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A Comparative Examination of Private Equity in the United States and Europe: Accounting for the Past and Predicting the Future of European Private Equity

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A COMPARATIVE EXAMINATION OF PRIVATE EQUITY IN THE UNITED STATES AND EUROPE: ACCOUNTING FOR THE PAST AND PREDICTING THE FUTURE OF EUROPEAN PRIVATE EQUITY

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ABSTRACT

Private equity has transformed from a small asset class into a major player in the global economy. Despite being a U.S. invention, the private equity model has also managed to spread throughout Europe. Recently, the spotlight has been put on the private equity industry for a number of reasons: the recent financial crisis; the adoption of the Dodd-Frank Wall Street Reform and Consumer Protection Act in the U.S. and the Alternative Investment Fund Managers Directive in the E.U.; and the run of Mitt Romney, founder of the prestigious U.S. private equity firm Bain Capital, for President of the United States. Despite this attention, a comparative examination of private equity regulation is absent from academic literature. This paper seeks to fill that gap and offers a comparative assessment of the legal framework governing private equity firms and transactions in both Europe and the U.S. This comparative examination will reveal that Europe has a particularly restrictive legal environment, which one would assume would inhibit European private equity activity and cause it to substantially lag behind the U.S. Nonetheless, underlying economic forces have provided and continue to provide a boost to the European market, allowing Europe to compete with the U.S. on an equal footing. Unraveling these underlying economic forces shall be

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the other major goal of this paper. When it comes to European private equity, there is no causation between the strictness of the legal regime and economic development. Rather, economic development shapes its own path and is unaffected by the prevailing legal regime.

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INTRODUCTION

> Private equity has, for the first time, allowed ordinary citizens to act as the "capitalist" during one of capitalism's periodic frenzies of "creative destruction." This is giving the "little guy," via his or her pension fund, 80% of the upside in wealth creation that has historically been the exclusive preserve of the Rockefellers and Mellons of the world.[1]

Thirty-four years after Kohlberg Kravis Roberts & Co. L.P. ("KKR") raised the first ever private equity fund to finance leveraged buyouts ("LBOs"),[2] private equity firms are now widely regarded as the new kings of capitalism.[3] Fueled by an abundance of liquidity in the financial system, private equity activity reached its greatest heights between 2003 and 2007. The peak of this period came in 2007, when an investor group led by KKR and Texas Pacific Group ("TPG") completed the buyout of TXU, which remains the biggest LBO in history.[4] This golden era ended with the bursting of the housing bubble and subsequent credit crunch, which caused the collapse of the private equity market as bidders tried to terminate or renegotiate their pending acquisitions.[5] Today, private equity activity has made some progress towards recovering but is still far from its heyday; this can be attributed to the current sovereign debt crisis in Europe as well as fragile debt markets, which further strain deal financing and evidence the dependency of private equity activity on credit market conditions.[6]

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1. Jenny Anderson, *Stephen Schwarzman Speaks*, DEALBOOK (Nov. 27, 2007, 8:04 AM), http://dealbook.nytimes.com/2007/11/27/stephen-schwarzman-speaks/.

2. GEORGE P. BAKER & GEORGE DAVID SMITH, THE NEW FINANCIAL CAPITALISTS: KOHLBERG KRAVIS ROBERTS AND THE CREATION OF CORPORATE VALUE 59 (1998).

3. *The New Kings of Capitalism*, THE ECONOMIST, Nov. 25, 2004, *available at* http://www.economist.com/node/3398496.

4. *In TXU's $45 Billion Deal, Many Shades of Green*, DEALBOOK (Feb. 26, 2007, 10:12 AM), http://dealbook.nytimes.com/2007/02/26/in-txus-45-billion-deal-many-shades-of-green/.

5. The total value of transactions terminated by private equity bidders exceeded $168 billion. See Matthew D. Cain et al., *Broken Promises: The Role of Reputation in Private Equity Contracting and Strategic Default* 2 (Sept. 11, 2012) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1540000.

6. Ulf Axelson et al., *Borrow Cheap, Buy High? The Determinants of Leverage and Pricing in Buyouts*, J. FIN. (forthcoming) (manuscript at 5), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1596019.

Nevertheless, the LBO association has managed to establish itself as a dominant organizational form providing an attractive alternative to the public corporation. Though Michael Jensen's famed 1989 prediction that the LBO association would eclipse the public corporation[7] never materialized, the private equity model has successfully challenged the predominance of the publicly held corporation.

Private equity, a U.S. invention, gained mainstream attention during the takeover boom of the 1980s. According to Mitchell and Mulherin, 57% of large U.S. firms were either takeover targets or underwent a restructuring between 1982 and 1989.[8] During this period, private equity received negative criticism due to its association with hostile takeovers and corporate bust-ups. However, in the years following, the private equity industry managed to disassociate itself from corporate raiders and their abusive practices, instead building the profile of a cutting edge industry that would promote U.S. economic growth. As a headquarter to many of the major industry players, the U.S. private equity market remains the most mature market worldwide. Nevertheless, buyout activity started spreading, particularly in Europe, after 1996.[9] Between 2000 and 2004, Western Europe surpassed the U.S. in buyout activity, accounting for 48.9% of worldwide transaction value.[10] The U.K. represents the most active European private equity market both in terms of transaction value and volume, as the majority of European and U.S. private equity firms operating in Europe are headquartered there. The U.K.'s attractiveness is based on its stable and favorable regulatory environment, sophisticated third-party advisers, well-developed debt and equity capital markets, and positive attitude towards entrepreneurial risk. Germany and France, the largest and second largest European economies respectively, distantly follow the

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7. *See* Michael C. Jensen, *Eclipse of the Public Corporation* 1–2 (1997) (unpublished revision, originally published as Michael C. Jensen, *The Eclipse of the Public Corporation,* HARV. BUS. REV., Sept.-Oct. 1989, at 61), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=146149.

8. Mark L. Mitchell & Harold J. Mulherin, *The Impact of Industry Shocks on Takeover and Restructuring Activity,* 44 J. FIN. ECON. 193, 199 (1996).

9. Mike Wright et al., *Leveraged Buyouts in the U.K. and Continental Europe: Retrospect and Prospect*, J. APPLIED CORP. FIN., Summer 2006, at 38.

10. Steven N. Kaplan & Per Strömberg, *Leveraged Buyouts and Private Equity*, J. ECON. PERSP., Winter 2009, at 121, 128.

U.K.[11] The underdevelopment of the private equity industry in continental Europe is attributable to a lagging financial infrastructure, unfavorable legal and fiscal environments for private equity investments, a risk-averse culture, and thin equity markets.[12] Europe and the U.S. combined represent the majority of worldwide private equity activity in terms of transaction value.[13] In contrast, private equity in emerging markets is either underdeveloped or employs a different model than the US and Europe altogether.[14]

The aim of this article is twofold. The first aim is to offer a comparative assessment of the legal framework governing the financing and structuring of private equity transactions[15] as well as the regulation of private equity firms in Europe and the U.S. As this comparative examination will reveal, private equity is subject to particularly stringent requirements in Europe both on a transactional and, subsequent to the adoption of the Alternative Investment Fund Managers Directive ("AIFM Directive"), fund manager level. One would therefore expect that the legal regime would affect the development of the European private equity market by inhibiting its activity and causing it to substantially lag behind the U.S. market. The second aim of the article is to both account for the past and predict the future of European private equity. Despite the strict legal regime, private equity activity in Europe

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11. Wright et al., *supra* note 9, at 38, 39.

12. *Id.* at 52–53. A well-developed stock market is important for a flourishing private equity industry, since it offers private equity investors the possibility to exit their investment through an initial public offering ("IPO"). *See generally* Bernard S. Black & Ronald J. Gilson, *Does Venture Capital Require an Active Stock Market?*, J. APPLIED CORP. FIN., Winter 1999, at 36.

13. Kaplan & Strömberg, *supra* note 10, at 121, 127.

14. For instance, while Brazil is one of the hottest markets for private equity firms, the private equity model employed by Brazil relies less on debt financing and the relevant deals usually involve minority acquisitions in medium-sized companies. *See Alternative Investments in Brazil: The Buys from Brazil*, THE ECONOMIST, Feb. 17, 2011, at 5, *available at* http://www.economist.com/node/18178275. In China, another lucrative market for private equity, a wide variety of industries are considered to be "strategic." Therefore, controlling investments in these companies are either prohibited or subject to governmental approval. As a result, private equity is confined to non-controlling participations. *See Private Equity in China: Barbarians in Love*, THE ECONOMIST, Nov. 25, 2010, at 3–4, *available at* http://www.economist.com/node/17580583.

15. This article will concentrate on public-to-private transactions. A public-to-private transaction involves the leveraged acquisition of a listed company that is subsequently delisted from the stock exchange and transformed into a private company.

has and will continue to grow at levels similar to those in the U.S. This growth can be attributed to underlying economic forces. The development of the single market, introduction of the euro, growth of European capital markets, liquidity boom in the European financial system, financialization of Europe, and move towards the Anglo-Saxon capitalist model has contributed to the growth of European private equity activity, particularly during the last decade. While there are fears that the adoption of the AIFM Directive will inhibit buyout activity in Europe, underlying economic forces, albeit different from those that drove the last boom, will fuel further growth of the European private equity market. The current sovereign debt crisis in Europe will spark vast reforms in European countries. These reforms, most notably labor deregulation and privatizations, will provide a boost to European public-to-private activity.

The article will proceed as follows. Part I of this article will offer an overview of private equity, the structure of a typical public-to-private transaction, the history of private equity in the U.S. and certain European countries, and the sources of value creation in LBOs. Part II of the article will examine the legal rules governing the financing and structuring of public-to-private transactions on both continents. Part III of this article will be devoted to a comparative analysis of the regulation of private equity firms in the U.S. and Europe, including an assessment of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") and the AIFM Directive. Part IV will offer an account of the past and a prediction of the future of European private equity, as well as seek to explain why its development remains unaffected by the hostile European legal regime. We will attempt to unravel the economic forces that have and will continue to provide a boost to private equity activity, allowing Europe to compete with the U.S. on an equal footing.

I. PRIVATE EQUITY, ITS HISTORY, AND SOURCES OF VALUE CREATION

A. WHAT IS PRIVATE EQUITY?

Private equity is a generic term encompassing a wide variety of investments.[16] The customary characteristic of private equity investments is illiquidity,[17] since private equity involves unregistered securities.[18] Private equity includes venture capital, development capital, mezzanine capital, LBOs, and distressed investing.[19] Venture capital funds provide financing to start-ups and early stage firms, thereby contributing to macroeconomic growth and job creation.[20] Development capital involves the provision of funds to existing

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16. Private equity funds are different than hedge funds. While private equity funds concentrate their investments in illiquid securities, hedge funds invest in publicly traded securities pursuing short-term investment strategies. As it is often said, private equity is focused on *creating* value. By contrast, hedge funds pursue an investment strategy of *finding* value. However, recent years have seen the convergence of hedge funds and private equity funds. In particular, hedge funds are increasingly making long-term investments in public corporations and becoming involved in their corporate governance. A recent phenomenon is hedge funds competing with private equity funds to take companies private. *See generally* Houman B. Shadab, *Coming Together After the Crisis: Global Convergence of Private Equity and Hedge Funds*, 29 NW. J. 'INT'L L. & BUS. 603 (2009); Jonathan Bevilacqua, *Convergence and Divergence: Blurring the Lines Between Hedge Funds and Private Equity Funds*, 54 BUFF. L. REV. 251 (2006); JONATHAN R. MACEY, CORPORATE GOVERNANCE: PROMISES KEPT, PROMISES BROKEN 244 (2008).

17. Jennifer Payne, *Private Equity and Its Regulation in Europe*, 12 EUR. BUS. ORGANIZATIONAL L. REV. 559, 564 (2011) (U.K.).

18. JOSEPH A. MCCAHERY & ERIK P.M. VERMEULEN, CORPORATE GOVERNANCE OF NON-LISTED COMPANIES 171 (2008).

19. ANDREW METRICK, VENTURE CAPITAL AND THE FINANCE OF INNOVATION 7 (2006); PETER TEMPLE, PRIVATE EQUITY: EXAMINING THE NEW CONGLOMERATES OF EUROPEAN BUSINESS 4 (1999). Private equity has diversified over time. Private Investments in Public Equity (PIPEs) are the latest innovation in the private equity market. In a typical PIPE transaction, a public corporation will issue common stock or securities convertible into common stock in a private placement to a private equity investor. PIPE issuers are usually small cap companies with a weak stock price unable to raise capital in the public equity markets. *See* CYRIL DEMARIA, INTRODUCTION TO PRIVATE EQUITY 96 (2010); William K. Sjostrom, Jr., *PIPEs*, 2 ENTREPRENEURIAL BUS. L.J. 381, 386 (2007).

20. Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067, 1068 (2003).

companies to support their expansion.[21] Mezzanine funds provide financing to LBOs in the form of subordinated debt, with equity participation in the form of warrants to subscribe for shares in the borrower.[22] Distressed debt investors purchase debt of troubled companies at a discount, and then use their rights as debtholders to promote a restructuring of the company.[23]

The most well known category of private equity transactions is LBOs. In a typical LBO, a private equity firm will acquire control of an already existing business using a small amount of equity and a large amount of debt. The transaction is defined as a public-to-private transaction when the target of an LBO is a public company that is subsequently delisted from the stock exchange and transformed into a private company. Subcategories of LBOs are management buyouts, management buy-ins, and institutional buyouts. In a management buyout, the incumbent management will partner with a private equity investor to privatize the company. Management will obtain a significant stake in this new company. Conversely, in the case of a management buy-in, an outside management team backed by a private equity investor leads the bidding. In an institutional buyout, a private equity firm buys a company, with its incumbent management typically receiving an equity stake in the company as part of its remuneration package.[24]

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21. TEMPLE, *supra* note 19, at 4.

22. Payne, *supra* note 17, at 569; GEOFF YATES & MIKE HINCHLIFFE, A PRACTICAL GUIDE TO PRIVATE EQUITY TRANSACTIONS 193 (2010).

23. A popular strategy for distressed debt investors is to engage in loan-to-own transactions, whereby investors acquire the debt of a company with a view to converting it into equity and obtaining control of the company. An example of a successful distressed debt investment was Yucaipa's investment in the debt of Allied Holdings, Inc. After Allied entered into Chapter 11 bankruptcy proceedings, Yucaipa purchased debt in the company and used its leverage as a debtholder to influence the terms of Allied's reorganization plan. Yucaipa emerged as the controlling shareholder in the reorganized company by exchanging its debt for a controlling equity stake. *See* Michelle M. Harner, *The Corporate Governance and Public Policy Implications of Activist Distressed Debt Investing,* 77 FORDHAM L. REV. 703, 719–20 (2008).

24. In both a management buyout and an institutional buyout, the incumbent management will end up with a stake in the acquired company. The difference lies in the way that management obtains its equity stake. In the case of a management buyout, the incumbent management gains its stake by being part of the bidding group, whereas in the case of an institutional buyout the equity stake is granted to management as part of its new remuneration package.

Private equity investments are channeled through specialized intermediaries that are usually organized as limited partnerships,[25] commonly known as private equity funds. Private equity firms such as KKR, Blackstone, and TPG periodically establish private equity funds in the form of limited partnerships[26] where they serve as general partners. The general partner is responsible for managing the fund. Furthermore, the general partner solicits capital from investors, who are the limited partners of these funds.[27] The principal investors in private equity funds are institutional investors such as pension funds,[28] university endowments, insurance companies, and banks, as well as wealthy individuals.[29] Private equity firms usually invest a certain

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25. The preference for investing in an issuer through intermediaries rather than by direct investment is based on the complexity of private equity investments. The extensive pre-screening and post-investment monitoring required for private equity investments are more efficiently performed by specialized intermediaries, rather than by a large number of outside investors. *See* GEORGE W. FENN ET AL., BD. OF GOVERNORS OF THE FED. RESERVE SYS., STAFF SERIES 168, THE ECONOMICS OF THE PRIVATE EQUITY MARKET 28 (1995).

26. Funds are organized as limited partnerships in order to take advantage of the pass-through tax treatment of partnership profits. Tax liability on partnership profits is not incurred at the entity level, but is rather passed on to the individual investor. *See* Alan L. Kennard, *The Hedge Fund Versus the Mutual Fund,* 57 TAX LAW. 133, 136 (2003).

27. Investors commit to provide capital to the private equity fund. Once an investment opportunity is identified, the fund manager sends a notification to the investors and draws down committed capital equal to the amount required for the specific investment. *See* Per Strömberg, *The Economic and Social Impact of Private Equity in Europe: Summary of Research Findings* 4 (Sept. 2009) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1429322.

28. Public pension funds have been a major source of financing for private equity firms. *See* Steven M. Davidoff, *Wall St.'s Odd Couple and Their Quest to Unlock Riches*, DEALBOOK (Dec. 13, 2011, 7:18 PM), http://dealbook.nytimes.com/2011/12/13/wall-st-s-odd-couple-and-their-quest-to-unlock-riches/ (describing private equity firms' love affair with public pension funds).

29. In order to avoid securities regulation, private equity funds are closed to retail investors and offered solely to "sophisticated" investors. However, recent years have seen the rise of what Steven Davidoff refers to as "black market capital." Recently emerging capital market phenomena such as special purpose acquisition companies (SPACs), business development corporations (BDCs), and exchange traded funds (ETFs) seek to replicate private equity. SPACs raise funds through an IPO in order to complete acquisitions of private companies by employing structures and practices comparable to private equity. BDCs invest in debt securities associated with private

amount of capital into the fund[30] in order to ensure an alignment of interests with the other fund investors.[31] Such funds are "closed-end" vehicles, meaning that investors cannot withdraw their capital during the life of the fund.[32] The funds have a fixed life, typically of ten years with the possibility of a two-year extension. Therefore, private equity firms must regularly return to the market and raise new capital. To do this, the firms must have earned a reputation for delivering superior returns in their previous funds.[33]

Private equity firms are responsible for managing the fund as general partners, as well as selecting and managing the investments. During the first three to five years of the fund's life—the investment period—the private equity firm will deploy its capital to acquire companies. During the remaining years of the fund's life—the holding period—the private equity firm manages and eventually sells the investments.

The compensation of the general partner consists of an annual management fee and a share of the fund's profits, known as carried interest. The management fee usually amounts to 2% of all capital and the carried interest is commonly set at 20% of the fund's profits.[34] The carried interest is typically claimed after the investors' capital has been returned and a designated rate of return called the hurdle rate, typically

equity transactions while ETFs can track private equity performance. *See generally* Steven M. Davidoff, *Black Market Capital*, COLUM. BUS. L. REV. 172 (2008).

30. Usually 1% of the total capital. *See* Kaplan & Strömberg, *supra* note 10, at 123.

31. *See* Payne, *supra* note 17, at 563.

32. The illiquidity of investments in private equity funds has been remedied by the rise of a secondary market in limited partnership interests. Subject to the general partner's approval, investors in private equity funds are able to transfer their partnership interests in the secondary market.

33. This high-powered incentive of private equity firms to show good performance is being compromised by the public listing of private equity firms. A public listing allows private equity fund managers to obtain permanent capital and, therefore, makes the raising of new funds in the market unnecessary. *See* Michael C. Jensen, *The Economic Case for Private Equity (and Some Concerns)* (Harvard NOM Working Paper No. 07-02, 2007), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=963530.

34. Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds,* 83 N.Y.U. L. REV. 1, 8 (2008).

set at 8%, has been achieved.[35] In addition, private equity firms charge monitoring and deal fees on the companies in which they invest.[36]

Though limited partners benefit from the fact that their liability is capped at the amount of their invested capital in the fund, their inability to participate in the fund's management exposes them to the opportunistic behavior of the general partner. Partnership agreements regulating the relationship between general and limited partners contain a number of provisions seeking to restrain the general partner's discretion. These covenants include: limits on the amount the fund can invest in a single company, restrictions on the types of assets that the fund can purchase, and restrictions on the general partner's outside activities.[37] In addition, private equity firms periodically provide reports to the limited partners detailing the value and progress of the fund's portfolio.[38] Private equity funds also establish special advisory committees with the participation of limited partners.[39]

B. THE STRUCTURE AND FINANCING OF A PRIVATE EQUITY FUND'S PUBLIC-TO-PRIVATE TRANSACTION

In order to complete a public-to-private transaction, a private equity buyer will create a special purpose vehicle with no material assets to acquire the target company. The private equity fund will not be a party to the transaction and therefore avoids any liabilities. The fund will control the acquisition vehicle, subscribe shares in it, and make an additional investment through a loan note in the vehicle.[40] Management

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35. FIN. SERVS. AUTH., PRIVATE EQUITY: A DISCUSSION OF RISK AND REGULATORY ENGAGEMENT 24 ¶ 3.16 (2006). It is often argued that since the size of the carried interest depends on performance, carried interest creates a powerful incentive for private equity fund managers to achieve good returns. *See* Fleischer, *supra* note 34, at 8. However, in reality, the general partner derives the majority of its compensation from fixed revenue components, namely, management and transaction fees. Only one-third of the general partner's compensation is performance-based and derived from the carried interest. *See* Andrew Metrick and Ayako Yasuda, *The Economics of Private Equity Funds*, 23 REV. FIN. STUD. 2303, 2327–28 (2010).

36. Metrick & Yasuda, *supra* note 35, at 2314.

37. Paul Gompers & Josh Lerner, *The Use of Covenants: An Empirical Analysis of Venture Partnership Agreements*, 39 J. L. & ECON. 463, 479–84 (1996).

38. William A. Sahlman, *The Structure and Governance of Venture Capital Organizations*, 27 J. FIN. ECON.. 473, 492 (1990).

39. *Id.* at 493.

40. YATES & HINCHLIFFE, *supra* note 22, at 50.

will also subscribe to shares in the vehicle, though it will be a small fraction of the total equity component.[41] The capital raised, along with debt, will be used to finance the purchase of a public company. The target company's shareholders will receive cash and retain no interest in the post-acquisition company.

In a public-to-private transaction, between 60% and 70% of the purchase price is funded by debt.[42] In the years prior to the 2008 financial crisis ("Financial Crisis"), the availability of debt increased significantly and the secondary market for bank debt buoyed, which helped contribute to the LBO boom.[43] Another hallmark of these golden years was the rise and expansion of the collateralized loan obligation ("CLO") market.[44] These two markets allowed banks to unload risky loans from their balance sheets, raising concerns about their monitoring and screening incentives.[45]

Another result of the overly liquid and relaxed lending standards was the emergence of "covenant-lite" loans and "payment-in-kind" toggle notes. In a typical loan transaction, the lender will impose financial covenants on the borrower, such as a requirement to maintain monthly or quarterly performance standards. Covenant-lite loans part with maintenance covenants and instead include looser incurrence

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41. *Id.* at 52.

42. In the wake of the Financial Crisis, a growing number of deals are financed solely through equity. Examples include Apax Partner's acquisition of Bankrate and Apollo's acquisition of Parallel Petroleum. *See* Steven M. Davidoff, *Bankrate: A New Model for Private Equity Deals*, DEALBOOK (July 24, 2009, 1:02 PM), http://dealbook.nytimes.com/2009/07/24/bankrate-a-new-model-for-private-equity-deals/; Steven M. Davidoff, *New Model Emerging for Private Equity Deals*, DEALBOOK (Sept. 16, 2009, 2:29 PM), http://dealbook.nytimes.com/2009/09/16/new-model-emerging-for-private-equity-deals/.

43. Viral Acharya et al., *Private Equity: Boom or Bust?*, J. APPLIED CORP. FIN., Fall 2007, at 44.

44. *See* Steven M. Davidoff, *A Debt Market's Slow Recovery is Burdened by New Regulation*, DEALBOOK (Jan. 31, 2012, 3:44 PM), http://dealbook.nytimes.com/2012/01/31/a-debt-markets-slow-recovery-is-burdened-by-new-regulation/. A collateralized loan obligation is a debt security issued by a special purpose vehicle and backed by loans extended to finance leveraged buyouts. The debt securities are divided in several tranches with different maturity, interest and repayment schedules. *See* Anil Shivdasani & Yihui Wang, *Did Structured Credit Fuel the LBO Boom?*, 66 J. FIN. 1291, 1295 (2011).

45. Acharya et al., *supra* note 43, at 3.

covenants, allowing the borrower to take a variety of actions such as paying a dividend and incurring additional debt so long as a certain threshold has not been exceeded.[46]

Private equity firms Warburg Pincus LLC and TPG were the first to use payment-in-kind toggle notes during their buyout of luxury retailer Neiman Marcus Group, Inc.[47] These securities allow issuers to pay interest to lenders or note holders either in cash or by issuing more securities (in-kind).

The debt component of a typical public-to-private transaction includes senior debt, second-lien debt, mezzanine debt, and high-yield bonds. Senior debt comprises the majority of the debt incurred in an LBO transaction, is secured by the target's assets and shares on a first-ranking basis, and is divided into three separate term loans and a revolving facility. The term loans are used to fund the purchase price, whereas the revolving facility is used to fund the target's working-capital requirements.

Second-lien debt developed in the U.S. during the 1990s and is secured by the same assets or shares as senior debt, though it ranks secondary to senior debt in priority. Hedge funds have historically been the main investors in second-lien debt,[48] though a variety of institutional investors, including banks, are increasingly becoming involved in this type of financing.[49]

Mezzanine debt is subordinate to senior debt as well, and carries a higher interest rate to compensate lenders for their inferior position in case of the issuer defaults.[50] Mezzanine lenders usually obtain share

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46. Financial covenants can be separated in two broad categories: maintenance and incurrence covenants. Maintenance covenants, which are used in most credit agreements, require the borrower to adhere to a financial ratio test at regular intervals, usually at the end of each quarter. On the contrary, incurrence covenants oblige the borrower to meet a financial ratio test upon the occurrence of an event such as the incurrence of additional debt. Incurrence covenants are common to high yield bonds. *See A Beginner's Guide to Thinking About Covenants,* BANKING AND FINANCE MARKET SNAPSHOT, (Kramer Levin), Dec. 2006, at 2.

47. Henny Sender, *What's Aiding Buyout Boom: Toggle Notes*, WALL ST. J., Feb. 21, 2007, at C1.

48. LOUISE GULLIFER & JENNIFER PAYNE, CORPORATE FINANCE LAW: PRINCIPLES AND POLICY 669 (2011).

49. *Id.*

50. While both second-lien and mezzanine debt are subordinate to senior debt, second-lien debt benefits from a second-ranking security on the borrower's assets. On the contrary, mezzanine capital is typically unsecured. *See* Arthur D. Robinson et al.,

warrants, allowing them to subscribe for shares in the portfolio company under certain circumstances, such as a sale or IPO.

High-yield bonds are another important source of financing for LBOs. These debt securities were developed and perfected by the infamous Michael Milken of Drexel Burnham and Lambert. They are mainly purchased by institutional investors, are rated below investment grade, and usually carry a fixed interest rate. A crucial advantage of high-yield bonds is the inclusion of more flexible incurrence-based covenants, rather than covenants requiring the borrower to maintain ongoing financial capital ratios.

Once the financing has been put in place, a private equity fund, acting through the acquisition vehicle, will complete the target acquisition and transform the company into a privately held company. After the target company has gone "dark", the private equity investors will work with management to increase the target company's value.

A private equity fund's fixed duration motivates its managers to quickly restructure their portfolio companies and exit their investments. The main exit strategies for private equity investors are the sale of a portfolio company to a strategic buyer, called a trade sale; an initial public offering; a sale to another private equity fund, called a secondary buyout; or a leveraged dividend recapitalization.[51]

C. THE HISTORY OF PRIVATE EQUITY FUNDS IN THE U.S. AND EUROPE

In the U.S., the modern LBO model traces its roots back to the late 1960s. While at Bear Stearns, Jerome Kohlberg, Henry Kravis, and George Roberts established a unit that specialized in LBOs of private

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Mezzanine Finance: Overview, PRACTICAL LAW – THE JOURNAL (Feb. 2013), *available at* http://www.stblaw.com/google_file.cfm?TrackedFile=4B46116602D7EAD896B179&TrackedFolder=585C1D235281AED996A07D5F9F9478AB5A90188899.

51. In a leveraged dividend recapitalization, the portfolio company will issue debt and use the proceeds to pay a special dividend to the private equity investors. Dividend recapitalizations have been heavily criticized for allowing private equity investors to reap a quick profit while saddling the portfolio company with more debt. *See* Ryan Dezember & Matt Wirz, *Debt Fuels a Dividend Boom.* WALL ST. J., October 19, 2012, available at http://online.wsj.com/article/SB10000872396390444592704578064672995070116.html.

family firms.[52] In 1976, the trio decided to leave Bear Stearns and form the first-ever private equity firm, KKR.[53] KKR raised its first private equity fund devoted to financing public-to-private buyouts in 1978. The buyout of Houdaille Industries, completed in 1979, was the first LBO of a large public company.[54] The successful closing of the deal soon attracted attention, and imitations followed.

The development of a liquid high-yield debt market was pioneered by Michael Milken of Drexel Burnham Lambert, and contributed to the LBO boom of the 1980s. The privatization of RJR Nabisco highlighted the excesses of the era. Political backlash against highly leveraged transactions, tightened credit markets, and the collapse of the high-yield debt market put an end to the boom, and the 1990s saw a substantial decline in U.S. LBO activity.[55] However, the passage of the Sarbanes-Oxley Act ("SOX") on corporate governance increased the costs of being a public company[56] and provided a boost to private equity activity, which resumed in 1997. The period between 2003 and 2007 saw a meteoric rise in private equity activity, and firms such as KKR, Blackstone, and TPG executed multi-billion dollar public-to-private transactions. This wave of public-to-private transactions is attributable to vast inflows of capital into private equity funds, easy credit, and public company CEO's growing receptiveness to private equity.[57] Nevertheless, the Financial Crisis caused the collapse of the U.S. private equity market and revealed deep flaws in its structure.[58] In the aftermath

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52. BAKER & SMITH, *supra* note 2, at 52; Allen Kaufman & Ernest J. Englander, *Kohlberg Kravis Roberts & Co. and the Restructuring of American Capitalism*, 67 BUS. HIST. REV. 52, 67–68 (1993).

53. Kaufman & Englander, *supra* note 52, at 67–68.

54. *Id.* at 71.

55. In addition, U.S. corporations' adoption of shareholder-friendly policies by U.S. corporations, such as the rise of incentive-based compensation and active monitoring of management by institutional investors, made LBOs unnecessary. *See* Bengt Holmstrom & Steven N. Kaplan, *Corporate Governance and Merger Activity in the United States: Making Sense of the 1980s and 1990s,* J. ECON. PERSP., Spring 2001, at 132–36.

56. For a criticism of SOX, see generally Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521 (2005).

57. Steven N. Kaplan, *Private Equity: Past, Present and Future*, 19 J. APPLIED CORP. FIN. 8, 9 (2007).

58. An innovation of the private equity golden era was the reverse termination fee. Private equity buyers were able to back out of a deal by paying a fee to the target company. This made the completion of deals optional. ' Thus, during the financial

of the Financial Crisis, the sovereign debt crisis in Europe is still causing tight credit markets that constrain U.S. private equity activity.

Within Europe, private equity was first developed in the U.K., which experienced a buyout boom during the 1980s. An important development that contributed to the boom was a change in the U.K.'s legislative framework; prior to 1981, it was illegal for a target company to grant a security to a bidder for the purpose of acquiring its own shares.[59] The Companies Act of 1981 allowed the granting of securities subject to the fulfillment of certain requirements.[60] The buyout boom ended with the recession of the early 1990s. However, private equity activity eventually resumed, reaching a peak in 2000 before declining due to the dot-com bubble bursting and the repercussions that followed. The last buyout boom in the U.K. started in 2003 and lasted until the onset of the financial crisis in 2007. In 2007, Alliance Boots went private with the help of KKR and its largest shareholder, Stefano Pessina. This was the first ever public-to-private transaction involving a FTSE 100 company, and was the largest buyout in Europe to date.[61]

LBO activity in continental Europe never reached the maturity and depth of the U.S. or U.K. markets, but there were still periods when the private equity market thrived. The first LBO boom came during the late 1980s, followed by a dormant market during the early 1990s. Activity picked up again in the late 1990s, and 2003 marked the start of the golden era of private equity in continental Europe. Two of the biggest public-to-private transactions in continental Europe—the buyout of Danish telecommunications giant TDC and the leveraged acquisition of a controlling stake in the semiconductor unit of Royal Philips Electronics—both took place in 2006.[62] As far as individual European

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crisis, private equity firms were able to easily terminate their pending acquisitions. *See generally* Steven M. Davidoff, *The Failure of Private Equity,* 82 S. CAL. L. REV. 481 (2009).

59. JOHN GILLIGAN & MIKE WRIGHT, ICAEW CORPORATE FINANCE FACULTY, PRIVATE EQUITY DEMYSTIFIED—AN EXPLANATORY GUIDE 16 (2d ed. 2010).

60. GILLIGAN & WRIGHT, *supra* note 59, at 16.

61. Julia Finch, *Pessina Wins the Battle for Boots*, THE GUARDIAN, Apr. 24, 2007, http://www.guardian.co.uk/business/2007/apr/25/privateequity.retail.

62. *See* Telis Demos, *NXP Semiconductor Launches Secondary Offering*, FIN. TIMES, Mar. 28, 2011, http://www.ft.com/intl/cms/s/2/aa0d191a-57c7-11e0-9abf-00144feab49a.html#axzz1yMhK70Mn; Heather Timmons, *TDC Joins Spree of E.U. Buyouts*, N.Y. TIMES, Nov. 30, 2005, http://www.nytimes.com/2005/11/30/business/

countries are concerned, Germany and France represent the largest individual private equity markets in continental Europe, due in part to the size of their economies.

The birth of the LBO model in Germany has been attributed to the existence of family offices, which provided the necessary initial capital for the first LBOs.[63] Private equity activity remained subdued until the late 1990s and mostly concentrated on the so-called Mittelstand companies,[64] which form the backbone of the German economy. 1997 was a landmark year for private equity in Germany.[65] Major corporations started spinning off underperforming businesses, while executives became more receptive to private equity buyouts.[66] The dot com bubble caused private equity activity in Germany to slow down considerably, but the market quickly picked up; between 2004 and 2007, the number of LBOs grew exponentially.[67] However, the German market was not immune to the Financial Crisis, which caused a substantial drop in German private equity activity.

While the U.S. and the U.K. were experiencing their LBO booms during the 1980s, private equity remained largely unknown in France for a better part of the decade. Certain buyout shops, including LBO France established in 1985, led the way and started utilizing the LBO model to take over small family businesses.[68] The private equity market in France grew substantially during the late 1980s and early 1990s, with a number of U.K. buyout firms opening offices in Paris.[69] However, it was not until the early 2000s that France experienced an LBO boom, fueled by the willingness of banks to lend, the rise of the junk bond market, and the flow of institutional investor funds into private equity.[70] Two of the

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worldbusiness/30iht-tdc.html?_r=1.

63. PAUL JOWETT & FRANCOISE JOWETT, PRIVATE EQUITY: THE GERMAN EXPERIENCE 75 (2011).

64. The term "Mittelstand" refers to family-owned small and medium-sized German businesses. *See* Brian Blackstone & Vanessa Fuhrmans, *The Engines of Growth*, WALL ST. J., June 26, 2011, http://online.wsj.com/article/SB10001424052748703509104576329643153915516.html.

65. JOWETT & JOWETT, *supra* note 63, at 300.

66. *Id.*

67. *Id.* at 426.

68. David Carey, *The Downstroke of PE in France*, DEAL MAG., Feb. 17, 2012, http://www.thedeal.com/magazine/ID/044719/features/the-downstroke-of-pe-in-france.php.

69. *Id.*

70. *Id.*

biggest buyouts in French history—the acquisition of a controlling block in PagesJaunes and the LBO of Rexel—were completed between 2006 and 2007.[71] Although the French market was not immune from the Financial Crisis, it is interesting to note that the French buyout market rebounded quickly and France still remains a dominant force in the European private equity market.

D. Sources of Value Creation in LBOs

After a buyout has been completed, private equity firms work alongside management to increase the value of the company and reap any profit generated by successfully exiting their investment via a trade sale, a secondary buyout, or a flotation. Various explanations have been offered for the sources of value creation in LBOs.

1. Corporate Governance Engineering

In their seminal book, *The Modern Corporation and Private Property*,[72] Berle and Means observed that separation of ownership and control plagued the modern publicly held corporation.[73] This separation creates an agency problem, as the interests of diffuse principal-shareholders and agent-managers often diverge.[74] Shareholders want to maximize the profit of the firm, while managers tend to be risk averse, prone to slack, and interested in maximizing the size of the firm.

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71. *See* Jason Singer, *France Télécom Will Sell Its Stake in Yellow Pages to KKR, Goldman*, WALL ST. J., July 24, 2006, http://online.wsj.com/article/SB115367846787314758.html?mod=home_whats_news_us; Peter Smith, *Rexel Picks Four Banks for Float*, FIN. TIMES, Oct. 7, 2006, http://www.ft.com/intl/cms/s/0/4361d36e-55a0-11db-acba-0000779e2340.html#axzz1yMhK70Mn.

72. ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).

73. *Id.* at 355; *see also* Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301 (1983).

74. REINIER H. KRAAKMAN ET AL., THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 22 (2004). This separation of ownership and control offers important benefits as well. Shareholders specializing in risk bearing are able to profit from business opportunities even though they lack managerial skills. All the same, managers without significant personal wealth can also pursue profitable ventures. *See* Eugene F. Fama & Michael C. Jensen, *Agency Problems and Residual Claims*, 26 J.L. & ECON. 327 (1983).

Agency costs[75] arise as a result. Private equity has been praised for applying governance mechanisms that reduce these costs.[76]

Private equity investors ensure an alignment of managerial and shareholder interests by giving management substantial ownership positions in portfolio companies through stocks and options. In addition, investors require the management team to invest a significant part of their personal wealth in the company. Executives in charge of running the company have a strong incentive to perform because they will profit heavily from any upside, but will also stand to lose part of their personal wealth in case of suboptimal performance.

Another mechanism that reduces agency costs is the highly indebted structure of companies acquired through LBO transactions. Michael Jensen has pointed out the agency costs generated by free cash flow;[77] for example, managers have an incentive to spend excess cash flow in negative present value projects. By issuing debt, managers are bonding their promise to pay out future excess cash flows instead of using them inefficiently. In addition, the threat of bankruptcy resulting from failure to meet interest and principal repayments motivates the management team to run the company efficiently.

After an LBO, the private equity investor will end up holding a majority stake in the target company. The creation of a large stakeholder provides both stronger incentives and more information to

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75. Jensen and Meckling define agency costs as the sum of (a) the costs incurred in monitoring the agents, which are borne by shareholders; (b) the bonding costs incurred by managers; and (c) the residual loss incurred due to divergence between the manager's decisions and the decisions that would maximize shareholder welfare. *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976).

76. Ronald W. Masulis & Randall S. Thomas, *Does Private Equity Create Wealth? The Effects of Private Equity and Derivatives on Corporate Governance*, 76 U. CHI. L. REV. 219, 227 (2009). However, one should note that governance engineering applies solely to publicly held corporations with a diffuse ownership structure. This corporate model is prevalent in the U.S. and U.K. On the contrary, corporations in Continental Europe are dominated by controlling shareholders that are able to effectively monitor management. Therefore, corporate governance engineering is unlikely to be a source of value creation in buyouts involving corporations in Continental Europe. *See* Ann-Kristin Achleitner et al., *Private Equity Acquisitions of Continental European Firms: The Impact of Ownership and Control on the Likelihood of Being Taken Private*, 19 EUR. FIN. MGMT. 72, 73–74 (2013).

77. Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. 323 (1986).

monitor management. In addition, the private equity investor will appoint its nominees to the company's board of directors and obtain majority control. The boards of private equity companies tend to be smaller and meet more frequently than those of public companies,[78] and are thus considered to be more effective. Unlike public boards, which are often preoccupied with governance and risk management, private equity boards are more focused on strategic leadership and value creation.[79]

2. Operational Engineering

In recent years, private equity firms have focused on what Steven Kaplan refers to as operational engineering.[80] By applying industry and operating expertise, they strive to improve the operating performance of portfolio companies. In order to achieve this improvement, private equity firms organize into industry groups and seek to recruit professionals with relevant operating and industry expertise. Indeed, these strategies have proven to be successful, as studies concerning different countries have found that buyouts result in significant operating improvements.[81]

3. Tax Savings

Apart from the beneficial use of debt in reducing agency costs associated with the use of free cash flow, debt also carries important tax

78. Francesca Cornelli & Oğuzhan Karakaş, Corporate Governance of LBOs: The Role of Boards 12 (May 23, 2012) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1875649.

79. Viral V. Acharya et al., *Private Equity vs. PLC Boards in the U.K.: A Comparison of Practices and Effectiveness*, J. APPLIED CORP. FIN., Winter 2009, at 45.

80. Kaplan, *supra* note 57, at 11.

81. In a study of U.S. public-to-private transactions during the 1980s, Kaplan found that the operating margin of portfolio companies increased by between 10% to 20% and cash flow margin increased by almost 40%. *See* Steven Kaplan, *The Effects of Management Buyouts on Operating Performance and Value*, 24 J. FIN. ECON. 217 (1989). In addition, Harris et al., in their study of management buyouts in the U.K., show that private equity-backed companies experienced a substantial increase in total factor productivity after the buyout. *See* Richard Harris et al., *Assessing the Impact of Management Buyouts on Economic Efficiency: Plant-Level Evidence from the United Kingdom*, 87 REV. ECON. STAT. 148 (2005).

benefits. The tax deductibility of interest generates tax shields. Kaplan shows that between 1980 and 1986, U.S. public-to-private transactions generated tax benefits equal to between 21% and 143% of the premium paid to pre-buyout shareholders.[82] LBOs have been particularly criticized for causing substantial tax losses to the state. However, Jensen et al. examines the effects of buyouts on tax revenues of the U.S. Treasury and finds that buyouts actually result in increased tax revenues.[83]

4. Wealth Expropriation from Other Stakeholders

Shleifer and Summers famously argued that wealth gains caused by LBOs are attributable to the breach of implicit contracts between a corporation and its employees.[84] Firms enter into implicit contracts with employees who, in exchange for lifetime employment, agree to lower wages. The firm can profit by breaching these implicit contracts and firing workers. LBOs have attracted strong criticism for reducing the number of employees in target companies.[85] However, various studies suggest that the effect of LBOs on employment is minimal. Davis et al. studied a sample of U.S. LBOs that took place between 1980 and 2005 and found that employment levels in target firms declined after

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82. Steven Kaplan, *Management Buyouts: Evidence on Taxes as a Source of Value*, 44 J. FIN. 611 (1989).

83. *See* Michael C. Jensen et al., *Effects of LBOs on Taxes Revenues of the U.S. Treasury*, 42 TAX NOTES 727 (1989). The sources of increased tax revenues are the capital gains taxes imposed on pre-buyout shareholders, taxes on interest income earned by creditors financing the transaction, and capital gains taxes resulting from asset sales following the buyout. Furthermore, LBO firms show an increase in operating income resulting in added tax revenues. Moreover, LBOs eliminate wasteful capital expenditures. The funds saved are returned to shareholders who can invest them in positive net present value projects, creating an additional source of tax revenues. The resulting increased revenues offset the tax losses generated by interest deductions and reduced dividends.

84. Andrei Shleifer & Lawrence H. Summers, *Breach of Trust in Hostile Takeovers, in* CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES 33, 53 (Alan J. Auerbach ed., 1988).

85. *See* Paul Krugman, Op-Ed., *All the G.O.P.'s Gekkos*, N.Y. TIMES, Dec. 9, 2011, at A39, *available at* http://www.nytimes.com/2011/12/09/opinion/krugman-all-the-gops-gekkos.html?_r=1.

buyouts.[86] However, target companies rapidly created new jobs at new establishments, so that the overall net job losses were less than 1% of the initial employment levels.[87] In another study concerning the impact of LBOs on employment in the U.K., Amess et al. found that private equity-backed acquisitions have no significant impact on wages and employment.[88]

Another common explanation for the source of gains in private equity-backed acquisitions is that they expropriate value from pre-buyout bondholders through a large increase in the debt of the target company. However, the evidence does not support this view. Even though pre-existing bonds' ratings are often downgraded after a leveraged buyout, the value of the bonds does not actually decrease.[89]

II. THE FINANCING AND STRUCTURING OF PUBLIC-TO-PRIVATE TRANSACTIONS IN THE U.S. AND EUROPE

A. SOME DIFFERENCES IN FINANCING PUBLIC-TO-PRIVATE TRANSACTIONS IN THE U.S. AND EUROPE

1. The Certain Funds Requirement

A public-to-private deal is mostly financed by debt. A bank's commitment to lend is usually made at the time the acquisition agreement is signed or the bid is launched, while the actual funding happens at the closing of the transaction. This period between signing and closing can be particularly long, especially in cases where antitrust or other regulatory approvals are required. The circumstances of a lender may thus change after a commitment to lend is made, which leads to heavy negotiations between lenders and borrowers about conditions

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86. Steven J. Davis et al., *Private Equity and Employment* 31-34 (U.S. Census Bureau Ctr. for Econ. Studies, Working Paper No. CES-WP-08-07R, 2011), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1107175.

87. *Id.*

88. Kevin Amess et al., *What are the Wage and Employment Consequences of Leveraged Buyouts, Private Equity and Acquisitions in the U.K.?* 17 (Nottingham Univ. Bus. Sch. Research Paper Series No. 01, 2008), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1270581.

89. *See* Laurentius Marais, Katherine Schipper & Abbie Smith, *Wealth Effects of Going Private for Senior Securities*, 23 J. FIN. ECON. 155, 159 (1989).

precedent to funding. An essential difference between U.S. and European acquisition finance is the "certain funds" requirement prevalent in most European jurisdictions. The purpose of the certain funds requirement is to preclude highly conditional and speculative offers. The U.K. City Code on Takeovers and Mergers ("Takeover Code"),[90] which governs takeovers of U.K. public companies, was the first to introduce the certain funds requirement. A majority of European jurisdictions have followed the U.K. approach and introduced the requirement as well. General Principle 5 of the Takeover Code provides that "[a]n offeror must announce a bid only after ensuring that he/she can fulfill in full any cash consideration."[91] Accordingly, Rule 24.8 provides that when an offer is for cash,[92] the offer document must include "confirmation" by the offeror's bank or financial adviser that sufficient resources are available to the offeror to satisfy acceptance of the offer.[93] Financial advisers will thus have to ascertain that the bidder has adequate cash to implement the offer.

In order to satisfy the certain funds requirement, the lending bank cannot impose onerous funding conditions on the offeror to provide the bank an escape hatch to funding. Yet, lenders are able to refuse the disbursement of funds for a limited set of conditions; current market practice is that lenders can deny funding only in cases of illegality or for matters that are solely within the control of the bidder.[94] For instance, banks are not able to refuse the advancement of funds in the case of a "material[ly] adverse change in the target group."[95] To satisfy the certain funds requirement, the bidder and the lender must enter into a signed loan agreement at the time the offer is announced or the agreement signed.[96] Commitment letters or heads of terms agreements,

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90. THE CITY CODE ON TAKEOVERS AND MERGERS (10th ed. 2011) (U.K.), *available at* http://www.thetakeoverpanel.org.uk/wp-content/uploads/2008/11/code.pdf [hereinafter TAKEOVER CODE].

91. *Id.* § B.5.

92. This is always the case in private equity acquisitions since the bidder will want to ensure that target shareholders do not participate in the post-acquisition company.

93. TAKEOVER CODE, *supra* note 90, at § I(24.8).

94. John D. Markland, *How Certain Can You Get?*, FINANCIER WORLDWIDE, April 2007.

95. *Id.*

96. *See When Will a Commitment Letter Constitute a Firm Commitment? Some Thoughts on the Clear Channel Litigation from a U.K. Perspective*, FINANCING BRIEFING (Slaughter & May), July 2008, at 1, 2.

which are commonplace in U.S. acquisition finance, will not suffice under the certain funds requirement.

Banks in the U.S. are accustomed to insisting on a broad range of funding conditions as part of the negotiation between the lender and the acquirer. Nonetheless, in recent years, U.S. banks have been "willing to provide more certain financing terms."[97]

The buyout of SunGard Data Systems significantly changed the structure of private equity deals.[98] Under the SunGard approach, private equity bidders no longer have a financing condition in the purchase agreement, meaning they are obligated to fund the acquisition even if financing is not available. However, purchasers now insist that the conditions to funding in the commitment letter are reciprocal to those in the acquisition agreement. By aligning the conditions in the debt commitment letter with the ones in the acquisition agreement, the purchaser is protected from the possibility of having to complete the acquisition even though the lenders are excused from performance.

The certain funds requirement imposed by European countries obligates banks to provide financing for a transaction, subject only to limited funding conditions. As a result, banks are forced to bear the risk of market deterioration between the time that the acquisition agreement is signed or the offer launched, and the closing of the transaction. Therefore, banks are likely to demand compensation for this additional risk by charging a higher interest rate on the funds lent. As a result, the transaction will have to be funded with more expensive debt, diminishing the returns of private equity bidders.

2. Debt Subordination

The financing package of a public-to-private transaction involves different types of debt. A typical public-to-private transaction will be financed with senior bank debt, as well as one or both of mezzanine or high-yield debt. Junior debt, namely mezzanine debt and high-yield, is subordinated to senior bank debt. A crucial difference between U.S. and European acquisition finance is the means by which such subordination is achieved. While subordination in the U.S. is achieved contractually,

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97. David J. Sorkin & Eric M. Swedenburg, *Recent U.S. Deals Depart from Traditional Financing*, INT'L FIN. L. REV., Jan. 2006, at 103.

98. *See* Davidoff, *The Failure of Private Equity*, *supra* note 58, at 495.

uncertainty regarding the enforceability of contractual subordination in Europe has obliged legal practitioners to effect such subordination structurally.

In a U.S. public-to-private deal, the various categories of debt are loaned to a single entity and debt holder priority is determined by an intercreditor agreement. A common subordination provision is the prohibition of payments to junior creditors in case of a payment default on senior debt. Only once this payment default is cured or waived may the borrower resume making payments to junior creditors. Furthermore, in case of any other breach of a senior obligation such as a breach of a covenant, the senior lenders have the right to prohibit the borrower from making any payments to junior creditors for a period of time, usually 179 days.[99] Unless the senior creditors elect to accelerate their indebtedness, the issuer will resume payments on the bonds after the passage of this period of time.

In Europe, subordination is achieved structurally. Junior creditors will extend financing to a parent company with no assets other than shares in operating subsidiaries. Senior lenders will make their loans to operating subsidiaries with title to business assets, and thus benefit from collateral on these assets. As a result, if the parent and its subsidiaries both become insolvent, the junior creditors' recovery will be limited to any amounts paid as distribution on the equity of the parent company. Junior creditors' claims will be effectively subordinated to the senior lenders' claims against the subsidiaries holding the underlying business assets. A major shortcoming of structural subordination is the fact that junior creditors' claims will also be subordinated to the claims of the subsidiary's other creditors, such as trade creditors.

Structural subordination of debt has given rise to one of the most rigorous debates in European acquisition finance. In 2002, European high-yield investors threatened to boycott future high-yield debt offerings.[100] These investors felt vulnerable because of their weak bargaining position in case of insolvency, which was attributable to the structural subordination of their claims as well as weak recovery rates

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99. William J. Wheelan, III, *Bond Indentures and Bond Characteristics, in* LEVERAGED FINANCIAL MARKETS: A COMPREHENSIVE GUIDE TO HIGH-YIELD BONDS, LOANS AND OTHER INSTRUMENTS 171, 175 (William F. Maxwell & Mark R. Shenkman eds. 2010).

100. Richard A. Ginsburg, *European High Yield- Bondholder Insubordination,* PRIVATE EQUITY ALERT (Weil, Gotshal & Manges), Apr. 2004, at 1.

on defaulted bonds. This threat materialized in the 2003 high-yield offering for the acquisition of LeGrand, a French industrial group.[101] High-yield investors demanded guarantees from operating subsidiaries, and then boycotted the issue when the company rejected their demand. The issue was eventually brought to the market, but at a higher interest rate. The LeGrand issue forced market participants to reevaluate the financing structure of European leveraged buyouts. After LeGrand, granting credit support in the form of guarantees from the operating subsidiaries of the high-yield borrower became the norm in European high-yield issuances[102]

The European market practice of structurally subordinating the claims of various debt categories requires specialist legal advice. Such specialists would be expected to advise on the formation of different corporate entities, as well as complex negotiations between senior lenders and high-yield bondholders demanding credit support to improve their ranking in case of borrower insolvency. As a result, significant transaction costs often arise for parties structuring private equity transactions in Europe.

3. Ban on Financial Assistance

The European Second Council Directive of December 13, 1976 ("Second Directive") [103] introduced the legal capital doctrine, the mandatory rules which seek to protect creditors from shareholder opportunism.[104] The Second Directive obligates Member States of the European Union to impose a minimum capital requirement on companies, restrict shareholder distributions such as dividend payments and share-buybacks, and ban a target company from granting financial

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101. Bryant Edwards, *Innovation Fuels Europe's High-yield Market*, INT'L FIN. L. REV. Mar. 2005, at 28, 31.

102. *Id.*

103. Second Council Directive 77/91,1976 O.J. (L 26) (EC) [hereinafter Second Council Directive].

104. Shareholders may "benefit themselves at the expense of the creditors in a number of ways." GULLIFER & PAYNE, *supra* note 48, at 116. For example, they may withdraw assets from the firm by making distributions to themselves (asset diversion); authorize additional debt in such a way as to increase the risk profile of the firm and limit the pre-existing creditors' recovery (claim dilution); or abandon projects with a positive net value that only benefit debt holders (underinvestment). *See id.*

assistance for the purpose of acquiring its own shares.[105] The mandatory nature of the Second Directive is in sharp contrast to the U.S. approach to creditor protection. In the U.S., creditors protect themselves from exploitation using contract law, not corporate law.[106]

Article 23 of the Second Directive is of utmost importance for public-to-private transactions. Article 23 prohibits public companies from granting financial assistance to third parties for the acquisition of the public companies' shares, through the provision of loans or security over their assets.[107] Some criticize this prohibition for impeding buyout transactions in situations where the bidder intends to use the target's assets to secure debt necessary to finance the acquisition. However, these financial assistance rules are designed to prevent asset-stripping takeovers and protect pre-existing creditors from the risks that LBOs pose by incurring additional debt.[108] Directive 2006/68/EC, which amended the Second Directive, relaxed the prohibition on financial assistance and permitted it subject to the fulfillment of certain requirements, such as the ex ante approval of the transaction by shareholders, the occurrence of the transaction at fair market conditions, and the investigation of the third party's credit standing.[109] However,

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105. A detailed examination of the Second Directive is beyond the scope of this article. For an overview of the Directive and related criticism, see generally Luca Enriques & Jonathan R. Macey, *Creditor Versus Capital Formation: The Case Against the European Legal Capital Rules,* 86 CORNELL L. REV. 1165 (2001).

106. *See id.* at 1173. The U.S. approach can be seen as a manifestation of the contractual theory of the firm. According to this prevalent American economic theory, the firm is viewed as a "nexus of contracts" among participants in the organization such as shareholders, employees, and creditors. These participants should be allowed to structure their relations, as they desire. Mandatory rules are seen as an intrusion on the freedom to contract. Thus, the state's role should be limited to enforcing these contracts and providing default rules that the parties can alter. *See generally* R. H. Coase, *The Nature of the Firm,* 4 ECONOMICA 386 (1937); Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization,* 62 AM. ECON. REV. 777 (1972); FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW (1996); Steven N. S. Cheung, *The Contractual Nature of the Firm*, 26 J.L. & ECON. 1 (1983).

107. *See* Second Council Directive 77/91, art. 23, 1976 O.J. (L 26) 1, 8.

108. *See* John Armour, *Share Capital and Creditor Protection: Efficient Rules for a Modern Company Law*, 63 MOD. L. REV. 355, 368–69 (2000).

109. Council Directive 2006/68/EC of the European Parliament and of the Council of 6 September 2006 amending Council Directive 77/91/EEC regarding the formation of public limited liability companies and the maintenance and alteration of their capital, art. 1, 2006 O.J (L 264) 32, 33–35.

this relaxation has proven pointless, since a private equity bidder is still deterred by the costs and time associated with meeting these requirements.

Despite the ban on financial assistance, Europe has seen a remarkable rise in LBO activity, indicating that the prohibition lacks bite.[110] In particular, when structuring private equity transactions, private equity bidders and target companies are able to exploit the fact that private companies are outside the reach of the ban. Thus, the main technique developed to evade financial assistance rules in the U.K.[111] and Germany[112] is to convert a public company into a private one before granting security over the target's assets. Nonetheless, certain national legislatures have extended the ban to cover private companies as well. Both Spain and Italy prohibit the granting of financial assistance by both public and private companies.[113] As a result, private equity bidders in these countries rely on exemptions from merger restrictions in order to complete buyouts.[114] In Spain, scholars' and practitioners' opinions have spurred the development of an exemption for buyouts structured as mergers,[115] while Italian legislators have introduced Article 2501 *bis* Cod. civ., which explicitly allows merger LBOs subject to the fulfillment of certain conditions.[116] France, another important European private equity market, has adopted an absolute ban on financial

110. Luca Enriques, *EC Company Law Directives and Regulations: How Trivial Are They?*, 27 U. PA. J. INT'L ECON. L. 1, 39 (2006).

111. Pursuant to section 678 of the Companies Act of 2006, the law on financial assistance is applicable solely to public companies. *See* Companies Act, 2006, c. 46, § 678 (U.K.).

112. The German Stock Corporation Act prohibits any form of financial assistance by the company to a third party for the purpose of acquiring shares in the company. *See* Aktiengesetz [AktG] [Stock Corporation Act], Sept. 6, 1965, BGBL. I at 1089, § 71(a) (Ger.), *available at* http://www.nortonrose.com/files/german-stock-corporation-act-2010-english-translation-pdf-59656.pdf. A similar ban does not exist in case of German private limited companies (GmbH).

113. *See* Eilís Ferran, *Regulation of Private Equity-Backed Leveraged Buyout Activity in Europe* 23 n.110 (Eur. Corp. Governance Inst., Working Paper No. 84, 2007), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=989748.

114. *See id.* at 23.

115. *See id.*

116. *See* Marco Silvestri, *The New Italian Law on Merger Leveraged Buy-Outs: A Law and Economics Perspective*, 6 EUR. BUS. ORGANIZATIONAL L. REV. 101, 111–12 (2005).

assistance by both public and private companies.[117] There, private equity investors rely on post-acquisition dividends paid by the target in order to service the debt incurred to complete the buyout.[118]

A similar ban on financial assistance does not exist in the U.S, where creditors are protected against opportunistic buyouts by federal and state fraudulent conveyance laws.[119] Following a wave of bankruptcies of companies that had been taken private during the 1980s, trustees representing the interests of creditors used fraudulent conveyance laws to invalidate these buyouts.[120] The U.S. Bankruptcy Code, the Uniform Fraudulent Conveyance Act ("UFCA"), and its successor, the Uniform Fraudulent Transfer Act ("UFTA")' protect creditors against actual and constructive fraud on both federal and state levels.[121] Due to the difficulty of proving intent to defraud, which is a necessary element of actual fraud, LBOs are usually attacked on the basis of constructive fraud.[122]

For a court to determine that there has been constructive fraud, either the trustee in bankruptcy or the creditors must satisfy a two-pronged test. If the Bankruptcy Code or UFTA[123] applies, the first prong requires the plaintiff to show that the transfer was not made for a reasonably equivalent value.[124] If the UFCA is invoked, the plaintiff must show that the transfer was not made for fair consideration.[125] In the context of a leveraged buyout, it can be argued that the target never received fair consideration or reasonably equivalent value, since the target provides security for the benefit of the lender, while the proceeds of the loan will pass to the target's selling shareholders. As a result, the target will have extended security over its assets without receiving anything in return. The second prong requires the target company to be

117. *See* Ferran, *supra* note 113, at 24.

118. *See id.*

119. Kevin J. Liss, Note, *Fraudulent Conveyance Law and Leveraged Buyouts*, 87 COLUM. L. REV. 1491, 1495–96 (1987).

120. *See* Silvestri, *supra* note 116, at 118.

121. The Uniform Fraudulent Conveyance Act or the Uniform Fraudulent Transfer Act has been adopted by most U.S. states. States that have not adopted a uniform act address fraudulent conveyance either in non-uniform statutes or common law.

122. Liss, *supra* note 119, at 1495–96.

123. UNIF. FRAUDULENT TRANSFER ACT §§ 4(2), 5(a) (1984) [hereinafter "U.F.T.A."].

124. 11 U.S.C. § 548(a)(1)(B)(i) (2006).

125. UNIF. FRAUDULENT CONVEYANCE ACT § 3 (1918) ["hereinafter U.F.C.A."].

one of the following: insolvent at the time of the transaction, rendered insolvent by the transaction,[126] left with unreasonably small capital,[127] or the debtor intended to incur, or believed he would incur, debts beyond his or her ability to pay (if the UFCA applies, the standard is 'reasonably should have believed').[128] Once a court determines that there has been a fraudulent conveyance, the consequences can be severe. For instance, the court can order the avoidance or subordination of the lender's claims, the recovery from the lender of any loan repayments, and the recovery from the target's old shareholders of any proceeds received from the sale of their stock to the private equity bidder.[129]

When comparing the U.S. and E.U. approaches to LBOs, it becomes clear that there is a remarkable divergence.[130] The E.U. adopts an ex ante general ban on LBOs, considering LBO transactions to be a form of financial assistance, while the U.S. prefers an ex post standard. In addition, legal intervention in the U.S. is exceptional in the sense that LBOs may be attacked on grounds of fraudulent conveyance only in cases of bankruptcy or insolvency. Thus, parties structuring LBO transactions in Europe are faced with additional transaction costs generated by the E.U.-wide ban on financial assistance and the relevant rules promulgated by national legislatures. Costly legal advice is necessary to ensure compliance with both national rules and local market practices. In addition, the outright ban on financial assistance impedes the functioning of the market for corporate control[131] and has an important signaling effect. It signals European legislators' hostility towards LBOs, which still have not gained the widespread acceptance that they enjoy in the U.S.[132]

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126. 11 U.S.C. § 548(a)(1)(B)(ii)(I); U.F.T.A. § 5(a); U.F.C.A. § 4.

127. 11 U.S.C. § 548(a)(1)(B)(ii)(II); U.F.C.A. § 5. The applicable test under the U.F.T.A. is whether "the remaining assets of the debtor were unreasonably small in relation to the business or transaction." U.F.T.A. § 4(a)(2)(i).

128. 11 U.S.C. § 548 (a)(1)(B)(ii)(III); U.F.T.A. § 4(a)(2)(ii); UFCA § 6.

129. Robert A. Fogelson, Toward a Rational Theory of Fraudulent Conveyance Cases involving Leveraged Buyouts, 68 N.Y.U. L. Rev. 552 (1993), 581-586.

130. *See* Silvestri, *supra* note 116, at 120.

131. Enriques & Macey, *supra* note 105, at 1197–98.

132. For instance, Poul Nyrup Rasmussen, former Prime Minister of Denmark, openly criticized LBOs for saddling companies with debt and compromising workers' rights. *See generally* Poul Nyrup Rasmussen, *Taming the Private Equity 'Locusts'*, THE GUARDIAN, Apr. 10, 2008, http://www.guardian.co.uk/commentisfree/2008/apr/10/tamingtheprivateequitylo.

B. STRUCTURING PUBLIC-TO-PRIVATE TRANSACTIONS IN THE U.S. AND EUROPE

1. Structuring Public-to-Private Transactions in the U.S.

A public-to-private transaction in the U.S. can be structured as either a one-step merger or a tender offer[133] followed by a back-end merger.[134] In a one-step merger, also known as a long-form merger, section 251 of the Delaware General Corporation Law ("DGCL") dictates that the board of directors of each corporation must approve the merger and submit the merger agreement to a stockholder vote.[135] Prior to the shareholder meeting, a merger proxy must be submitted for review to the Securities and Exchange Commission ("SEC"), and once cleared, it is mailed to the shareholders.[136] Thus, the process to complete a one-step merger is particularly long and typically requires a period of between two and three months.

A tender offer followed by a short-form merger is the quickest way for a private equity buyer to complete an acquisition. Pursuant to Rule 14e-1 of the Securities and Exchange Act of 1934, a tender offer must be open for at least 20 business days.[137] If the bidder acquires more than 90% of the target's shares, it can effectuate a short-form merger[138] and close the transaction in as few as 20 days. However, if the acquirer fails

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133. A tender offer is a public and open offer to all the shareholders of a public company to tender their shares for sale. Tender offers are regulated by the Williams Act of 1968, Pub L. No. 90-439, 82 Stat. 454 (codified as amended at 15 U.S.C. §§ 78*l*–78n (2006)), which amended the Securities Exchange Act of 1934.

134. For the purpose of this article, we are assuming that both the bidder and the target are incorporated in Delaware, the preferred state of incorporation for the majority of U.S. public companies. Delaware's competitive advantages are a developed body of statutory law (The Delaware General Corporation Law), network and learning externalities flowing from wide use of Delaware corporate law, a highly specialized court system and Delaware's commitment to shaping its law according to the needs of its corporations. *See generally* Ehud Kamar, *A Regulatory Competition Theory of Indeterminacy in Corporate Law*, 98 COLUM. L. REV. 1908 (1998).

135. At least 51% of shareholders of both the acquirer and target must approve the transaction. *See* DEL. CODE. ANN. tit. 8, § 251(c) (2010).

136. *See* 17 C.F.R. §§ 240.14a-3, 240.14a-6 (2012).

137. 17 C.F.R. § 240.14e-1.

138. According to section 253 of the Delaware General Corporation Law, a short-form merger requires only a resolution of the board of directors of the acquirer. A vote of the target shareholders or a resolution of the board of directors of the target company is not required. *See* DEL. CODE. ANN. tit. 8, § 253(a) (2010).

to reach the 90% threshold, the bidder will have to complete a back-end merger under section 251 of the DGCL and such timing benefits will be lost. The latest innovation seeking to remedy this shortcoming is the top-up option, which is increasingly used.[139] A top-up option gives the acquirer the right to purchase newly issued shares of the target upon receiving a certain minimum of the target's shares (usually 51%) in a tender offer. This allows the acquirer to obtain a 90% ownership stake, at which point it can complete a short-form merger.

A major drawback of tender offers is the implication of the margin rules, which are regulations promulgated by the Board of Governors of the Federal Reserve System. Regulations U and X[140] limit the ability of banks to extend financing for the purpose of acquiring margin stock secured directly or indirectly by the margin stock.[141] The margin rules limit the amount banks can loan to 50% of the value of the collateral, namely the value of margin stock. Nonetheless, these rules are not involved in either a one-step merger or a tender offer followed by a short-form merger. In a one-step merger, the debt extended to finance the acquisition is secured by the target's assets and not by margin stock. Furthermore, in a tender offer followed by a short-form merger, if the bidder acquires above 90% of the target's stock and therefore is able to complete a short-form merger, the merger will happen at the same time as the conclusion of the tender offer. Therefore, the loans will be considered secured by the target's assets. On the contrary, if the bidder does not succeed in obtaining 90% of the target's stock and therefore cannot complete a short-form merger, the bidder will be required to perform a long-form back-end merger months after the front-end tender offer. During that period, the only assets available to secure the loans will be the shares acquired in the tender offer, namely margin stock. As a result, the financing will be limited to 50% of the value of that margin stock. The margin rules have historically been a major impediment to structuring private equity transactions as tender offers.

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139. Steven M. Davidoff, *Behind the Growing Number of Tender Offers*, DEALBOOK (Oct. 14, 2010, 3:16 PM), http://dealbook.nytimes.com/2010/10/14/behind-the-growing-number-of tender-offers.

140. 12 C.F.R. §§ 221, 224 (2012).

141. Margin stock includes any security that is publicly-traded.

2. Structuring Public-to-Private Transactions in Europe

The structure of public-to-private deals in Europe depends upon the mechanisms offered by the legal regimes of individual European countries. The mergers and acquisitions landscape in Europe remains particularly fragmented, with considerable divergence between each nation's rules. Differing national rules necessitate extensive and costly legal advice by local lawyers. Such transaction costs for private equity bidders inhibit the creation of a Pan-European buyout market.

a. Merger Structures in Europe

It is common for all European countries to offer a framework for carrying out a merger. Nonetheless, European countries impose certain onerous requirements, making this structure particularly unattractive for parties involved in a public-to-private transaction. This is in contrast to Delaware, which offers a relatively straightforward and simple procedure for effecting mergers tailored to the needs of private equity bidders. Our discussion relating to the relevant rules will be limited to the U.K., Germany, and France, which account for the majority of private equity activity in Europe.

In the U.K., private equity bidders utilize a form of corporate reconstruction known as a "scheme of arrangement."[142] Schemes of arrangements in private equity transactions are structured as "cancellation schemes" in which the target cancels all of its issued shares and new shares are issued to the private equity bidder.[143] Target shareholders then receive cash in exchange for their cancelled shares. Such a scheme requires the approval of 75% of target shareholders in value with a majority of the shareholders present and voting at the

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142. A "scheme of arrangement" resembles a merger structure in the sense that it allows a bidder to obtain full control of the target company. *See* Scheme of Arrangement, Practical Law Company (2013), http://uk.practicallaw.com/0-107-7201. The provisions for completing a scheme of arrangement are found in Part 26 of the Companies Act of 2006. The Companies Act, 2006, c. 46, is the main statute that regulates U.K. public and private companies.

143. A "cancellation scheme" involves a reduction of capital and therefore requires the target to comply with the relevant provisions of the Companies Act 2006. According to the Companies Act 2006, a reduction of capital requires a shareholder resolution and a court order. *See* Companies Act, 2006, c. 46, §§ 645–649.

meeting,[144] and must additionally be sanctioned by the court.[145] Schemes of arrangement are beneficial due to their binding effect on shareholders who voted against the scheme or abstained from voting, allowing the private equity investor to obtain full control of the target. However, the high shareholder approval threshold and the requirement for sanction by a court create considerable uncertainty to the consummation of the transaction.

German law also provides for a statutory merger procedure (*Verschmelzung)*. In a German statutory merger,[146] the shareholders of the target company merging into the private equity acquirer receive shares from the bidder in exchange for their own shares. A court-appointed auditor must examine the adequacy of the exchange ratio.[147] The shareholders of both the acquirer and target company, representing at least 75% of the share capital present, must approve the merger.[148] The statutory merger takes effect upon the filing of the merger resolutions with the companies' registrars.[149] Shareholders may challenge the merger resolution and thereby block the entry of the resolution in the register.[150] In addition, creditors may demand security from the surviving company for any debts that are insufficiently backed.[151] Statutory mergers are rarely used in private equity transactions, mainly because the private equity bidder will not want target shareholders to be part of the post-acquisition company. Furthermore, the aforementioned shareholder and creditor rights

144. *Id.* § 899(1). The shareholders' meeting requires a court order in order to be convened. *See id.* § 896.

145. *Id.* § 899(2). The court will sanction the scheme after determining that the statutory scheme has been adhered to, the meeting has been held properly and the proposal for the scheme submitted to the shareholders is such that an intelligent and honest man, a member of the class concerned and acting in respect of his interest, might reasonably approve. *See Re* Nat'l Bank Ltd., [1966] 1 W.L.R. 819 (Eng.).

146. The statutory merger is regulated by the German Transformation (or Reorganization) Act (Umwaldungsgesetz or UmwG). *See* Umwaldungsgesetz [UmwG] [Transformation Act], Oct. 28, 1994, Bundesgesetzblatt [BGBl.] I (Ger.).

147. *Id.* at 3210, §§ 9–12, 60.

148. *Id.* § 65(1).

149. *Id* § 16(1). The commercial register is the German public authority responsible for approving the incorporation and keeping a registry of all companies incorporated in its territory.

150. *Id*. § 14.

151. *Id*. § 22.

introduce an element of legal uncertainty, which is unacceptable for private equity bidders eager to quickly complete acquisitions of promising companies.

A unique feature of the German legal system is the domination and profit or loss transfer agreement.[152] Under this agreement, one company (the dominated company) submits itself to the direction of another company (the dominating company). The dominating company may give legally binding instructions to the dominated company.[153] The dominated company's profits are transferred to the dominating company, but the dominating company must compensate the dominated company for any annual losses.[154] A domination and profit or loss transfer agreement must be approved by 75% of the dominated company's shareholders.[155] If the dominating company is a public company, an approval by a similar majority is required.[156]

In the German private equity market, a bidder will first launch a public takeover offer for all of the target company's shares. After the bidder succeeds in acquiring 75% of the target's shares, they can vote in favor of the domination and profit and loss agreement. However, to protect the dominated company's minority shareholders from exploitation, German law requires the dominating company to offer to acquire its own shares at fair market value as well as guarantee a minimum dividend to minority shareholders who elect to stay in the dominated company and not tender their shares.[157]

In France, the legal system offers a statutory merger procedure known as a *fusion*.[158] A French statutory merger involves an exchange of shares whereby target shareholders exchange their own shares for

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152. A domination and profit or loss transfer agreement resembles a merger procedure insofar as it allows the bidder to obtain complete control of the target. It is widely used in private quity transactions. For example, Blackstone Group employed a domination and profit or loss transfer agreement in its buyout of Celanese.

153. Aktiengesetz [AktG] [Stock Corporation Act], Sept. 6, 1965, BGBL. I at 1089, § 291(1) (Ger.), *available at* http://www.nortonrose.com/files/german-stock-corporation-act-2010-english-translation-pdf-59656.pdf.

154. *Id.*

155. *Id.* § 293(1).

156. *Id.* § 293(2).

157. *Id.* §§ 304, 305.

158. Statutory mergers (*fusions*) between public companies incorporated in France (denoted by the label "S.A.") are regulated by arts. L.236-8 to 236-22 of the French Commercial Code, Code de Commerce.

shares in the bidder.[159] As mentioned above, this requirement is particularly unattractive for private equity acquirers. Furthermore, both the bidder's and target's shareholders must approve the merger by a majority vote of 75%.[160] Additionally, French law requires the appointment of one or several merger auditors (*commissaires à la fusion),* designated by the Chief Judge of the Commercial Court, who ensure that the valuation of the relevant companies' shares is appropriate and the exchange ratio is fair.[161] Creditors of both companies can also oppose the merger plan in a court proceeding. The Commercial Court may approve or reject the opposition. However, even in the case that the opposition is rejected and the merger is allowed to proceed, the court can order the repayment of the debt or the constitution of guarantees, if offered by the absorbing company. The strictness of the French law governing statutory mergers can be seen as a manifestation of the heavy-handed social control over business that characterizes the French legal system.[162]

b. Takeover Offers in Europe

The takeover offer is an alternative mechanism that is widely used by private equity bidders in order to complete public-to-private deals in Europe. In a private equity transaction, the bidder will typically launch a voluntary takeover offer for all the shares of the target company. Since a bidder rarely succeeds in obtaining 100% of the target's share capital, it will attempt a statutory procedure called a "squeeze-out".[163] In a squeeze out, the bidders seek to acquire enough shares to meet the threshold required by national rules, at which point the bidder can force the minority shareholders to sell their shares.

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159. These are known as statutory mergers by absorption (*fusion-absorption*).

160. CODE DE COMMERCE [C. COM.] art. L.236-9 (Fr.), *available at* http://www.legifrance.gouv.fr/Traductions/en-English/Legifrance-translations.

161. C. COM. art. L.236-10.

162. Rafael La Porta et al., *The Economic Consequences of Legal Origins*, 46 J. ECON. LITERATURE 285, 307 (2008).

163. The term "squeeze-out" refers to a statutory procedure whereby a bidder who has acquired a certain percentage of shares (the relevant percentage varies between Member States) is able to require the remaining minority shareholders to sell their shares in return for consideration.

A major impediment to private equity bidders structuring deals as takeover offers is the divergence of national takeover regimes within the European Union. In an effort to create a harmonized takeover regime, lower the costs of takeovers, and promote takeover activity in the European Union, the E.U. adopted Directive 2004/25/EC of the European Parliament and of the Council of April 21, 2004, on takeover bids ("Takeover Directive").[164] The legislative process lasted fifteen years and was marked by heated negotiations and intense lobbying of individual European countries.[165] This was especially true for Germany, which viewed the liberal takeover regime promoted by the Takeover Directive as a threat to its closed and consensual corporate system, commonly referred to as *Deutschland AG*.[166] The resulting Directive establishes a common framework for takeover bids in the E.U. and sets minimum requirements that must be followed by individual Member States. The relevant rules apply to takeover offers[167] for shares of listed companies.[168]

The Takeover Directive requires bidders to announce their decision to make a bid without delay and to prepare an offer document containing enhanced disclosures that will be made publicly available. This promotes market transparency and enables target shareholders to make

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164. Directive 2004/25/EC, of the European Parliament and of the Council of 21 April 2004 on Takeover Bids, 2004 O.J. (L 142) 12.

165. Nigel Waddington, The Europeanisation of Corporate Governance in Germany and the U.K. 14 (June 2004) (unpublished manuscript), *available at* http://aei.pitt.edu/6119/.

166. *Id.*

167. According to article 2(1)(a) of the Takeover Directive, a takeover bid is defined as "a public offer . . . made to the holders of the securities of a company to acquire all or some of those securities, whether mandatory or voluntary, which follows or has as its objective the acquisition of control of the offeree company in accordance with national law." Parliament and Council Directive 2004/25, art. 2(1)(a), 2004 O.J. (L 142) 12, 15 (EC).

168. Since the Directive establishes only minimum requirements, Member States are allowed to introduce more stringent provisions. *Id.*, art. 3(2), at 16. Additionally, Member States are able to extend the application of their national takeover legislation to non-listed companies. A prominent example is the U.K. Takeover Code, which applies to takeovers for both listed and non-listed public companies. Subject to certain conditions being fulfilled, the Takeover Code also applies to private companies. *See* TAKEOVER CODE, *available at* http://www.thetakeoverpanel.org.uk/the-code/download-code.

informed decisions.[169] The target board should also prepare a public document setting forth its opinion on the bid.[170] All of the target company's shareholders must be treated equally[171] and offered the highest offer price.[172] Furthermore, in order to allow target shareholders to properly evaluate the takeover offer, Member States are required to provide a sufficient time period for the acceptance of the bid, ranging from two to ten weeks.[173] By setting a floor on the acceptance period, the Takeover Directive protects target shareholders from so-called "Saturday Night Specials."[174]

The most innovative and controversial rules of the Takeover Directive are the mandatory bid rule, the board neutrality rule, the break-through rule, and squeeze-out and sell-out rights. The mandatory bid rule obligates a bidder who acquires a specified percentage of voting rights in a target company, and is granted control over that company, to make an offer to purchase the entire company at an equitable price.[175] Thus, bidders are prevented from launching highly coercive partial bids and front-end loaded bids.[176] In addition, the rule protects minority shareholders by ensuring that they will share any control premium along with any controlling shareholder that sells his stake. Member States are

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169. Parliament and Council Directive 2004/25, arts. 6(2), 8, 2004 O.J. (L 142) 12, 18–19 (EC).

170. *Id.*, art. 9(5), at 19.

171. *Id.*, art. 3(1)(a), at 15.

172. *Id.*, art. 5(4), at 17.

173. *Id.*, art. 7, at 18.

174. A "Saturday Night Special" is a coercive takeover offer open for a very short period of time, usually a few days. Target shareholders are pressured to quickly accept or decline the offer without having sufficient time to properly evaluate it. This technique was widely used in the U.S. in the early 1970s.

175. Parliament and Council Directive 2004/25, art. 5(1), 2004 O.J. (L 142) 12, 17 (EC).

176. In a partial bid, target shareholders will be pressured to tender their shares out of fear that they will be left with low value minority shares in a company controlled by a new shareholder. A "front-end loaded" bid creates the same pressure for shareholders to tender their shares. In a "front-end loaded" bid, the bidder will launch an initial partial bid at a high premium in order to gain effective control of the target company and will simultaneously indicate its intention to launch a "back-end" offer for the remaining shares at a reduced price. Therefore, shareholders are pressured to tender their shares at the initial bid even if they view the rejection of the bid as the value-maximizing choice. *See generally* Lucian A. Bebchuk, *The Pressure to Tender: An Analysis and a Proposed Remedy*, 12 DEL. J. CORP. L. 911 (1987).

responsible for determining the requisite percentage of voting rights that triggers a mandatory bid. Another area where discretion is afforded to Member States is the ability to waive the application of the mandatory bid rule in individual cases.[177]

In contrast with the U.S. approach that provides management with broad latitude to defend against takeovers, the Takeover Directive, incorporating the principle of shareholder choice, prohibits target management from erecting pre- or post-bid takeover defenses.[178] The board neutrality rule prevents the board of the target company from taking any action to frustrate a takeover bid without prior shareholder approval.[179] Article 11 of the Takeover Directive introduces the breakthrough rule that neutralizes *vis-à-vis* a bidder certain takeover defenses installed prior to the launch of a takeover offer, such as restrictions on the transfer of shares, voting caps, and multiple voting shares. Nevertheless, the impact of both of these rules is weakened by Article 12 of the Takeover Directive, which makes the implementation of Articles 9 and 11 optional by giving Member States the power to opt out of these rules.[180]

In order to protect a majority shareholder from the opportunistic behavior of minority shareholders, Article 16 of the Takeover Directive allows a majority shareholder who has acquired between 90% and 95% of the capital carrying voting shares to obligate minority shareholders to sell their shares at the price offered in the preceding takeover offer.[181] The squeeze-out right makes takeover offers more attractive by enabling a successful bidder to fully integrate the target into its operations. This procedure is widely used by private equity bidders, who seek to obtain full control of the target company. On the other hand, the sell-out right introduced by Article 15 of the Takeover Directive protects a minority shareholder from being exploited by a controlling shareholder by providing him a put option to sell his shares to the controlling shareholders.[182] The relevant thresholds and price to be offered mirror the ones applicable in the case of a squeeze-out.

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177. Directive 2004/25, art. 4(5), 2004 O.J. (L 142) 12, 17 (EC).

178. *Id*., art. 9, at 19.

179. *Id.*

180. Parliament and Council Directive 2004/25, art. 12, 2004 O.J. (L 142) 12, 21 (EC).

181. Parliament and Council Directive 2004/25, art. 16, 2004 O.J. (L 142) 12, 22 (EC). The relevant threshold is to be determined by individual Member States.

182. *Id.* art. 15, at 22.

Overall, even after the adoption and implementation of the Takeover Directive, a truly harmonized Pan-European takeover regime is still far from becoming a reality. European legislators prefer minimum harmonization, thus allowing Member States to impose more stringent and extensive provisions than the ones found in the Takeover Directive. Nevertheless, the harmonization of the rules governing the organization of takeover offers, such as the requirement for enhanced disclosures to target shareholders and the minimum acceptance period, is a particularly welcome development in line with the European Union's goal of promoting takeover activity. On the other hand, the optionality arrangement allowing Member States to avoid the application of the board neutrality and break-through rules does little to facilitate and promote cross-border takeover activity. In fact, the European Commission has acknowledged the reluctance of Member States to lift takeover barriers.[183]

As a result of the minimum harmonization strategy adopted by European legislators, the Member States' takeover regimes show considerable variability, in line with the differing stages of development of each country's takeover market. For instance, the Takeover Code's specialized provisions for management buyouts [184] reflect the sophistication of the U.K.'s takeover market, which has traditionally been the most developed in Europe. Furthermore, the framework nature of the Takeover Directive—where the EU sets minimum standards—allows individual Member States to introduce more stringent requirements when implementing the relevant rules. For example, Article 9(5) of the Takeover Directive requires a target company's board of directors to publish its opinion of the bid, the impact it will have on the company's interests (specifically employees), and the bidder's

183. Only three out of twenty-five Member States have introduced the break-through rule into their national legislation. *See generally Commission Report on the Implementation of The Directive on Takeover Bids*, SEC (2007) 268 final (Feb. 21, 2007).

184. *See, e.g.*, TAKEOVER CODE, Rule 3.1, at D20 (stressing the importance of independent advice to the board of the offeree company in case of a management buyout); Rule 20.3, at I12 (requiring the private equity bidder to disclose to the target board all the information that is furnished to external providers of finance for the transaction).

strategic plans for the company.[185] The vague and open-ended nature of the provision is a perfect example of the EU's minimum harmonization strategy, which grants Member States wide discretion in implementing the provision. Contrasting the ways in which Germany and the U.K. have implemented the abovementioned article illustrates the EU's minimum harmonization strategy. Section 27 of the German Securities Acquisition and Takeover Act,[186] which governs takeover offers for listed companies, requires the target board's statement to describe the type and amount of consideration offered, the objectives of the bidder, the consequences of a successful bid for the target company and its employees, and the intention of the target board members with regards to accepting the offer if they hold securities in the target. On the contrary, Rule 25 of the Takeover Code contains more extensive information requirements on the part of the target's board including details of any securities held by the target or its directors in the bidder,[187] service contracts between any director of the target with the company,[188] and the fees and expenses that the target will incur in relation to the offer.[189]

Another example is the implementation of the squeeze-out procedure in the laws of Member States. As mentioned above, the Takeover Directive provides individual Member States with the opportunity to set a threshold above which a majority shareholder may exercise the right to squeeze-out minority shareholders, provided that it is between 90% and 95% of the voting shares. While the relevant threshold in France is set at 95% of the voting shares, in Spain, a controlling shareholder who has acquired only 90% may effectuate a squeeze-out.[190] In addition, certain Member States, such as Germany, have introduced more stringent requirements for completing a squeeze-out of minority shareholders by requiring court approval.[191]

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185. Parliament and Council Directive 2004/25, art. 9(5), 2004 O.J. (L 142) 12, 18–19 (EC).

186. Wertpapiererwerbs- und Übernahmegesetz [WpÜG] [Securities Acquisition and Takeover Act], Dec. 20, 2001, BGBL. I at 3822, § 27 (Ger.).

187. TAKEOVER CODE, Rule 25.4, at J19.

188. *Id.*, Rule 25.5, at J21.

189. *Id.*, Rule 25.8, at J23.

190. BONELLI EREDE PAPPALARDO ET AL., GUIDE TO PUBLIC TAKEOVERS IN EUROPE (2013) at 325, 335, *available at* http://www.debrauw.com/News/Publications/Pages/GuidetoPublicTakeoversinEurope.aspx.

191. Securities Acquisition and Takeover Act § 39a (Ger.).

Thus, despite the adoption of the Takeover Directive, a Pan-European takeover market is still far from a reality. Private equity bidders structuring buyouts are left to deal with a variety of supervisory authorities and local rules. Local lawyers need legal advice from specialists, thereby raising transactions. One should contrast European takeover regulations with the U.S. model, where the Williams Act regulates tender offers on a federal level without the involvement of U.S. states. Although the conduct of the board of directors in the U.S. takeover context is regulated on a state level, the laws of Delaware are widespread as it is the preferred state of incorporation for U.S. public companies. As a result, the U.S. has effectively adopted a unified and coherent takeover regime, providing certainty to parties structuring buyouts.

III. After the Crisis: The Alternative Investment Fund Managers Directive and the Dodd-Frank Wall Street Reform and Consumer Protection Act

Politicians and the public on both sides of the Atlantic regularly criticize the private equity industry—commonly viewed as the dark side of capitalism—for slashing jobs, breaking up companies, and pressuring them to focus on short-term results instead of long-term growth.[192] The Financial Crisis was the perfect opportunity for politicians to fulfill their desire to regulate the private equity industry. The AIFM Directive and the Dodd-Frank Act, both adopted in the aftermath of the crisis, contain provisions directly aimed at private equity. While the AIFM Directive solely targets the alternative investment fund industry, the ambit of the Dodd-Frank Act is much broader. As Skeel notes, the Dodd-Frank Act's objectives are twofold: "[i]ts first objective is to limit the risk of contemporary finance . . . ; and the second is to limit the damage caused by the failure of a large financial institution."[193] The provisions relating to the regulation of private equity funds can be seen as fulfilling the first objective.

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192. Rasmussen, *supra* note 132.

193. David A. Skeel, The New Financial Deal: Understanding the Dodd-Frank Act and Its (Unintended) Consequences 4 (2010).

A. AIFM DIRECTIVE

The AIFM Directive, adopted in November 2010, was one of the most controversial and hotly debated pieces of legislation in European legislative history. Calls to regulate the alternative investment fund industry were common even before the Financial Crisis. Within Europe, the European Parliament was one of the most prominent institutions to criticize the industry. The Parliament adopted various resolutions calling upon the Commission to examine the industry's potential negative effects.[194] Furthermore, the Parliamentary Socialist Group, traditionally hostile to Anglo-Saxon capitalism, published a report in March, 2007 highlighting the detrimental effects of private equity and hedge funds and the need for tight regulation.[195] The overall sentiment in favor of regulation was supported by public criticism of hedge funds and private equity tactics by politicians of individual Member States.[196] The Financial Crisis, regarded as a crisis of Anglo-Saxon capitalism, was the ideal opportunity for Germany and France, the main proponents of stricter regulation, to put forward their own agenda. They did so despite resistance from the U.K., which viewed the AIFM Directive as a threat to London's prominence as a center for hedge funds and buy-out firms operating in Europe.[197] The final version of the AIFM Directive was adopted after eighteen months of intense lobbying and heated negotiations.[198]

The main goal of the AIFM Directive is to create a harmonized regulatory and supervisory framework for alternative investment fund

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194. *See generally* European Parliament Resolution on the Future of Hedge Funds and Derivatives, P5_TA(2004)0031; European Parliament Resolution on Asset Management, P6_TA-PROV(2006)0181.

195. IEKE VAN DEN BURG & POUL NYRUP RASMUSSEN, PSE, SOCIALIST GROUP OF THE EUROPEAN PARLIAMENT, HEDGE FUNDS AND PRIVATE EQUITY: A CRITICAL ANALYSIS (2007).

196. For instance, Guilio Tremonti, the Italian Finance Minister described hedge funds as "hellish" and demanded their abolishment. *See* Tracy Corrigan, *Hedge Funds Don't Need Punishing – They are Suffering Enough*, THE TELEGRAPH (U.K.), Oct. 16, 2008, http://www.telegraph.co.uk/finance/comment/tracycorrigan/3212102/Hedge-funds-dont-need-punishing-they-are-suffering-enough.html.

197. Elena Moya, *City Lobbying Helps Water Down European Hedge Fund Legislation Plans*, THE GUARDIAN (U.K.), July 27, 2009, http://www.guardian.co.uk/business/2009/jul/27/hedge-funds-european-directive.

198. Eilís Ferran, *After the Crisis: The Regulation of Hedge Funds and Private Equity in the EU,* 12 EUR. BUS. ORGANIZATIONAL L. REV. 379, 398 (2011).

managers ("AIFMs") and promote an internal market for their activities. The need for regulation was premised on the perceived lack of transparency in the industry and the systemic risk that this posed to the financial system.[199] The scope of the AIFM Directive is broad; it covers alternative investment fund managers established in the E.U. that manage alternative investment funds ("AIFs"), whether EU-based or not, and non-E.U. based AIFMs that manage and/or market one or more AIFs in the EU.[200] An AIFM is defined as "[any] legal person[] whose regular business is managing one or more AIFs."[201] As a result, the AIFM Directive covers a broad array of AIFMs that includes managers of private equity funds, hedge funds, commodity funds, and real estate funds.

AIFMs covered by the AIFM Directive must receive authorization from the competent authorities of their home Member States.[202] The Directive grants an exemption to AIFMs managing AIFs whose assets under management do not exceed €100 million.[203] It also exempts AIFMs managing unleveraged AIFs that grant investors no redemption rights for a period of five years and whose assets do not exceed €500 million.[204] These thresholds have been heavily criticized as being too low, thus extending the application of the Directive to AIFMs that pose

199. Proposal for a Directive of the European Parliament and of the Council on Alternative Investment Fund Managers and Amending Directives 2004/39/EC and 2009/65/EC, at 2–3 (COM) (2009) 207 final (Apr. 30, 2009).

200. Directive 2011/61 of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and Amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010, Preamble, 2011 O.J. (L 174) 1, 3 [hereinafter AIFM Directive].

201. *Id.*, art. 4(1)(b). Pursuant to Article 4(1)(a), an AIF is defined as any collective investment undertaking that "raise[s] capital from a number of investors with a view to investing it in accordance with a defined investment policy for the benefit of those investors" and which "do[es] not require authorization pursuant to Article 5 of Directive 2009/65/EC" (commonly known as "UCITS" Directive).

202. *Id.*, art. 7.

203. *Id.*, art. 3(2). The second exemption has in essence been created for private equity firms. One should note that the AIFMs exempted are still required to register with the competent authorities of their home Member State and provide information on the main instruments on which they are trading and their investment strategies. *See id.*, art. 3(3).

204. *Id.*

no systemic threat to the financial system.[205] Additionally, the AIFM Directive imposes minimum capital requirements on AIFMs[206] and requires them to devise and maintain appropriate liquidity[207] and risk management systems,[208] remuneration policies that discourage excessive risk-taking,[209] and systems for identifying and managing any conflicts of interests.[210] AIFMs must also ensure that a depository is appointed for each AIF under management[211] and that each of AIF's assets are valued at least once per year.[212]

In addition, the AIFM Directive imposes wide-ranging transparency and disclosure obligations. AIFMs must make available to their supervisory authority and, on request, to investors, an audited annual report with respect to each E.U. fund managed by and marketed in the EU.[213] Additionally, Article 24 of the AIFM Directive requires fund managers to regularly report to their supervisory authorities on matters such as the principal markets in which they trade, the main exposures of each fund they manage, and the main asset classes in which a fund is invests.[214] AIFMs must also ensure that certain information is made available to investors prior to their investment in a fund and periodically thereafter.[215]

The AIFM Directive includes provisions aimed directly at LBOs of E.U.-listed and non-listed companies. AIFMs managing AIFs that acquire voting rights reaching, exceeding or falling below certain thresholds (starting at 10%) must notify their appropriate authorities.[216] In addition, once an AIF acquires control of a non-listed company, the

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205. According to the European Private Equity and Venture Capital Association, private equity firms below €1 billion that provide financing to small and medium-sized firms and operate on a regional, local or national level pose no threat to financial stability. *See* EUR. PRIVATE EQUITY & VENTURE CAPITAL INDUS., RESPONSE TO THE PROPOSED DIRECTIVE OF THE EUROPEAN PARLIAMENT AND COUNCIL ON ALTERNATIVE INVESTMENT FUND MANAGERS (AIFM) 3 (2009).

206. AIFM Directive, art. 9, 2011 O.J. (L 174) 1, 22.

207. *Id.*, art. 16.

208. *Id.*, art. 15.

209. *Id.*, art. 13.

210. *Id.*, art. 14.

211. *Id.*, art. 21.

212. *Id.*, art. 19.

213. *Id.*, art. 22.

214. *Id.*, art. 24.

215. *Id.*, art. 23.

216. *Id.*, art. 27(1).

fund manager must notify its supervisory authority, the non-listed company, and its shareholders of the acquisition.[217] Article 28 imposes additional disclosure requirements once control of a listed or non-listed company is acquired. In particular, the AIFM managing the AIF that obtains control over the company shall make its identity, as well as its policy for managing any resulting conflicts of interest, available to the supervisory authority and the company.[218] The annual report of a non-listed company controlled by an AIF, as well as the report of the AIF itself, must also contain a fair review of the company's past and future business development.[219] Additionally, the AIF must make available to the relevant authorities information regarding the financing of an acquisition of a non-listed company.[220] Article 30 is a particularly interventionist provision. This provision prevents an AIFM, managing an AIF that acquires control of a listed or non-listed company, from facilitating, supporting, instructing, or voting in favor of any distribution, capital reduction, share redemption, or share buyback for a period of two years following the acquisition of control.[221]

A positive aspect of the AIFM Directive is the creation of an internal market for alternative investment funds. E.U.-based AIFMs are allowed to market E.U. AIFs with a passport across the Union.[222] However, non-E.U. based AIFMs marketing AIFs (E.U. based or not) and E.U. based AIFs marketing non-E.U. AIFs must market funds according to national private placement regimes until the European Commission allows the extension of the passporting provisions which is expected to take effect in 2015.[223]

Overall, the AIFM Directive has been criticized as being an "odd, political piece of law making."[224] The main target of European

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217. *Id.*, art. 27(2)–(3).

218. *Id.*, art. 28(1)–(2).

219. *Id.*, art. 29.

220. *Id.*, art. 28(5).

221. *Id.*, art. 30. This restriction is subject to the qualification that payments out of distributable profits are allowed but only when such payments do not cause the company's net assets to fall below the level of subscribed capital plus non-distributable reserves.

222. *Id.*, art. 32.

223. *Id.*, arts. 35–42 & 67(6).

224. Walter R. Henle & Allan Murry-Jones, Alternative Investment Fund Managers Directive (Skadden, Arps, Meagher, Slate & Flom LLP), Nov. 29, 2010.

legislators was the hedge fund industry, with private equity being swept along as well.[225] The rationales underpinning the adoption of the AIFM Directive—namely the need to tackle systemic risk and increase the transparency of the industry—are unsound reasons for regulating private equity. The private equity industry is unlikely to be a source of systemic risk,[226] and therefore obligating disclosures to supervisory authorities makes little sense.[227] An important concern is the effect that a widespread failure of private equity-backed companies would have on the banking system, which finances LBO deals. Nevertheless, even the European Central Bank has acknowledged that LBO activity poses little systemic risk to the banking sector.[228] Furthermore, assuming that a danger does exist, the best course of action would be to directly regulate the banking sector, which was the main contributor to the LBO boom through its extension of cheap financing to private equity buyers.[229] In addition to necessitating enhanced disclosures to supervisors, the AIFM Directive also requires that substantial disclosures be made to investors. However, investors in private equity funds are sophisticated and capable of demanding this information in an arm's length bargain.[230]

The valuation and depository requirements also add undue costs on the private equity industry. Valuation requirements make little sense in the private equity context. Distributions to investors are made upon liquidation of the investments via an initial public offering ("IPO"), secondary sale, or trade sale, which provides an objective third party valuation.[231] The use of depositories is intended to prevent Madoff-style frauds. However, as Dan Awrey notes, "[t]he long term, illiquid and typically very public nature of the investments made by these

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225. Payne, *supra* note 17, at 582.

226. Indeed, private equity neither contributed to nor caused the recent financial crisis and there was no widespread failure of private equity-backed companies.

227. Payne, *supra* note 17, at 584.

228. EUROPEAN CENTRAL BANK, LARGE BANKS AND PRIVATE EQUITY-SPONSORED LEVERAGE BUYOUTS IN THE EU (Apr. 2007).

229. Shasha Dai, *The Inner Circle of Systemic Risk*, WALL ST. J. PRIVATE EQUITY BLOG, (Mar. 10, 2009, 5:03 PM), http://blogs.wsj.com/privateequity/2009/03/10/the-inner-circle-of-systemic-risk/.

230. Indeed, disclosures to funds' investors have generally been found to be adequate. *See generally* DAVID WALKER, DISCLOSURE AND TRANSPARENCY IN PRIVATE EQUITY: CONSULTATION DOCUMENT JULY 2007 (2007).

231. Dan Awrey, *The Limits of E.U. Hedge Fund Regulation*, 20 (Oxford Legal Studies Research Paper No. 8.2011), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1757719.

institutions virtually eliminates the potential for Madoff-type fraud."[232] Furthermore, the disclosure provisions aimed at LBOs have been criticized for putting private equity investors at a competitive disadvantage to other investors such as sovereign wealth funds, foundations, and pension funds, which fall outside the ambit of the AIFM Directive.

The AIFM Directive imposes significant and undue costs on the private equity industry. It has been estimated that the sum of one-time and ongoing costs amount to € 1 billion.[233] For example, private equity firms may decide to exit the European market, depriving European investors of the opportunity to invest in private equity and lowering the competitiveness of the European economy. On the flip side, the firms which decide to continue operating in Europe and marketing their funds to E.U. investors will face higher costs that will be passed on to investors in the form of higher fees and lower returns.

B. THE DODD-FRANK ACT

The Dodd-Frank Act is the first attempt in the U.S. to directly regulate the private equity industry. Title IV of the Dodd-Frank Act[234] forces the traditionally secretive private equity industry to disclose information about its operations to regulators and the investing public. Thus, regulators are able to monitor the build-up of systemic risk in the financial system. In addition, the Volcker Rule, found in section 619 of the Act, prohibits banking entities from sponsoring or retaining any equity, partnership or other ownership interest in a private equity fund, subject to certain exceptions.[235] The aim of the Volcker Rule is to reduce excessive risk taking by the banking sector and to prohibit banking entities from benefiting from government support for their speculation at the expense of taxpayers and depositors.[236]

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232. *Id.* at 19.

233. KYLA MALCOLM ET AL., CHARLES RIVERS ASSOCIATES, IMPACT OF THE PROPOSED AIFM DIRECTIVE ACROSS EUROPE 112–13 (2009).

234. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, art. IV, 124 Stat. 1376 (2010) [hereinafter Dodd-Frank Act].

235. Dodd-Frank Act, sec. 619, § 13(a)(1)(B).

236. The Volcker Rule is also applicable to non-bank financial companies supervised by the Board of Governors of the Federal Reserve that engage in the above mentioned activities. Instead of prohibiting these entities from sponsoring or investing

Title IV of the Dodd-Frank Act repeals section 203(b)(3) of the Investment Advisers Act of 1940 ("Advisers Act"), thereby requiring fund managers to register as investment advisers. Section 203(b)(3) previously allowed fund managers who did not hold themselves out as investment advisors to the general public and had fewer than fifteen clients over a twelve-month period to avoid registration with the SEC. As a result, private equity fund managers controlling assets above certain thresholds[237] will be subject to enhanced disclosure requirements. Fund managers must maintain certain reports and records for each private equity fund they manage, as well as make them available to the SEC for inspection. These reports and records include information about the fund's assets, trading practices, valuation policies and practices, types of assets held, and trading and investment positions.[238] The Act further requires the SEC to share reports and documents with the Financial Stability Oversight Council, a newly established body tasked with monitoring systemic risk in the U.S. financial system.[239]

The so-called Volcker Rule, named after its creator and former Chairman of the Federal Reserve Paul Volcker, prohibits banking entities[240] from acquiring or retaining any equity, partnership, or other

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in hedge funds or private equity funds, these entities will be subject to additional capital requirements and quantitative limits. *See* Dodd-Frank Act, sec. 619, § 13(a)(2).

237. An adviser with assets under management of less than $100 million and subject to state regulation will generally be prohibited from registering with the SEC and must register with its state regulator. *See* Dodd-Frank Act, sec. 410, § (2). Furthermore, the Dodd-Frank Act contains an exemption from registration for advisers solely to private funds if they manage assets under $150 million. *See id.*, sec. 408, § 203. A private fund is defined as any issuer that would be an investment company, as defined in section 3 of the Investment Company Act of 1940, but for section 3(c)(1) or 3(c)(7) of that Act. *See id.*, sec. 402, § 202(a)(29). Section 3(c)(1) of the Investment Company Act of 1940 provides an exemption for an issuer whose securities are owned by not more than 100 persons, while section 3(c)(7) exempts any issuer who offers its securities to "qualified purchasers." Therefore, the definition of "private fund" includes private equity funds that rely on sections 3(c)(1) or 3(c)(7) in order to avoid regulation as an investment company.

238. *Id.*, sec. 404, § (2)(b)(3).

239. *Id.*, sec. 404, § (1)–(2)(b)(7).

240. The definition of a banking entity is wide, encompassing any insured depository institution, any company that controls an insured bank, any company treated as a bank holding company under the International Banking Act, and any affiliate or subsidiary of any such entity.

ownership interest in a private equity fund.[241] It also prohibits them from sponsoring a private equity fund, which includes serving as a general partner, managing member, or trustee of a fund; selecting or controlling the funds' directors, trustees, or management; or sharing the same name as the fund.[242] Despite this prohibition, banking entities are still allowed to advise such funds.[243] The Volcker Rule creates an exception, allowing a banking organization to organize and offer a private equity fund and make a *de minimis* investment in such fund.[244] The entity must provide *bona fide* trust, fiduciary, or investment advisory services to such fund and organize and offer the fund solely to its customers who use such services. An investment is permitted provided that it has not exceeded 3% of the outstanding ownership interests in the fund one year after its establishment. The total investments of a banking entity in such funds should be limited to 3% of its Tier 1 capital. Nonetheless, regulators may prohibit such activities if they pose a threat to the financial stability of the banking entity or the U.S., involve material conflicts of interest, or would result in a material exposure of the banking organization to high-risk assets or trading strategies.[245]

Overall, the U.S. has decided to adopt a more lenient approach than Europe when it comes to regulating private equity. The U.S. position is rooted in the long history of private equity within the country, as well as its role as a positive force in promoting business activity. In contrast to the EU's AIFM Directive, which imposes wide-ranging disclosure requirements and mandates the use of depository and valuation mechanisms, the Dodd-Frank Act contains registration and limited disclosure requirements intended to monitor systemic risk. Even though the private equity industry is unlikely to be a source of systemic risk, these requirements do not burden it with insurmountable costs and will

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241. A private equity fund is defined as any issuer that would be an investment company pursuant to the Investment Company Act of 1940, but for section 3(c)(1) or 3(c)(7) of that Act or any similar fund as the regulators may determine. *See id.*, sec. 619, § 13(h)(2).

242. *Id.*, sec. 619, § 13(h)(5).

243. *The Dodd-Frank Act*, COMMENTARY AND INSIGHTS (Skadden, Arps, Slate, Meagher & Flom LLP), July 2012, *available at* http://www.skadden.com/insights/skadden-commentary-dodd-frank-act.

244. Dodd-Frank Act, sec. 619, § 13(d)(1)(G).

245. *Id.*, sec. 619, § 13(d)(1)(I).

therefore not significantly impact LBO activity. However, the Volcker Rule may have a chilling effect on private equity activity since banks are an important source of investment capital for private equity.[246] In addition, private equity investments represent a negligible amount of total bank assets and therefore pose little risk on banks' balance sheets.[247] However, one should note that the Volcker Rule seeks to regulate a limited segment of the private equity industry, namely banks' investments in and sponsorship of funds. Though banks are an important source of capital for private equity firms, there exists a wide array of other institutions such as pension funds, insurance companies, and university endowments that also serve as investors in private equity. For instance, public pension funds, which have long invested in private equity, are increasing their allocations to the industry and starting to make direct private equity style investments in companies.[248] As a result, the rule's negative impact on the development of the U.S. private equity industry is overstated.

IV. EXPLAINING THE PAST AND PREDICTING THE FUTURE OF EUROPEAN PRIVATE EQUITY

Despite the hostile legal regime governing private equity transactions, the European private equity market managed to grow and mature from 1996 onwards,[249] reaching its greatest heights between 2003 and 2007. Indeed, between 2000 and 2004, Western Europe was able to surpass the U.S. in transaction value.[250] 2001 was the first time that European LBO activity exceeded that of the U.S.[251] Public-to-private transactions featured prominently during the European LBO

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246. *Implications of the 'Volcker Rules' for Financial Stability: Hearing Before the S. Comm. on Banking, Hous. & Urban Affairs*, 112th Cong. 13 (2010) (statement of Hal Scott, Professor, International Financial Systems, Harvard Law School, and Director, Committee on Capital Markets Regulation).

247. *Id.* at 14.

248. Michael Corkery, *Public Pensions Increase Private Equity Investments*, WALL ST. J., Jan. 26, 2012, http://online.wsj.com/article/SB10001424052970203806504577181272061850732.html.

249. Wright et al., *supra* note 9, at 38.

250. Kaplan & Strömberg, *supra* note 10, at 128.

251. Jake Powers, *The History of Private Equity & Venture Capital,* CorporateLiveWire (Feb. 20, 2012, 9:24 AM) http://www.corporatelivewire.com/top-story.html?id=the-history-of-private-equity-venture-capital.

boom.[252] Economic forces fueled the growth of private equity and overcame its unfavorable legal regime. The introduction of the common currency, the euro, and the development of the European single market facilitated cross-border acquisitions by eliminating currency risks and investment barriers. Furthermore, the abundant liquidity in the financial system made European banks eager to provide financing to private equity sponsors. European banks were also increasingly willing to provide larger loans for private equity transactions.[253] The development of a European high-yield debt market, virtually non-existent before 1997, provided an additional source of funding for private equity dealmakers.[254]

Another important factor was the financialization[255] of Europe during the 2000s. Europe saw its financial sector grow exponentially, with European countries embracing the latest innovations of finance. The banking sector experienced a boom while investment banking, hedge funds, and private equity became household names. Throughout the last decade, European policymakers promoted the liberalization of the financial sector and the integration of European financial markets.[256] Furthermore, the end of the Cold War in 1991 and the advent of globalization and economic liberalism, particularly during the last

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252. Mike Wright et al., *Private Equity and Corporate Governance: Retrospect and Prospect*, 17 CORP. GOVERNANCE 353, 354 (2009).

253. The lending standards of European banks were so lax that, according to Dalip Pathak, managing director of Warburg Pincus' London office, private equity firms dealing with banks in Europe "literally had to say to the banks that they did not want to take all that money." *See Expect Europe's Private Equity Market to Contract*, KNOWLEDGE@WHARTON (Jan. 12, 2011), http://knowledge.wharton.upenn.edu/ article.cfm?articleid=2508.

254. Brian Hoffmann et al., *Europe's High-Yield Bond Market Evolves*, N.Y. L.J., Nov. 13, 2001, at M6.

255. As Epstein notes, "financialization means the increasing role of financial motives, financial markets, financial actors and financial institutions in the operation of the domestic and international economies. FINANCIALIZATION AND THE WORLD ECONOMY 3 (Gerald A. Epstein ed., 2006).

256. The integration of financial markets was one of the goals included in the Lisbon Agenda, as it was considered a means of enhancing the efficient allocation of capital, thereby promoting growth and employment. *See* Presidency Conclusions, Lisbon European Council (Mar. 23, 2000).

decade, led to the relative decline of social democracy[257] in Europe and the rise of laissez-faire Anglo-Saxon capitalism.[258] Global competition in the product and capital markets forced European companies to restructure their operations, rationalize costs, and adopt the principle of shareholder value.[259] Private equity investors cooperated with target companies, offering their expertise in achieving these goals.

The adoption of the AIFM Directive has raised concerns about the future of the European private equity market. There are growing fears that the AIFM Directive could result in an exit of private equity firms and funds from Europe, putting the continent at a competitive disadvantage versus other markets, such as the U.S. Nonetheless, even assuming that the AIFM Directive's impact is negative, underlying economic forces sparked by the sovereign debt crisis will provide a boost to public-to-private activity in Europe. The current debt crisis, which began in Greece, spread throughout the periphery of the Eurozone and now threatens the survival of the euro. The crisis has obligated Member States such as Greece, Ireland, Spain, Italy, and Portugal to enact broad reforms, including privatizations and labor deregulation. These countries have moved forward with ambitious privatization plans

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257. According to Gourevitch, "[s]ocial democracy gives voice to claims on the firm in addition to those of the shareholders: employee job security, income distribution, regional or national development, social welfare and social stability, and nationalism, to name a few." *See* Peter A. Gourevitch, *The Politics of Corporate Governance Regulation*, 112 YALE L.J. 1829, 1830 (2003) (reviewing MARK J. ROE, POLITICAL DETERMINANTS OF CORPORATE GOVERNANCE: POLITICAL CONTEXT, CORPORATE IMPACT (2003)).

258. The Anglo-Saxon capitalist model is characterized by deregulated labor and financial markets, a legal regime promoting competition in the product markets, limited or non-existent workers' participation rights in the governance of corporations, and a recognition of shareholders as their ultimate owners.

259. Pursuant to the principle of shareholder value creation or shareholder primacy that developed in the U.S., the corporation should be managed in the interests of shareholders who exercise ultimate control over its affairs. *See* Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L. J. 439, 440–441 (2001). Continental European countries, most notably Germany and France, have adopted the stakeholder theory of the corporation. The corporation should be managed in the interests of all stakeholders in the firm, including shareholders, employees, customers and communities. *See* Michael C. Jensen, *Value Maximization, Stakeholder Theory and the Corporate Objective Function* (Harvard NOM Working Paper No. 01-01, 2001), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=220671.

seeking to enhance the competitiveness of their economies[260] and repay their massive debt burdens.[261] Additionally, inefficiently run state-owned companies managed according to the desires of special interest groups are natural targets for private equity firms specializing in rationalizing costs and restructuring poorly managed enterprises.[262]

Furthermore, the debt crisis has obligated southern European countries to enact broad-ranging reforms aimed at deregulating their rigid labor markets and relaxing their strict employment protection regulation.[263] Private equity investments often involve labor

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260. For an excellent overview of the beneficial effects of privatizations, see William L. Megginson & Jeffrey M. Netter, *From State to Market: A Survey of Empirical Studies on Privatization*, 39 J. ECON. LITERATURE 321 (2001).

261. *See* Alkman Granitsas, *Greece Speeds Up Plans to Sell Off State-Held Assets*, WALL ST. J., May 24, 2011, *available at* http://online.wsj.com/article/SB1000142405 2702304520804576341414080784514.html; Nektaria Stamouli, *Greece Accepts OPAP's Bid for State Lotteries*, WALL ST. J., Dec. 12, 2012, *available at* http://online.wsj.com/article/BT-CO-20121212-706753.html; Eamon Quinn, *Ireland Identifies State Assets for Sale*, WALL ST. J., Feb. 22, 2012, *available at* http://online.wsj.com/article/SB10001424052970203960804577238793257737830.htm l; Pablo Dominguez, *Spain Hires RBS to Privatize Airports*, WALL ST. J., June 20, 2011, *available at* http://online.wsj.com/article/SB1000142405270230393670457639 7394220462996.html; Stephen L. Bernard, *Italy's Frattini Sees Next Austerity Package Soon*, WALL ST. J., Sept. 22, 2011, *available at* http://online.wsj.com/article/SB10001 424053111904563904576585282025615242.html; Wayne Ma & Patricia Kowsmann, *China Gets Stake in Portugal's EDP*, WALL ST. J., Dec. 23, 2011, *available at* http://online.wsj.com/article/SB10001424052970204464404577114471370252 452.html; Patricia Kowsmann, *Portugal Shelves TAP Sale*, WALL ST. J., Dec. 20, 2012, *available at* http://online.wsj.com/article/SB1000142412788732446160457819152380 6172276.html.

262. For instance BC Partners and TPG have expressed interest in buying the Greek government's 33% stake in Greek gambling monopoly OPAP. *See* Stelios Bouras, *BC Partners, TPG, Among Seven Cleared to Take Part in OPAP Sale*, PRIVATE EQUITY NEWS (Nov. 29, 2012) http://www.penews.com/archive/keyword/opap/1/content/ 4071471253. OPAP is an emblematic, partly state-owned company which has been used by politicians as a vehicle for preferential allocation of lucrative contracts to suppliers, most notably the Intracom group and its affiliate Intralot, and has also been associated with exceptionally high labor costs. *See* Stavros Gadinis, *Can Company Disclosures Discipline State-Appointed Managers? Evidence from Greek Privatizations*, 13 THEORETICAL INQUIRIES L. 525, 528–530 (2012).

263. Fiona Ehlers et al., *Bitter Medicine: Belated Reforms Cut Deep in Southern Europe*, DER SPIEGEL, Apr. 16, 2012 (Ger.), *available at* http://www.spiegel.de/

restructurings in an effort to improve the performance of the company, and a flexible labor regime is therefore crucial for the success of such strategies. Indeed, in their study, Bozkaya and Kerr show that strict labor regulations are associated with lower levels of private equity investments.[264] Additionally, one would expect that the effect of flexible labor regulations would be even more pronounced in cases of private equity investment in state-owned companies. Labor restructurings feature predominantly when turning around companies with higher labor costs. Labor unions and politicians collude, using state-owned companies in order to promote their self interest.

CONCLUSION

The Financial Crisis, the adoption of the Dodd-Frank Act in the U.S., and the AIFM Directive in the E.U., and the run of Mitt Romney for President of the United States have put a spotlight on the private equity industry on both continents. This article has attempted to offer a comparative examination of the financing and structuring of public-to-private transactions as well as the regulation of private equity firms in the U.S. and Europe. This assessment reveals a particularly restrictive legal regime for transactions and firms in Europe, leading one to expect a corresponding effect on the development of the European private equity market. However, to the contrary, underlying economic forces have provided and will continue to provide a boost to European private equity activity. Thus, when it comes to European private equity, there is no causal link between the strictness of the legal regime and economic development. Rather, economic development shapes its own path, unaffected by the prevailing legal regime.

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international/europe/crisis-ridden-southern-europe-is-rapidly-reforming-labor-laws-a-827797.html.

264. Ant Bozkaya & William R. Kerr, *Labor Regulations and European Private Equity* (Harvard Business School Entrepreneurial Management, Working Paper No. 08-043, 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1527168.