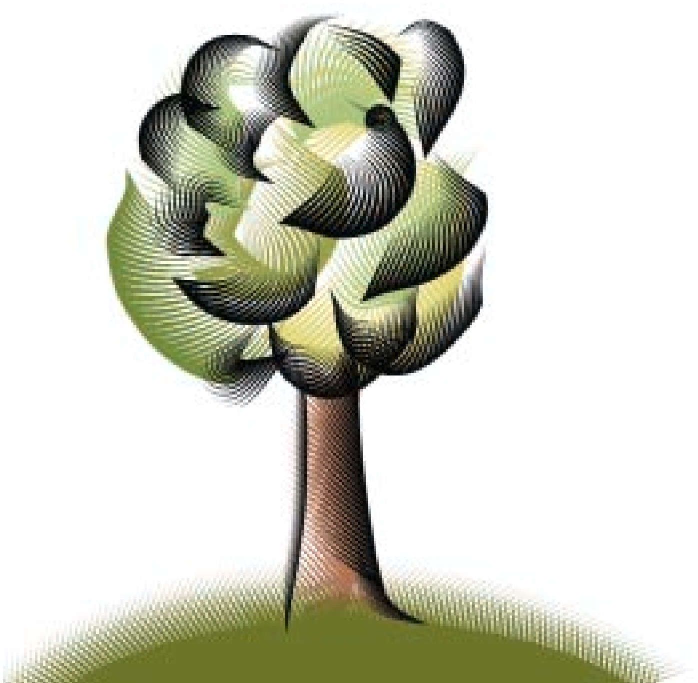
THE VENTURE CAPITAL REVIEW

ISSUE 9 • FALL 2001

A publication for venture capitalists and private equity professionals jointly produced by the National Venture Capital Association (NVCA) and Ernst & Young LLP



Dear Reader:

Articles for this issue of the Venture Capital Review were being prepared around the time of the tragic events of September 11. We all remember where we were as the news of that day unfolded. I was at the 27th Annual Venture Capital Institute (VCI) where I again had the privilege of serving on the faculty. VCI is an excellent program produced by NASBIC and the NVCA for the rising talent in the private equity industry. Again this year, it sold out all 300 seats and had a waiting list.

A Herculean effort by VCI leadership kept the course work pretty much on track. Despite the distractions outside the program, the future leaders of this industry kept their enthusiasm for learning to build companies and manage portfolios remarkably well. All of this was at a time when the industry was retreating from a record investment pace of $28 billion in the third quarter of 2000 to around $8 billion in third quarter 2001. There were many excuses for being pessimistic – but I only saw optimism.

The beat goes on. Deals are still being done. Despite this slower activity, 2001 will be the third best year for venture investment ever! The Venture Capital Review continues its commitment to providing the most useful guidance and insights to all involved in this industry, from those serving it to experienced general partners as well as to those associates with a 2001 Venture Capital Institute certificate.

With this issue, we are delighted to welcome Spencer Stuart as a contributor. Their inaugural article "The Ten Deadly Sins of CEO Recruitment and How to Avoid Them" provides very timely counsel as we work together to build excellent companies.

Let's get back to work!

Sincerely,

John S. Taylor
Editor-in-Chief, *Venture Capital Review*
Vice President, Research, National Venture Capital Association

European LBOs — Key Issues for U.S. Sponsors

KIRKLAND & ELLIS

by David Patrick Eich, James L. Learner, and Stuart L. Mills[1]

Introduction

U.S. sponsors considering European leveraged buyout ("LBO") transactions should be aware that various European cultural, commercial, and legal issues create a deal environment materially different from that in the U.S. *Cultural issues* range from greater employee influence in European society to the less frequent resort to private litigation in European dispute resolution. *Commercial issues* include European sellers' greater resistance to financing conditions in purchase agreements and many potential European LBO targets' ownership of long-term receivables arising from sales to European governments. *Legal issues* arise from the laws of both the European Union and the various European states, including those relating to:

- Tax structuring
- Financial assistance
- Labor and employment
- Governance formalities and restrictions
- Management incentives
- Director and shareholder duties and liabilities
- Securities sales and purchases
- Merger control and competition
- Foreign investment currency and regulation
- Attributes of investment vehicles and their securities

[1] The authors are grateful to their partners Nigel Dunmore, Jack S. Levin, Thomas O. Verhoeven and William R. Welke for their thoughtful contributions to this article.

Although any of these issues may be important in an LBO transaction, this article focuses on four of particular significance, comparing them to U.S. analogues and suggesting how to mitigate their potentially adverse effects in a European LBO.

Tax Structuring

In the U.S., due to the single federal tax code and the common usage of a U.S. (often a Delaware) corporation, limited partnership, or limited liability company as the LBO acquisition vehicle, tax structuring issues are generally similar across deals, providing sponsors with a high degree of certainty as to tax effects.[2] Sponsors of a U.S. LBO transaction typically have three principal tax concerns: (1) how to obtain the maximum tax benefit for interest expense on acquisition debt, (2) whether the acquisition can be structured to obtain stepped-up tax basis for the acquired assets in a tax-efficient manner, and (3) what form of management equity incentives should be employed in light of lower tax rates for a U.S. individual's capital gain (as compared to higher rates for such an individual's ordinary income). Although various tests must be met in order to secure the interest deduction in a U.S. LBO, there is no U.S. analogue to the obstacle presented by the European financial assistance restrictions discussed below. A U.S. LBO, moreover, can often be structured to result in stepped-up asset tax basis, sometimes even in a stock acquisition through a "§338(h)(10) election." A U.S. individual may also obtain favorable capital gain tax treatment for certain forms of management equity incentives, such as common stock (with a "§83(b) election" where such stock is subject to vesting restrictions) or a tax advantaged stock option (i.e., an "incentive stock option" or "ISO").

In a European LBO with a U.S. sponsor, on the other hand, multiple sets of complex tax rules may apply, including U.S. tax rules applicable to the U.S. sponsor and its owners, and a myriad of European tax rules from the acquisition vehicle's and the target's home jurisdiction and business locations. A stepped-up asset tax basis can be obtained in a European asset purchase, but may be subject to different and potentially more burdensome limits than in a U.S. LBO. These may include, among other things, a cap on tax basis at original cost, asset tax basis step-up without corresponding amortization, the lack of a §338(h)(10) analogue for stock acquisitions, the cumbersome formalities attendant upon the transfer of certain assets such as real property, and often material asset transfer taxes. Also significant are various European countries' restraints on interest deductions, which include thin capitalization and financial assistance rules that may prevent the use of typical U.S. LBO structures, repatriation of proceeds to the U.S. sponsor (typically not an issue in an LBO until exit), and management equity incentives (e.g., U.K. conditional share rules which tax shares upon vesting rather than upon grant).

Unique U.S. tax considerations. Certain U.S. tax rules generally apply when a U.S. fund invests in a non-U.S. company, including:

- controlled foreign corporation ("CFC") rules, and
- passive foreign investment company ("PFIC") rules.

CFCs. The CFC tax rules, in general, apply to any U.S. shareholder owning at least 10% by vote (a "10% Holder") of a foreign (i.e., non-U.S.) corporation if more than 50% of the foreign corporation's stock by vote or value is held by 10% Holders. Where applicable, the CFC rules (subject to certain exceptions) have several negative U.S. tax effects, including: (1) a 10% Holder is taxed currently at ordinary income rates on such shareholder's pro rata share of the CFC's passive income, such as interest, dividends, certain rents and royalties, and gains on the sale of securities held by the CFC, (2) a 10% Holder is treated as receiving a dividend and pays tax thereon on its share of the CFC's investment in U.S. property (for instance, in connection with a U.S. add-on acquisition), and (3) any gain realized by such shareholder on the sale of the CFC's shares is taxed at ordinary income rates to the extent of the shareholder's share of the CFC's undistributed earnings and profits.

[2] See, e.g., the extensive discussions of the U.S. tax implications of buyouts in Ginsburg and Levin, Mergers, Acquisitions, and Buyouts (Panel Publishers, June 2001), as updated semi-annually.

The CFC tax rules most often pose a problem where the CFC expects significant passive income (including dividends from subsidiaries in other countries), the CFC plans to sell stock of foreign subsidiaries, or the CFC owns or plans to purchase a U.S. subsidiary or branch.

Two tax-planning techniques are often employed to mitigate the effects of the CFC tax rules. First, a U.S. sponsor may use check-the-box elections with respect to the CFC's foreign subsidiaries in order to reduce the types of non-U.S. income subject to U.S. taxation. Second, the U.S. fund sponsor may form a parallel offshore fund (owned by the same persons owning the U.S. fund sponsor) to make investments in offshore entities in lieu of the U.S. fund. In many cases, use of such an offshore fund allows all or a large portion of the fund's investors to avoid U.S. tax under the CFC rules.

On the other hand, there are situations in which CFC status is helpful. For example, a 10% Holder of a CFC is generally not subject to the odious U.S. PFIC tax rules outlined below.

PFICs. PFIC issues typically arise when an offshore start-up receives early funding from the sponsor, creating passive assets and passive income before the start-up entity begins to earn significant active business income. Because an LBO often involves a mature company already generating active business income necessary to support the acquisition indebtedness, a European LBO generally raises significant PFIC concerns only in unusual circumstances.

The tax consequences to U.S. shareholders of a foreign corporation recognized as a PFIC, however, are draconian. Any gain on the sale of the entity's shares is taxed at U.S. ordinary income rates and subjected to a special interest charge. To mitigate PFIC risk, the sponsor can attempt to manage the entity's finances and operations to avoid PFIC status or make the tax election described below.

A foreign corporation is a PFIC if, in any given taxable year, either (1) 75% or more of its gross income for such year is "passive" income or (2) 50% or more of its assets held during such year produce passive income or are held for the production of passive income. With respect to each test, however, one may look through to a pro rata share of the income and assets of each subsidiary of which the subject company owns 25% or more of the stock by value. Because cash and near-cash assets held as working capital are viewed as passive assets, extra scrutiny of fund flows and uses of proceeds are required to avoid inadvertent PFIC status. Importantly, once a corporation becomes a PFIC, it is generally treated as a PFIC forever. However, in certain circumstances an entity which is a PFIC only in its first year (but not subsequent years) is not treated as a PFIC.

A so-called "QEF election" mitigates the adverse tax consequences upon a sale referred to above, but must be made with respect to the first year of the investment to be fully effective. However, when a QEF election is made, each U.S. shareholder must include its pro rata share of the acquisition vehicle's earnings in its U.S. taxable income each year.

While the PFIC rules do not apply to any 10% Holder of a CFC (or, in certain circumstances, to an entity which is a PFIC only in its first year), there is no such exception for smaller holders.

European tax considerations. Many European tax rules may affect a particular LBO. As in U.S. transactions, for instance, optimization of interest deductions in European LBOs is a critical consideration. As discussed below, however, financial assistance restrictions in European countries may prevent achievement of optimal tax results through the use of traditional U.S.-style LBO structures. In some jurisdictions, use of a newly created European holding company which incurs the acquisition indebtedness, purchases the stock of the European LBO target, and consolidates with the target for foreign tax purposes (allowing the holding company's interest deductions to be offset against the target's operating income) may allow effective use of interest deductions without running afoul of financial assistance restrictions.[3]

[3] Such structures may be tax efficient, for example, in the U.K. and Germany.

This section focuses principally on those rules applicable to a European holding company used as an LBO acquisition vehicle. In a U.S. transaction, an LBO sponsor would often choose a Delaware or other U.S. state vehicle. Because in a European transaction a U.S. corporation typically is not a tax-efficient vehicle for owning a non-U.S. operating company, a European vehicle is often employed in such circumstances.

Principal considerations in choosing an LBO holding company vehicle and jurisdiction from a European tax perspective include, among other things:

- whether the holding company must consolidate with a European LBO target (in which case it must normally be formed in the same jurisdiction as the target)
- avoiding capital tax on formation of the holding company
- treaty protection from withholding taxes on dividends paid to the holding company
- treaty protection from capital gains tax on the holding company's possible sale of underlying subsidiaries
- avoiding local European taxes on dividends received by the holding company
- avoiding European taxes on the U.S. sponsor's capital gains from a sale of stock in the LBO target (probably the critical concern where the goal of an investment is capital growth rather than income)

In light of these considerations, several jurisdictions are often not favorable for U.S. sponsors (e.g., Spain, Switzerland and the U.K.) desiring a pan-European holding company to hold the stock of various European operating companies.[4] Spain, for example, generally levies a 35% tax on capital gains recognized by a foreign shareholder on stock in a Spanish company, unless the shareholder is eligible for treaty protection (or, if the shareholder is an EU resident, it holds less than 25% of the company's equity). Notably, U.S. residents are not protected from the capital gains tax on the sale of stock in a Spanish company by the U.S.-Spain treaty.

Denmark and Belgium have favorable regimes based on the considerations noted above, but Denmark imposes a three-year holding period to avoid capital gains tax at the holding company level on the sale of subsidiaries and Belgium imposes a 5% tax on dividends received from subsidiaries.

Due to their ability to mitigate capital gains tax, capital formation tax and other tax considerations, the use of Netherlands and Luxembourg vehicles has become prevelant. While The Netherlands taxes capital gains realized by non-resident shareholders owning more than 5% of a Dutch company's shares, such taxes are subject to treaty relief in the case of U.S. and U.K. investors. Luxembourg, on the other hand, does not tax capital gains on a shareholding of a non-resident unless such holding is 25% or more and sold within six months after the acquisition (but notably does require a 12 to 24 month holding period before exempting capital gains on the sale of subsidiaries by a holding company).

Capital formation taxes are taxes levied by a jurisdiction on equity contributed to an entity organized under that jurisdiction's laws. These taxes can often be reduced by (1) the use of loan capital rather than share capital, (2) purchasing shares in the target and then exchanging them for holding company shares (rather than capitalizing the holding company with cash), or (3) deploying novel securities with both debt and equity features. In Luxembourg, for example, securities called preferred equity certificates ("PECs") are treated as debt for purposes of the 1% Luxembourg capital formation tax but equity for other purposes. Thus, a Luxembourg holding company can be capitalized with a small amount of common equity (which is subject to the capital formation tax) and a large amount by value of PECs (not subject to the tax).

Financial Assistance

U.S. fraudulent conveyance. In the U.S., the Federal Bankruptcy Code and various state statutes permit, under the doctrine of "fraudulent conveyance," a prejudiced creditor (or a trustee in bankruptcy) to avoid certain transfers (i.e., to require certain assets to be returned to

[4] A U.K. company may, however, be a tax-efficient vehicle for acquiring a U.K. target, because the holding company can generally consolidate with the target under U.K. group relief rules and the U.K. generally does not tax foreign shareholders on their capital gains with respect to U.K. companies.

the bankrupt company to benefit creditors). Essentially, a transfer may be avoided under the fraudulent conveyance doctrine if consideration for the transfer is inadequate and, after the transfer, the company is insolvent, under-capitalized, or unable to pay its debts as they mature. In an LBO, therefore, fraudulent conveyance risks may arise if the target becomes liable for acquisition debt in a way which prejudices the target's pre-existing creditors. Such risks may be mitigated by demonstrating, among other things, that no "badges of constructive fraud" exist—that is, after the transaction, the target remains solvent, is adequately capitalized, and is able to meet its obligations as they mature. Because of such defenses, fraudulent conveyance rules have not been a significant obstacle to undertaking highly leveraged transactions in the U.S.

Financial assistance. European financial assistance legislation is the European analogue to the U.S. fraudulent conveyance doctrine. As a result of national legislation implementing the Second European Directive of 13 December 1976, most European countries prohibit outright the use of a corporation's assets to support debt incurred to purchase the corporation's stock. Thus, a European corporation generally may not advance funds, grant loans or provide guarantees or security with a view to acquiring its own shares or aiding another person in acquiring its shares. Such restrictions, moreover, typically are combined with other restrictions on the repurchase of capital, pledges and intergroup holdings for the ostensible purpose of protecting the integrity of a company's capital, whether the company is privately or publicly held. In several European jurisdictions, a violation of these financial assistance restrictions is subject to *criminal* sanctions. The restrictions thus must be given serious consideration in structuring a European LBO.

Various methods may be employed to mitigate the consequences of such financial assistance restrictions on typical LBO structures, depending on the applicable jurisdiction and the sponsor's risk tolerance. However, relief strategies cannot be considered in isolation from tax planning because of their potentially significant tax effects. In general, a distinction may be drawn between jurisdictions such as the U.K., Belgium and Ireland where, although the financial assistance doctrine applies, its impact may be largely relieved through widely used mechanisms (and hence basic U.S.-style deal structures implemented), and other jurisdictions, where the basic economics of a U.S. LBO may be achieved only via considerable restructuring and assumption of additional risks by the sponsors and their lenders.

U.K. In the U.K., financial assistance restrictions generally apply but private companies may obtain relief from the restrictions via formalistic statutory "whitewash" procedures. These procedures permit the provision of financial assistance so long as the target's net assets are not thereby reduced (or, to the extent they are, that the financial assistance comes out of distributable profits). The required procedures include: (1) a statutory declaration by the directors that the company will be able to pay its debts as they fall due during the year immediately following the acquisition, (2) a report by the company's auditors stating that the directors' declaration is not unreasonable under the circumstances, and (3) within one week after the directors' declaration, approval of the financial assistance by at least 75% of the equityholders (unless the company is wholly owned). Compliance with the whitewash procedures adds significantly to the costs of consummating a transaction and can cause significant delays. In order to permit application to a court to cancel the resolution, the financial assistance cannot be given until four weeks after equityholder approval (unless equityholder approval is unanimous) or until eight weeks after the directors' declaration.

Belgium. In Belgium, financial assistance restrictions are nominally strict, but do not generally bar: (1) an operating company from using its assets to support the acquisition of its parent's shares, or (2) with proper drafting of the loan and security documentation, the target from using its assets (a) to support *other* debt (e.g., a tranche linked not to the acquisition of its shares but to the acquisition of a sister company in another country) or (b) to provide other credit (e.g., working capital). Other Belgian rules compound the difficulty of mitigation, however. Cash of the operating company may be dividended to a newly formed acquisition vehicle to service the latter's debt, for instance, but such payments will be subject to a 25% withholding tax for a period of one year after incorporation. This, among other reasons,

dictates merging the operating company into the acquisition vehicle as soon as possible—but that risks violation of the financial assistance rules until the end of the acquisition vehicle's first financial year (in Finland, as another example, the merger process may take up to eight months).

France. On the other end of the scale are several countries, such as France, Finland and Sweden, in which methods for mitigating financial assistance restrictions are relatively more complex and uncertain. Accordingly, in such countries, an otherwise typical LBO tends to engender greater risks of director liability, rescission, and criminal sanctions than elsewhere. In France, for example, a company is prohibited from granting any security for the purchase of its own shares by a "third party," which has been very broadly interpreted to include all persons other than the company itself. Thus, in France, even the Belgian "parent shares" exception discussed above is prohibited. Several novel and highly technical approaches to relief from the restrictions discussed by French commentators (e.g., dividends from the target to the purchasing company, financing arrangements entered into after the acquisition) remain largely theoretical and thus engender considerable risk.

Germany. Agreements in which an AG (a stock corporation the shares of which may be publicly held) provides collateral security in support of debt used to acquire its shares are null and void in Germany. Methods of relief include (1) converting the AG into a different form of entity, (2) liquidating the AG after the acquisition and distributing its assets to shareholders, and (3) most recently, merging the AG upstream into a separate acquisition vehicle. Somewhat more flexible rules apply to a GmbH (i.e., private limited company) and, by analogy, a GmbH & Co. KG (i.e., limited partnership). A GmbH, with the unanimous consent of its equityholders, may grant loans to its equityholders or provide security, such as liens, to a third party so long as the use of capital does not deplete the company's equity below the amount of its registered share capital (roughly equivalent to the U.S. concept of par value). If the capital is thereby depleted, the equityholders *and managing directors* (and, some commentators now argue, even third-party lenders) may be held jointly liable for such depletion.

Labor and Employment

U.S. labor regulations. In the U.S., a purchaser generally has a legal obligation to communicate with employees prior to consummating an acquisition only if the transaction implicates the WARN Act (i.e., it is likely to result in the termination of 50 or more employees within a certain period) or if required to do so by contract (e.g., an applicable collective bargaining agreement). As a result, labor and employment regulations, while important, tend not to significantly encumber most U.S. LBOs.

European labor relations. Europe's stronger tradition of employee protectionism, has given rise to many more employees' rights regulations significantly affecting LBOs. Such regulations include, for instance, the European Union's Transfer of Undertakings (or "Acquired Rights") Directive, which has been implemented in every member state, and requires (1) notification of and consultation with employees regarding a transaction involving a change of employer and (2) the transfer to the buyer and maintenance of employment contracts on substantially the terms and conditions existing prior to the transaction. The European Works Council Directive, part of the social policy chapter of the Maastricht Treaty, also has been implemented in every member state and requires, under certain conditions (i.e., in larger companies), the establishment of works councils and other bodies (in some countries, with business management authority on behalf of employees).

Denmark. Denmark has highly protective labor statutes and national collectivized bargaining which have resulted in an extensive regime of employee protections and rights. Employees of a Danish company with more than 35 employees are permitted to elect one-half (with a minimum of two) of the members of the board of directors (and, in a group of companies, the board of directors of its parent). As elsewhere in the European Union, moreover, employees must be informed of the details of any proposed transfer of a business in a "timely" manner and consulted regarding the transaction prior to closing. The buyer also will automatically assume all the rights and obligations of the seller with respect to the employees, and will not be able to dismiss employees unless "reasonably justified" due to economic, technical,

or organizational reasons not including the acquisition and until expiration of the applicable notice period.

France. Under French law, all companies with more than 50 employees must have a works council and employers are required to inform and consult the works council on all issues relating to the organization, management, and operation of the company—including any merger, acquisition, or sale of the company (including, interestingly, the sale by a majority shareholder of its shares). Although such consultation rights do not amount to employee approval and are typically undertaken after signing a definitive transaction document and just prior to closing, the council is entitled to at least three days notice before the consultation, which must precede LBO consummation. Failure to observe the requirements does not void a sale but is a *criminal* offense punishable by fines and imprisonment.

Italy. In Italy, as in Denmark, all employment contracts must contain the minimum conditions established in the relevant national collective agreement negotiated between the applicable union and employers' association, each of which is renewed approximately every three years. Obligations to Italian employees also follow the business in a transfer but, with respect to accrued rights, remain the joint responsibility of the seller and the buyer (which should be a consideration for the private equity investor upon exit). No demotion from existing employment arrangements is permitted.

Notification requirements, moreover, are longer than in France, requiring in respect of any transferred business with more than 15 employees at least 25 days' notice to relevant trade unions, plus seven days in which such unions have the right to ask the parties to meet and discuss the transaction. Although there is no approval right if requested consultation is obligatory.

Additionally, although company pension schemes are rare, high-cost social security payments made on behalf of employees cause concern in that, even after the statute of limitations for government action to recover underpaid contributions has expired, an employee can bring a claim against the company. All amounts paid to employees, moreover, whether in cash or in kind, must be included in salary for purposes of calculating such contributions.

Employment termination agreements also should be treated with caution. Unless executed before an appropriate government authority or via a specified procedure with the assistance of the national unions, any such agreement may be declared null and void if challenged by the employee within six months after termination or execution of a settlement agreement.

Governance

With few exceptions, corporate governance in European countries is more formalistic than in the U.S. Although many formalities have been liberalized during the last decade in connection with the national implementation of various European Union directives, there remain noteworthy governance challenges to replicating U.S.-style LBOs, including (1) formation-related issues, (2) operating formalities, (3) the roles and duties of officers and directors, and (4) more widespread application of criminal sanctions to the transactional environment.

Formation. Formation-related issues range from minimum capital contribution requirements which vary by country and type of entity being formed to lengthy delays in newco formation created by the necessity of approval from various governmental authorities prior to conducting business. Although not large amounts, the required capital contributions are not nominal, as they are in Delaware and most other U.S. jurisdictions. Additionally, unlike in the U.S., forming a company in Europe can take considerably more time. In certain jurisdictions, such as The Netherlands, a notarial deed of incorporation containing the company's articles of association (i.e., charter) must be passed before a Dutch civil law notary and approved by the Ministry of Justice. In addition, it is often necessary to obtain Dutch tax court authority approval of aggressive tax structures prior to effective reorganization. Hence, formation timetables can be considerably longer than the typical few hours or few days necessary in the U.S. or the U.K.

In several countries, the remedy employed to expedite the process is the "shelf" company, a company formed on speculation prior to any specific transaction (often by a financial institution, law firm, or corporate services entity), the articles and other constitutive documents of which need only be amended as appropriate. Because such a company will have some (albeit limited) history unrelated and prior to the transaction, however, U.S. lenders unfamiliar with European transactions sometimes react negatively.

Operating formalities. Operating formalities can be more cumbersome than expected. In some countries, for instance, a dual governing board structure is mandatory in certain circumstances. In The Netherlands, companies with at least 100 employees are required to have both a management board (which has powers analogous to both a U.S. board of directors and executive officers) and a supervisory board. Both legal entities and natural persons may be members of the management board, which is charged with management of the company, and may represent the company to third parties, while only natural persons may be members of the supervisory board, which supervises the management board and performs certain other specified duties (e.g., representing the company in a conflict of interest between the company and a member of the management board). The supervisory board, moreover, is not appointed by the general meeting of the shareholders, but rather elects and appoints its own members in compliance with procedures designed to ensure that not only the shareholders, but the employees (via the works council) have influence over the supervisory board's composition. As noted above, in certain countries such as Germany and Denmark, employees are actually entitled to elect board members.

Importantly, such a large-company Dutch supervisory board has the power to dismiss the members of the management board and to adopt the annual accounts, as well as to approve the issuance of debt and equity securities, amendments of the articles, and important investments, among other things. For comparison, a similar two-tier board structure is required for a German company with more than 500 employees, an Austrian company with more than 300 employees, and a Danish company with more than 35 employees. Similarly, in the case of a Belgian company with more than 100 employees, a Supervisory Director who is a member of the Institute of Auditors must be appointed to the board.

Other operating formalities constitute more nuisance than obstacle, but require attention. One such formality is director qualifications. In Switzerland, which is not a member of the European Union, for instance, the majority of directors must be Swiss nationals residing in Switzerland. In Austria, the nationality criterion is not mandatory, but at least one director should be Austrian; otherwise, the courts may appoint such a person in certain circumstances. Another issue is the language in which corporate documents must be kept. In France, for instance, anything required to be filed with the French tax authorities (e.g., a share transfer agreement) must be translated into French, even if governed by non-French law. Dutch companies similarly must keep certain corporate records in Dutch, thus often necessitating costly and time-consuming translation of English documents in transactions sponsored by U.S. parties.

Officers and directors. In the U.S., the roles and duties of corporate (and other business entity) officers and directors are widely understood, particularly with respect to entities formed in commonly used jurisdictions such as Delaware. A private equity sponsor must be aware, however, that diverse rules, some of which are significantly different that those in the U.S., govern the conduct of such persons and their analogues in Europe, occasionally with significant individual and institutional consequences. In the U.K., for instance, directors act as both directors in the U.S. sense and executive officers. A U.K. limited company, therefore, typically has several managing directors, but no president or vice president. A U.K. director acting alone, moreover, can bind a company in most regards; whereas, in the U.S., only an authorized officer can do so, and only with appropriate board approval. The role of a company secretary is also different and has more authority in the U.K. than in the U.S. Hence, sponsors used to associating status and responsibility with certain corporate titles must consider carefully their local implications.

Directors in certain jurisdictions may also have unusual liabilities. In Spain, for instance, directors may be held personally liable for the company's unpaid taxes, even in the case of simple negligence, and newly appointed directors (which, in a U.S.-style deal, would typically include a representative of the private equity sponsor) similarly may be held liable for pre-acquisition tax debts not liquidated or paid upon consummation of the transaction.

Criminal sanctions. Perhaps most daunting from a U.S. private equity sponsor's perspective, criminal sanctions are widely applicable to European corporate law violations. As noted above, criminal sanctions are applicable in many countries to worker protection and financial assistance law violations. Recent court cases in Italy, for instance, cast doubt over the ease with which financial assistance restrictions could be avoided without criminal liability in the event that, retrospectively, a company's insolvency could be traced indirectly to excessive leverage employed in its acquisition (although newly adopted legislation permitting consolidation of a leveraged acquisition vehicle and its target provides prospective relief). Because of the highly structured and uncertain solutions in many countries to achieving relief from such restrictions, every reasonable measure should be undertaken to insulate the U.S. sponsor from liability, including keeping its representatives off the relevant management board (and exercising control over directors via employment agreements, for example) under certain circumstances.

Conclusion

For various historical and cultural reasons, the European LBO market is more fragmented and less mature than the U.S. market. As a result, European LBOs potentially involve certain unique legal risks. While such risks can in most jurisdictions be effectively managed to permit the effects of applicable legal rules and replication of U.S.-style leveraged transactions, the costs of managing resulting risks should be seriously considered by U.S. sponsors modeling the potential returns of any particular European LBO transaction.

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