

Some Tender Offer Quirks

PENpoints

In considering a tender offer, sponsors should be aware of a number of quirks that have come to light in recent tender offer transactions that may impact or offset its advantages.

With the SEC's 2006 clarifications to the "best price" tender offer rules and the occurrence of a few all-equity sponsor buyouts, there has been a significant increase in use of the two-step (tender offer followed by merger) format for both private equity and strategic acquisitions. Some of the perceived tender offer benefits include speed to closing, avoiding adverse recommendations from proxy advisory firms such as RiskMetrics (ISS) and mitigating the risk of "empty voting" (when someone holds the right to vote a security but has no economic interest in the security).

However, several tender offer quirks may impact or offset the advantages of using this two-step structure.

First, many index and quantitative funds will not tender into an offer if the market price is above the offer price or the stock is still included in the index which the fund mirrors or tracks. These policies and practices can determine a tender offer's success or failure where such funds have significant holdings of target stock and reaching the minimum tender condition is a close call.

Second, to the extent such fund decisions are in fact affected by market price at the time the tender offer expires, these practices create an additional opportunity for arbitrageurs to influence outcome by causing minor price movements above or below an offer price.

Third, even if a tender offer achieves its minimum condition (generally the tender of enough shares to approve a merger), the ability of an acquirer to reach the minimum threshold (usually 90 percent) necessary to effect a back-end short-form merger (and thereby avoid the expense and delay of a full-blown proxy

statement) may be constrained by the behavior of those funds that will not tender under any circumstances while the stock is still in the relevant index.

Moreover, in some cases RiskMetrics appears to be abandoning its historical practice of not making recommendations on friendly tender offers. Some recent high profile examples include adverse recommendations in the CVS/Long Drug Stores and Apax/Bankrate tender offers.

A few suggestions if a tender offer structure is being considered or has been selected:

- Ensure that assessment of the target's shareholder base includes the level of holdings by index or quantitative funds, particularly in industries or sectors where the target may be included in multiple indices, since these shares are often "sticky" and do not rotate into the hands of arbitrageurs following deal announcement.
- Seek the target's early removal from indices thereby freeing the funds to tender, generally after successful completion of the initial tender offer and during a subsequent offering period where the acquirer seeks to achieve the requisite ownership level for a short-form merger.
- As is usually the case in a one-step merger, engage with RiskMetrics and other proxy advisory firms early in the process to determine if they intend to issue a recommendation and seek to influence any such advice. Buyers should consider including in the purchase agreement a requirement that the target cooperate in these efforts.

If you have any questions about the matters addressed in this *KirklandPEN*, please contact the following Kirkland authors or your regular Kirkland contact.

David Fox

<http://www.kirkland.com/dfox>

+1 212-446-4994

Daniel E. Wolf

<http://www.kirkland.com/dwolf>

+1 212-446-4884

Susan J. Zachman

<http://www.kirkland.com/szachman>

+1 212-446-4947

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ILPA — Private Equity Principles

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The ILPA recently published its “Private Equity Principles,” which outline the trade group’s “wish list” for private equity fund terms.

As if the current economic climate has not made private equity fund raising tough enough, the largest trade association for private equity limited partner (LP) investors, the Institutional Limited Partners Association (“ILPA”), in September published “Private Equity Principles,” its “wish list” of more pro-LP private fund terms for LPs to seek from general partners (GPs).

What is ILPA?

ILPA began in the early 1990s as an informal networking club of a dozen or so investors sharing views and information and providing a forum for training and education. It has grown to include over 200 members globally, including public and corporate pension plans, endowments, foundations, family offices and insurance companies. ILPA claims its membership represents more than U.S. \$1 trillion in private equity assets under management. Its doors are not open to GPs or intermediaries, and it has traditionally maintained a rather low profile.

The Private Equity Principles

To a large extent the Principles mirror those adopted by the Oregon State Investment Council earlier this year. The three areas that the Principles seek to address are (1) alignment of interest, (2) governance standards, and (3) transparency.

1) Alignment of Interest

The alignment-of-interest Principles call for a full return of capital plus hurdle prior to payment of any carried interest. Alternatively, IPLA would accept a deal-by-deal model, so long as (a) LPs first recover all losses and write downs, (b) at least 30 percent of any carried interest distribution is escrowed as security for potential future GP clawback obligations, and (c) GP clawback obligations are joint and several among the GP’s individual investment professionals, with no reduction for personal tax liabilities on their carried interest.

The Principles call for management fees to be sufficient only to cover “normal operating costs,” with 100 percent offset for transaction and other fees received by the management company (rather than, as commonly

is the case, offset for only 80 or 50 percent of transaction and other fees).

The Principles also state that carried interest should be calculated by reference to returns net of all fees and taxes incurred at the fund level or below, resulting in reduced carried interest whenever there are fund or portfolio company level withholding taxes, even if such taxes result solely from an LP’s status.

2) Governance

The Principles disfavor any contractual reductions of fiduciary or other duties owed by the GP to the fund or to the LPs. They also require more frequent and detailed disclosure to and consultation with investor advisory committees and, to avoid so-called “style drift,” require the offering documents to contain more detailed descriptions of permissible investments. ILPA also believes that LP rights to force early fund and/or investment period termination, and to remove the GP (with or without cause), are necessary to achieve balanced governance between LPs and the GP.

3) Transparency

The Principles require the fund’s auditor to be independent of both the GP and the fund’s other activities, with frequent and detailed reporting and communication with LPs generally. In particular, the Principles require detailed disclosure of GP fees, carried interest payments and clawback and elaboration of calculation methods. Many GPs’ quarterly reports already satisfy the vast majority of these ILPA information reporting guidelines.

Comply or Explain?

It is too early to predict if the Principles will gain sufficient investor support to affect GP/LP negotiations in a significant way, although some of the industry’s largest LP investors have stated that the Principles are the beginning of a new chapter in the private equity industry. While LPs will likely continue to base investment decisions primarily on the GP’s past performance and investment team, rather than the fund’s legal terms and conditions, the Principles will also likely be a subject of discussion among GPs and LPs.

If you have any questions about the matters addressed in this *KirklandPEN*, please contact the following Kirkland author or your regular Kirkland contact.

Richard K. Watkins

<http://www.kirkland.com/rwatkins>

+44 20 7469 2185

PENnotes

Kirkland & Ellis Private Fund Manager Investment Adviser Registration Seminars
New York, New York - October 29, 2009
Chicago, Illinois - November 5, 2009

These Kirkland seminars, chaired by partner Scott Moehrke, will focus on developments under the Investment Advisers Act of 1940 that would require managers of private funds, including buyout funds, venture capital funds, real estate funds and hedge funds, to register with the SEC as investment advisers. Topics will include how new requirements will impact business and strategies for transitioning to registration. Panelists will include Kirkland partners Robert Sutton and Andrew Wright (in New York) and Bruce Ettelson and Nabil Sabki (in Chicago).

Kirkland & Ellis Buyouts in a Troubled Economy Seminars
Chicago, Illinois
November 6, 2009

This Kirkland seminar, chaired by partner Jack Levin, will review the legal, tax, structuring and practical negotiating aspects of complex private equity deals in the current economic climate. Topics covered will include: negotiating and structuring a buyout of a target company; debt financing and equity financing; special issues in acquiring public and/or distressed companies; restructuring distressed portfolio companies and forming private equity funds, including developments in taxation of carried interest.

Kirkland & Ellis Licensing Law Seminar
New York, New York
October 30, 2009

This Kirkland seminar is designed for in-house counsel and licensing professionals responsible for managing patent portfolios and intellectual property to maximize the value of their technology, generate revenue or gain competitive advantage through licensing, research collaborations and settlement of litigation. Kirkland partners Pierre-Andre Dubois, Stephen Johnson and David MacDonald will host.

PLI's "Outsourcing and Offshoring 2009: Meeting New Challenges" Conference
New York, New York
November 2-3, 2009

This program, hosted by the Practising Law Institute, will focus on negotiation strategies for creating and

realizing value in outsourcing transactions and resolving issues in outsourcing contracts. Kirkland partner Neil Hirshman will speak on "Renegotiation in the Current Economy."

The University of Chicago Booth School of Business' Third Annual Real Estate Conference
Chicago, Illinois
November 4-5, 2009

The University of Chicago's Third Annual Real Estate Conference will feature a discussion on current issues effecting the commercial real estate industry. Kirkland partner Nathaniel M. Marrs will moderate a panel on distressed debt investments. Sam Zell, chairman and chief executive of Equity Group Investments, will be the keynote speaker.

PLI's "Tax Strategies" Conference
Chicago, Illinois
November 18-20, 2009

This program, hosted by the Practising Law Institute, will focus on tax issues presented by the entire spectrum of major corporate transactions. Kirkland partner Jack Levin will speak on "Structuring Buyouts/Venture Capital Deals." Additionally, Kirkland partner Todd Maynes will speak on "Tax Strategies for Financially Troubled Businesses and Other Loss Companies" and partner Jeff Sheffield will speak on "Current Issues in Divisive Strategies – Spin-Offs and Synthetic Spin-Offs."

Kellogg School of Management's 2009 Real Estate Conference
Evanston, Illinois
November 18, 2009

This conference, hosted by Northwestern University's Kellogg School of Management, will review trends in the capital markets, the opportunities and pitfalls of distressed real estate investing in the current market and ongoing trends in restructuring. Kirkland partner Robert T. Buday will speak on "Distressed Investing Opportunities: Possibilities and Pitfalls."

Chicago

Kirkland & Ellis LLP
300 North LaSalle
Chicago, IL 60654
+1 (312) 862-2000
+1 (312) 862-2200 fax

Hong Kong

Kirkland & Ellis LLP
26th Floor
Gloucester Tower
The Landmark
15 Queen's Road Central
Hong Kong
+852-3761-3300
+852-3761-3301 fax

London

Kirkland & Ellis
International LLP
30 St Mary Axe
London, EC3A 8AF
United Kingdom
+44 20 7469 2000
+44 20 7469 2001 fax

Los Angeles

Kirkland & Ellis LLP
777 South Figueroa Street
Los Angeles, CA 90017
+1 (213) 680-8400
+1 (213) 680-8500 fax

Munich

Kirkland & Ellis
International LLP
Maximilianstrasse 11
80539 Munich
Germany
+49 89 2030 6000
+49 89 2030 6100 fax

New York

Kirkland & Ellis LLP
601 Lexington Avenue
New York, NY 10022
+1 (212) 446-4800
+1 (212) 446-4900 fax

Palo Alto

Kirkland & Ellis LLP
950 Page Mill Road
Palo Alto, CA 94304
+1 (650) 859-7000
+1 (650) 859-7500 fax

San Francisco

Kirkland & Ellis LLP
555 California Street
San Francisco, CA 94104
+1 (415) 439-1400
+1 (415) 439-1500 fax

Washington, D.C.

Kirkland & Ellis LLP
655 Fifteenth Street, N.W.
Washington, D.C. 20005
+1 (202) 879-5000
+1 (202) 879-5200 fax

Private Equity Practice at Kirkland & Ellis

Kirkland & Ellis LLP's nearly 400 private equity attorneys handle leveraged buyouts, growth equity transactions, recapitalizations, going-private transactions and the formation of private equity, venture capital and hedge funds on behalf of more than 200 private equity firms around the world.

Kirkland has been widely recognized for its preeminent private equity practice. In 2009, Kirkland received the awards for Best Law Firm (Private Equity Deals) and Best Law Firm (Fund Formation) in North America from *Private Equity International*. Mergermarket has ranked Kirkland first by volume for Global and North American Buyouts in its "Global M&A Round-up for Year End 2008," and Pitchbook named Kirkland the most active law firm representing private equity firms in its "Private Equity Breakdown" for Q2 2009.

For the second year in a row, *The Lawyer* magazine recently recognized Kirkland as one of the "The Transatlantic Elite," noting that the firm is "leading the transatlantic market for the provision of top-end transactional services ... on the basis of a stellar client base, regular roles on top deals, market-leading finances and the cream of the legal market talent." In addition, Kirkland's London office was recently named the 2008 "Banking Team of the Year" at the Dow Jones Private Equity News Awards for Excellence in Advisory Services.

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KIRKLAND & ELLIS LLP

EDITORS

Jack S. Levin, P.C.

Margaret A. Gibson, P.C.

Norbert B. Knapke II

SUBSCRIPTIONS

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kirklandpen@kirkland.com

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