets. Certain borrowers with investment grade credit ratings have overcome this obstacle by looking to the bond markets to refinance existing debt. Certain other borrowers have been able to rely on the equity markets to payoff all or a significant portion of existing debt. However, these options are not available to many borrowers with expiring debt. As a result, an option that is becoming increasingly popular is called “amend and extend” (so far this year, it has been estimated that more than \$25 billion of debt has been amended and extended). Pursuant to this option, existing debt remains in place while the lenders permit a maturity extension. Many lenders see the amend and extend route as a means to avoid the need to write-down a loan by saving a borrower that may be faced with a choice

between defaulting and/or being forced into bankruptcy (it also buys time for troubled companies by giving them time to de-leverage by improving their earnings, cutting costs, or riding out the current economic downturn). In addition, since many lenders need to be given an incentive to amend and extend, most amend and extend facilities reward lenders with better credit terms, which may be in the form of reduced commitments, security, additional guarantors, fees, increased interest rates, a large pay down, and/or more restrictive covenants. Set forth below are some issues that you may encounter in an amend and extend as well as some recent market trends.

Duration

The initial focus of an amend and extend facility is the extension of the maturity date. One of the primary issues associated with extending the maturity date is the vote required under the credit agreement to approve an amendment extending the maturity date. In some cases, the vote of all of the lenders is required to extend the maturity date. In other cases, the consent of each lender affected by such extension is required (i.e., only lenders consenting will have an extended maturity date and the maturity date of the other lenders will remain the same). In the latter case, the amend and extend facility will essentially wind up with two classes of loans—the loans of the extending lenders and the loans of non-extending lenders (and a host of issues as a result of having loans with two different maturity dates). The duration of the extension period of the extending lenders varies on a case-by-case basis. See the chart below for some recent examples.

| BORROWER | EXTENSION PERIOD OF EXTENDING LENDERS |
|-----------------------------------|--|
| The AES Corporation | The maturity date of extending lenders was extended 13 months, from June 23, 2010 to July 5, 2011. |
| Blockbuster Inc. | The maturity date of extending lenders was extended 13 months, from August 20, 2009 to September 30, 2010. |
| CapitalSource Inc. | The maturity date of extending lenders was extended two years, from March 13, 2010 to March 31, 2012. |
| Cedar Fair, L.P. | The maturity date of extending lenders was extended two years, from August 30, 2012 to August 30, 2014. |
| Eastman Kodak Company | The maturity date of extending lenders was extended 17 months, from October 18, 2010 to March 30, 2012. |
| Nebraska Book Company, Inc. | The maturity date of extending lenders was extended 14 months, from March 4, 2009 to May 31, 2010. |
| Sears Holdings Corporation | The maturity date of extending lenders and extended tranche was extended 27 months, from March 24, 2010 to June 22, 2012. |
| Spirit AeroSystems Holdings, Inc. | The maturity date of the extending lenders and extended tranche was extended two years, from June 30, 2010 to June 30, 2012. |
| Toys “R” Us, Inc. | The maturity date of the extending lenders and extended tranche was extended 22 months, from July 21, 2010 to May 21, 2012. |
| West Corporation | The maturity date of the extending lenders was extended 33 months, from October 24, 2013 to July 15, 2016. |

Reduced Commitments

As previously noted, commitment reductions have served as an incentive for lenders to agree to extend their maturity date. The chart below shows amend and extends that involved a commitment reduction in the past year.

When commitments of the extending lenders are reduced in connection with an amend and extend, and the commitments of the non-extending are not reduced, the voting power of the extending lenders (which is based on the commitments of the lenders) will be reduced relative to the voting power of the non-extending lenders. This can be problematic for the borrower as well as the extending lenders. If the non-extending lenders have voting control as a result of the commitment reduction, disgruntled non-extending lenders may be less willing to enter into amendments that a borrower may need to avoid triggering a default (and which the extending lenders would have otherwise consented to if they were in control). There is not much a borrower can do to avoid this precarious dynamic other than to make sure that enough lenders consent to the amend and extend to ensure that the extending lenders maintain voting control. In addition, if the non-extending lenders have voting control they can, with the Company's consent, amend the credit agreement by stripping out covenants (thereby leaving the extending lenders with a credit facility with limited rights). To safeguard against this, the amend and extend facility should provide that the approval of any action under the amend and extend facility requires the vote of the extending lenders as a separate class (or the approval threshold set forth in the definition of the term "Required Lenders" should be raised in a manner that guarantees that the extending lenders will always have a say).

Letters of Credit

It is common for lenders to issue letters of credit to third parties for borrowers under a revolving credit facility. However, under an amend and extend facility, issues will

arise when a letter of credit issued prior to the maturity date of the non-extending lenders (where all lenders, extending and non-extending, are responsible for their pro rata portion of such letter of credit) matures after their maturity date. Extending lenders will not want to incur the risk of assuming the non-extending lenders' obligations with respect to such letters without being protected. One way to deal with this is to simply provide under the amend and extend facility that no letters of credit can be issued prior to the non-extending lenders' maturity date if they would expire after the maturity date of the non-extending lenders. Most borrowers will not want to agree to this and will want to ensure a seamless transition between the original credit facility and the amend and extend facility where they can continue to have letter of credit capacity. One way to deal with allowing letters of credit to extend beyond the initial maturity date is, subject to certain conditions (e.g., no event of default, no lender being responsible for more than its committed amount), having the borrower cash collateralize the non-extending lenders' portion of such letters of credit. In deciding how to deal with any outstanding letters of credit, both borrower and extending lenders need to assess risk and understand the borrower's business need for such letters of credit and available liquidity outside the credit facility in question.

Treatment of LIBOR Loans

Generally speaking, borrowers will want their loan to bear interest at a rate based off of LIBOR. However, since the loans of extending lenders will continue past the maturity date of the loans of the non-extending lenders, issues will arise when the interest period of any LIBOR loan issued prior to the maturity date of the non-extending lenders expires after the maturity date of the non-extending lenders. In dealing with this issue, some amend and extend facilities simply do not permit borrowings in LIBOR prior to the maturity date of the non-extending lenders if the interest period of such LIBOR loan ends after the maturity date of the non-extending lenders. Another way to handle this

| BORROWER | AMOUNT OF COMMITMENT REDUCTION |
|-----------------------------|---|
| Eastman Kodak Company | Downsized from \$2.7 billion to \$500 million |
| Nebraska Book Company, Inc. | Downsized from \$85 million to \$65 million |
| Blockbuster Inc. | Downsized from \$450 million to \$250 million |
| CapitalSource Inc. | \$300 million* |

**The extending lenders under CapitalSource Inc.'s facility received a \$300 million cash payment and received a commitment reduction in the same amount (and the non-extending lenders did not receive any payments or a commitment reduction). This was a unique strategy (i.e., paying down, and reducing the commitments of, only extending lenders) and would not be available under most credit agreements as a result of the pro rata payment provision, which generally requires that all payments and commitment reductions be made pro rata to all lenders.*

situation is to allow borrowings in LIBOR loans with interest periods extending beyond the non-extending lenders' maturity date but have all such borrowings terminate on the non-extending lenders' maturity date and be subject to breakage fees or other make-whole payments.

Covenants

While drafting the documentation for an amend and extend facility, both lenders and borrowers will need to review the covenants to determine what continues to work for the business in the context of the current economic environment and the degree of risk and flexibility the lenders will accept. For example, if present in the underlying credit agreement, coverage ratio tests or other financial covenants or tests may need to be omitted or modified to deal with the borrower's current financial position.

Economic Incentives for Lenders

In many cases, the amend and extend gives lenders the ability to take a fresh look at pricing under the facility (many facilities entered into years ago were subject to historic low pricing) and to increase pricing to take into account current market conditions (but still take into account debt capacity). The chart below shows the pricing increases in certain recent amend and extend transactions.

Conclusions

The amend and extend approach is a viable option for many borrowers in the current market. The keys for the borrower are to: (i) effectively entice sufficient lenders to join the amendment, whether it be with offers of prepayment, interest rate increases, or other incentives; (ii) reach a realistic agreement on a revised maturity date that works with the borrower's business; and (iii) use the amendment as an opportunity to restructure the credit agreement covenants and other restrictions to better meet the borrower's current and anticipated business model as well as market conditions.

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| BORROWER | PRICING INCREASE |
|-----------------------------------|--|
| The AES Corporation | Interest rate increase from LIBOR plus 1.5% to LIBOR plus 3.5%. In addition, the AES Corporation paid extending lenders a fee of 1.25% on their committed amounts. |
| Blockbuster Inc. | Interest rate increase from LIBOR plus 3.5% to LIBOR plus 10% (with a LIBOR floor of 3.5%). In addition, Blockbuster Inc. paid extending lenders an 8% fee on their committed amounts. |
| Cedar Fair, L.P. | Interest rate increase from LIBOR plus 2.00% to LIBOR plus 4.00%. In addition, Cedar Fair, L.P. paid a 0.05% fee to extending lenders on their aggregate committed amounts. |
| Eastman Kodak Company | Interest rate increase from LIBOR plus 2.00% to LIBOR plus 4.00%. In addition, Eastman Kodak paid extending lenders an unspecified fee. |
| Nebraska Book Company, Inc. | Interest rate increase from LIBOR plus 2.75% to LIBOR plus 6%. In addition, Nebraska Book Company, Inc. paid extending lenders a 1% extension fee and a 1% amendment fee on their committed amounts. |
| Sears Holdings Corporation | Interest rate increase on the extended tranche from LIBOR plus 0.875% to LIBOR plus 4.00% (with a LIBOR floor of 1.75%). |
| Spirit AeroSystems Holdings, Inc. | Interest rate increase on the extended tranche from LIBOR plus a margin of between 2.25% and 3.00% to LIBOR plus a margin of between 3.00% and 4.00%. In addition, Spirit Aerosystems Holdings, Inc. paid extending lenders a fee of 0.25% on their committed amounts. |
| Toys "R" Us, Inc. | Interest rate increase on the extended tranche from LIBOR plus a margin of between 1.00% and 2.00% depending on availability to LIBOR plus a margin of 3.75%, 4.00% or 4.25% depending on availability (with a LIBOR floor of 1.50%). |
| West Corporation | Interest rate increase from LIBOR plus a margin of between 2.125% to 2.75% to LIBOR plus a margin of between 3.625% to 4.25%. In addition, West Corporation paid to extending lenders a 0.05% fee on their committed amounts. |

Determining the Value of the Share Transfer of a Leaving Partner



by **François Hellot** and
Jacques Sivignon

Summary

In a ruling dated 5 May, 2009, the Commercial

Chamber of the *Cour de Cassation* refused to apply an Article of incorporation concerning the determination of the value of the share transfer of a leaving partner. The court ruled that the third-party expert provided for under Article 1843-4 of the Civil Code (C. civ., art. 1843-4) could not be bound in his valuation by an Article of incorporation, and that the Court of Appeal—whose decision was, however, praised by the doctrine—had violated the aforementioned provision by deciding that the expert must be guided by the method set out in the Articles of incorporation.

The *Cour de Cassation*, by confirming that the rules of valuation that were negotiated between the parties could not hinder the expert's absolute freedom in his appraisal of the value, has created room for a substantial amount of juridical uncertainty. Indeed, due to the variety of expert profiles, it can be feared that the methods of valuation

may vary substantially from one expert to another, and the procedure of designating an expert by the tribunal will be similar as a consequence to a lottery, given that it would now be impossible to temper these disparities by appealing the decision, as only a glaring error of the expert could lead to the jurisdictional questioning of the valuation.

It must be noted that this solution creates a difference of treatment that is difficult to justify between the valuation of publicly traded shares, which can only be implemented via the multi-criteria method provided for by the Securities Law, and the valuation of a non publicly traded company, which can be determined freely and without any control by the expert.

Given the *Cour de Cassation's* insistence on defending this solution, one might wonder whether the Supreme Jurisdiction did not intend to establish, by applying this article, an absolute right of the leaving shareholder to an expertise pursuant to Article 1843-4 for the determination of the value of its shares, independent of any Articles of incorporation or other contractual provision.

There is a lot at stake since, if this is the case, the commented ruling would deprive the contractual mechanisms for the valuation of shares as we know them today of any effect.

In particular, in the area of private equity, buy-out clauses for shares of certain parties by the other parties in the case of the occurrence of certain events are, as a standard practice, contained in Articles of Constitution or in shareholder Agreements. Indeed, the practice of inserting clauses that fix the rules of valuation for the third-party assessor was very widespread up until now because it was viewed as necessary in order to ensure the contractual equilibrium of such transactions. More serious still, in practice, it is not rare that the price formula defined by the parties does not aim at the determination of a "fair value" in the market, but rather came with a variable discount in order to take into account the occurrence of certain events. This is the case, for example, with "good & bad leaver" clauses that sanction the departure of managers before the end of the contractually agreed term or their bad management by purchasing back their shares at a price significantly below their real value. Yet, expertise pursuant to Article 1843-4 will necessarily lead the expert to seek the "fair value" of the shares, in spite of the parties' will to distance themselves from this value.

From now on, therefore, caution will lead to avoiding such expertise and require to refer, in all cases where there is recourse to an expert for the determination of the value of the shares, to the arbitrator provided for under Article 1592 of the Civil Code in order to try to make this mode of contractual valuation effective again.



Nonetheless, it remains to be seen whether, in a case where the parties have made a direct reference to Article 1592 of the Civil Code in order to set the price of their future sales, the court will give effect, in case of conflict, to the request for the designation of an expert pursuant to Article 1843-4 instead of the request for the designation of a third party arbitrator bound by the contractually agreed valuation methods. The question remains open.

Without reaching these extremes, this ruling offers a significant negotiating tool against the shareholder who, in bad faith, refuses the negative consequences that the application of a contractual clause of valuation would have on him. This solution, which undermines the principle of the binding force of agreements, will probably generate many disputes initiated by departing shareholders.

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How the SEC's Proposed "Pay-to-Play" Rule Affects Private Equity and Hedge Funds



by **Carl A. de Brito**, **Kevin P. Scanlan**, and **Edward L. Pittman**

The Securities and Exchange Commission ("SEC") on July 22, 2009 voted to publish for comment new rules that are designed to prohibit "pay-to-play" practices that may occur when investment advisers seek business from public entities.¹ Proposed Rule 206(4)-5 ("Proposed Rule") under the Investment Advisers Act of 1940 ("Advisers Act") prohibits investment advisers from providing advisory services to any public entity within two years following a political contribution by the investment adviser, certain of its employees and partners, managers, or executive officers, and any affiliated political action committee ("PAC") that they control, to an elected official who has the ability

to influence the selection of investment advisers for a public fund.

In addition, the Proposed Rule would prevent investment advisers from using third-party intermediaries, including placement agents and finders, to solicit business from public entities. According to the release accompanying the Proposed Rule ("Proposing Release"), approximately 1,700 registered and unregistered investment advisers that do business with state or municipal government clients potentially would be affected if the Proposed Rule is adopted. As we describe below, the effect of the Proposed Rule on many alternative managers is likely to be significant.

Overview of Proposed Rule 206(4)-5

The Proposed Rule originally was published for comment by the SEC in a 1999 rule proposal ("1999 Proposal").² However, there was strong opposition to the proposal at that time and ultimately it was not considered by the SEC for adoption. The 1999 Proposal, as well as the Proposed Rule, are based on two rules of the Municipal Securities Rulemaking Board ("MSRB") governing the conduct of municipal underwriters that were adopted in 1994.³ These two rules have been credited with resolving "pay-to-play" problems in the public finance industry.

The SEC's decision to "dust off" the 1999 Proposal, almost 10 years after it was first proposed, is in large part due to a recent high-profile investigation conducted by the Attorney General of the State of New York.⁴ That investigation involves the alleged payment of kickbacks by advisers seeking assignments from the New York State Common Retirement Fund ("NY Retirement Fund"). In many instances, the investments made by the Retirement Fund were part of its alternative portfolio and represented interests in hedge funds and private equity. The NYAG's investigation revealed that a high percentage of third-party finders and placement agents were used to offer investment products to public entities in New York, and were not appropriately registered as broker-dealers.

As a result of the NYAG's investigation, the Retirement Fund and other funds in the state of New York have banned the use by advisers of third-party intermediaries. Moreover, following that investigation, numerous states and other public entities already have adopted, or are considering adopting, restrictions on activities similar to those in the State of New York. In addition, the Comptroller of the State of New York also requested that the SEC consider adopting nationwide standards for advisers providing services to public entities.

Effect of the Proposed Rule on Hedge Funds and Private Equity Funds

Limits on Political Contributions

As currently drafted, the Proposed Rule will apply to registered advisers as well as those that are not registered because they have fewer than 15 clients. Portions of the Proposed Rule limiting political contributions will prohibit an adviser from doing business with a public entity for two years following an impermissible contribution made by it, any of its employees, managers, partners, or executive officers, or any political action committee that they control. The prohibitions apply to all political contributions made to an elected official who has the ability to influence the selection of the investment managers, or who can appoint a member of a board or committee responsible for the selection or approval of managers. Thus, for example, a contribution to the governor of a state may affect the ability of managers to provide advisory services to public funds with trustees or board members that the governor has appointed.

A “look back” provision in the Proposed Rule means that at the time that an adviser solicits business from a public entity, or hires new employees who would be covered by the Proposed Rule, it will need to determine if there have been any impermissible contributions to an elected official of that particular entity in the prior two years. The Proposed Rule contains exceptions for contributions up to \$250 per election cycle made by an employee or executive officer who is entitled to vote for the candidate. Registered investment advisers also will be required to track and keep records of all contributions made by their employees and executive officers, regardless of whether or not they currently provide money management services to any public entities.

Advisers that run afoul of the limits on contributions potentially will be subject to harsh penalties that can include a forced withdrawal from the investment assignment, or waving advisory fees for up to a two-year period, as well as regulatory enforcement actions that may include disgorgement and penalties. The terms in the Proposed Rule defining those individuals covered by the limits on political contributions are complex, and there is little practical guidance in the Proposing Release about the way in which they may be applied in the context of organizations that offer alternative investments.⁵ Because of the severe consequences for non-compliance, we anticipate that most organizations that currently do business with public funds, or may seek to do business in the future, would adopt very conservative and strict compliance policies addressing political contributions.

Ban on Non-Affiliated Placement Agents and Finders

Despite their significant presence in the money management industry, the Proposed Rule also would prevent advisers from making direct or indirect payments to unaffiliated third parties for soliciting public entities. The ban would apply regardless of whether or not the placement agent is a registered broker-dealer or whether any referral fees are fully disclosed to the public entity in compliance with Rule 206(4)-3 (the “cash solicitation rule”) under the Advisers Act. This provision of the Proposed Rule also is based on an MSRB rule and is designed to prevent third-parties from making impermissible political contributions to provide access to public entities on behalf of their clients.

If adopted, the Proposed Rule would significantly alter the marketing practices of many firms, but is likely to have the most profound effect on smaller advisers that do not have significant internal resources. Advisers that would be most harshly affected if this provision of the Proposed Rule is adopted may be emerging managers, including new advisers formed from lift-outs. Both large and small advisers, however, rely on placement agents to enter new markets and to assist in the design and pricing of their funds. Some of the public entities that the SEC is seeking to protect already have indicated that they rely on placement agents to conduct initial due diligence and present new opportunities, and they believe that the ban on placement agents would have an adverse effect on portions of their investment program.

As currently crafted, the Proposed Rule would permit an adviser to make payments, including referral fees, to any affiliate and its individual employees. According to a study presented in the Proposing Release, a significant percentage of the larger investment advisers have affiliated broker-dealers, and in theory would not need to form new registered entities to market alternative investments. As a practical matter, however, in many organizations these affiliated entities may not provide an acceptable alternative to third-party placement agents because they lack the personnel or experience to market the advisers’ strategies to public entities. One possible effect of this provision, if adopted, is that those large and small advisers that would need to hire dedicated sales personnel, or form new broker-dealers⁶ in order to market to public entities, may choose to forego this segment of potential investors.

Conclusion

The comment period for the Proposed Rule expires on October 6, 2009. While the goals of the SEC are laudable, we anticipate that because of the Proposed Rule’s complexity, extensive compliance costs, and harsh penalties for non-

compliance, it is likely to be opposed by many members of the industry. If the Proposed Rule is adopted either in its current form or in a less-intrusive version, we would expect that there would be an extended effective date and grandfather provisions that would seek to minimize its immediate impact.

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- ¹ Political Contributions by Certain Investment Advisers, Advisers Act Release No. 2910 (August 3, 2009).
- ² Political Contributions by Certain Investment Advisers, Advisers Act Release No. 1812 (August 4, 1999).
- ³ MSRB Rules G-37 and G-38.
- ⁴ For a more detailed discussion of the Attorney General's investigation, please refer to "New York Attorney General Places Spotlight on 'Finders,' 'Placement Agents,' and 'Pay-to-Play' Practices," *DechertOnPoint*, Issue 13 (June 2009), available at www.dechert.com/library/FS_13_6-09_New_York_Attorney_General_Places.pdf.
- ⁵ As noted above, many of the terms in the Proposed Rule are taken from MSRB Rules G-37 and G-38, which are cited extensively in the Proposing Release.
- ⁶ Funds that market directly generally are not required to

register as broker-dealers. However, the individual partners or employees of the manager of a fund could, in some cases, be considered brokers if they are engaged in sales activities. However, a "safe-harbor" rule adopted by the SEC permits associated persons of an issuer, including funds, to offer securities without registering with the SEC as a broker-dealer. Significantly, the rule prohibits the partners or employees of the manager from receiving transaction-based compensation, including commissions and bonuses based on sales, and they also must perform non-sales related duties for the issuer. See Rule 3a4-1 under the Securities Exchange Act of 1934.

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News from the Group

Upcoming/Recent Seminars and Speaking Engagements

November 4, November 9 Dechert is hosting a seminar titled "Hedge and Private Equity Funds: Reloaded" in our London office on November 4 and in our New York office on November 9. The program will address current trends in structuring private equity and hedge funds across European, U.S., and Asian markets.

November 1 Dechert is sponsoring the 51st NASBIC Annual Meeting & Private Equity Conference in Washington, D.C.

October 8 Dechert hosted a seminar titled "363 Sales: Critical Issues to Consider When Buying Portfolio Companies Out of Bankruptcy" in the firm's New York office. Topics included corporate governance, knowing who your client is, disclosure, sale process, DIP financing, inherent risks and sponsor risk management strategies, and releases.

September 29 Dechert hosted a seminar titled "Luxembourg Alternative Funds: New Opportunities" in our London office. The seminar focused on opportunities available to international investment managers looking to

Luxembourg as an attractive jurisdiction for establishing alternative investment strategy fund products, including hedge funds, private equity funds, and real estate funds.

September 24 Martin Nussbaum participated as a panelist on a webcast titled "How to Sell a Division," where he discussed changing deal tactics, interrelationships between the seller and the target, transferring intellectual property and employees, and the interaction of credit agreements and indentures.

September 9 Kristopher Brown spoke on "Implications of Healthcare Reform on Investment and M&A Strategies" at the 7th Annual Healthcare M&A and Business Development: The Best Strategies for the Current Market conference in Atlanta.

To obtain a copy of the related presentation materials, please contact Michelle Lappen at +1 212 649 8753 or michelle.lappen@dechert.com.

About Dechert LLP

With offices throughout the United States, Europe, and Asia, Dechert LLP is an international law firm focused on corporate and securities, business restructuring and reorganization, complex litigation and international arbitration, real estate finance, financial services and asset management, intellectual property, labor and employment, and tax law.

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The United States Treasury Department issues Circular 230, which governs all practitioners before the Internal Revenue Service. Circular 230 was amended to require a legend to be placed on certain written communications that are not otherwise comprehensive tax opinions. To ensure compliance with Treasury Department Circular 230, we are required to inform you that this letter is not intended or written to be used, and cannot be used, by you for the purpose of avoiding penalties that the Internal Revenue Service might seek to impose on you.

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