KIRKLAND & ELLIS

KIRKLANDPEN
Private Equity Newsletter

November 30, 2010

Harsh Excise Tax Imposed on Health Insurance Plans Favoring Executives over Rank and File

PENpoints

Recently enacted health reform legislation imposes harsh new excise taxes on any employer whose insured medical plan treats one or more executives better than rank-and-file employees.

The health reform legislation enacted earlier this year imposes harsh new excise taxes on any employer (including any private equity firm or portfolio company) whose insured medical plan (or a side agreement relating to medical insurance) treats one or more executives better than its rank-and-file employees. Specifically, for a plan year beginning on or after September 23, 2010,[1] granting even one executive a benefit not also granted to rank-and-file employees—such as (i) company-paid medical premiums during the executive's employment period, (ii) company-paid COBRA premiums following employment termination, or (iii) an extension of post-employment medical coverage beyond the standard 18-month COBRA period—will result in an excise tax imposed on the employer in the amount of $100 per day, multiplied by the number of employees "discriminated against."

For example, according to recent IRS guidance an employer with 1,000 employees would be subject to an excise tax of at least $99,900 per day ($100 x 999) if it agrees to subsidize its CEO's health insurance or COBRA after employment termination without offering the same benefits to its other 999 employees. At this time, it is not known whether (i) the excise tax amount could instead actually be a multiple of $99,900 per day if, e.g., more than one executive receives a post-employment health insurance subsidy not received by rank and file employees or (ii) the excise tax begins to run (day by day) when the employer agrees to make future discriminatory payments or begins to run only subsequently when the discriminatory payments actually begin to be paid.

INSIDE KIRKLANDPEN

Exceptions

Self-insured Plans. An employer with a "self-insured" medical plan—i.e., one in which the employer, rather than a third-party insurer, bears all claims—is not subject to the new excise tax. However, in the absence of regulations, the definition of "self-insured" is unclear, as most self-insured medical plans have stop-loss provisions that cause the plan to effectively become insured at a certain point. In addition, any employer changing from a self-insured medical plan to an insured plan should now consider whether it has any discriminatory employee benefit arrangements.

"Grandfathered" Plans. Certain insured plans qualifying for "grandfather" status under the health reform law are exempt from the excise tax while grandfathered. However, the complexity and relative inflexibility of the grandfathering rules may make it very difficult for an employer's plan to remain grandfathered.

Small Employers. In most cases, an employer with less than 50 employees is exempt. However, the number of employees for this purpose is determined on a controlled group basis, so that all entities with, generally, 80% or greater common ownership (determined under very complex rules) or an "affiliated service group" relationship (also determined under very complex rules) will be considered a single employer for this purpose. Thus, it is unclear whether the IRS will take the position that, for example, (i) a private equity fund and all its 80%-owned portfolio companies constitute a single employer and/or (ii) a fund's management company is part of an affiliated service group with the fund and its portfolio companies, so that entities that may initially appear to have less than 50 employees do not when viewed on a "controlled group" basis.

What to Do?

An employer with an insured medical plan (or expecting to adopt such a plan in the future) should consider eliminating discriminatory health insurance provisions from all existing executive agreements, and should avoid agreeing in the future to any such provisions. If an affected employee refuses to give up a discriminatory benefit voluntarily, an immediate cash payment in exchange for the benefit should eliminate the possibility that excise tax accruals will continue to run, although it is possible the IRS could take the position that such a payment is itself prohibited, as it substitutes for the prohibited benefit.

An employer might instead agree to pay a specified cash amount in the future in lieu of the promised benefits (e.g., a cash payment upon retirement instead of employer-subsidized post-retirement health insurance), but the IRS may take the position that such a future payment substitutes for the prohibited benefit and is thus itself a prohibited discrimination.

These new rules will be an unpleasant surprise for many employers and, in the absence of additional IRS guidance, there is no grace period to allow companies to change prohibited arrangements. As a result, employers should closely review their health insurance plans and executive agreements to assess compliance and determine whether any remedial actions are necessary.

1 For an employer with a calendar "plan year" the excise tax provision will be effective on January 1, 2011; for an employer with a December 1 plan year, the provision will be effective December 1, 2010; but for an employer with an October or November plan year, this provision is already in effect.

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

Jack S. Levin, P.C.
http://www.kirkland.com/jlevin
+1 312-862-2004

Alexandra Mihalas
http://www.kirkland.com/amihalas
+1 312-862-2104

Test-Driving a Hybrid Go-Shop

PENpoints

An interesting hybrid of the "go-shop" and "no-shop" techniques has emerged in some recent strategic deals that may be useful for private equity-sponsored transactions.

The "go-shop" technique gained popularity during the 2006-08 LBO boom as an alternative to the traditional "no-shop" in public target merger agreements. An interesting hybrid has emerged in some recent strategic deals that may also be useful for private equity-sponsored transactions.

Traditional No-Shops and Go-Shops. In a perfect world, a public company board that has decided to sell the company would satisfy its fiduciary duties under Delaware law to maximize shareholder value by scouring the market to find the best available price and terms. In the real world, however, a pre-signing "market check" often is neither feasible nor desirable. Historically in such cases, including a no-shop (or "non-solicit" covenant) in the merger agreement—typically prohibiting the target from actively soliciting competing offers, while allowing the target's board to accept an unsolicited superior proposal by paying the original buyer a "reasonable" termination fee (usually around 3% of deal value)—has been considered sufficient to allow a target board to satisfy their obligations to maximize value even in the absence of a pre-signing marketing effort.

During the LBO boom, many target boards took advantage of the robust selling environment by signing a deal with a buyer—often a private equity sponsor—without a pre-signing market check, but including in the merger agreement a "go shop," rather than a no-shop, provision in order to burnish its credentials as the protector of shareholder value. Go-shops are more seller-friendly than a no-shop and almost always feature (1) an initial post-signing period (the go-shop period) during which the target board may actively solicit competing proposals, often followed by a traditional no-shop period, and (2) a lower break-up fee (often about half the standard break-up fee) for a deal resulting from indications of interest received during the go-shop period. While it appears that go-shops have been largely unsuccessful in actually generating competing offers, Delaware courts have supported the proposition that a target board selling the company to a private equity buyer may fulfill its "market-check" obligation via a go-shop even in the absence of a pre-signing auction.

In today's revived market, go-shops continue to be a common feature of private equity-sponsored buyouts. Surprisingly, go-shops have recently appeared in deals with strategic buyers such as Odyssey/Gentiva and Peet's Coffee/Diedrich, perhaps because target boards are becoming increasingly nervous about the fiduciary implications of single-buyer sale processes even outside the private equity buyout arena.

New Hybrid. A hybrid of the traditional no-shop and the more recent go-shop has appeared in recent strategic-buyer deals, including Pfizer/Wyeth, Hewitt/Aon and Pfizer/King. The hybrid model includes a traditional no-shop (without the active marketing period of a go-shop), but it also features a reduced break-up fee (ranging from about 45% to about 66% of the full target break-up fee) for termination on account of an unsolicited superior competing offer that surfaces during an initial period (often 30 days after announcement of the first deal), with a traditional full break-up fee thereafter. No doubt these structures are an attempt to compromise between buyer's insistence on deal protection via a traditional no-shop structure and target board's desire to satisfy its fiduciary duties.

The hybrid formulation balances buyer's interest in deal certainty and target board's interest in satisfying its fiduciary duties; buyer avoids the distraction of target management and arguably unseemly public search for alternative buyers under a go-shop, with target taking comfort that a public announcement of the initial deal is sufficient to attract likely alternative bidders even absent active solicitation. On the flip side, target preserves the key economic (and resulting fiduciary-duty fulfilling) benefit of a reduced break-up fee for a competing bid surfacing quickly after announcement, with buyer accepting that the relatively small difference between the reduced fee and the full termination fee is highly unlikely to determine whether a competing bidder will surface with a superior proposal.

In the ever-evolving market for deal terms, it is as yet unclear whether the hybrid model will gain traction in the private equity-sponsored public company buyout market. In addition, the viability of go shops (traditional or hybrid) may face scrutiny in light of the continuing proliferation of the tender offer structure with its shorter sign-to-close timetables.

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

PENbriefs

Revlon—Different Strokes for Different Folks?

Delaware courts have long held that in a transaction involving a sale of control of a target company, the target's board has a duty (the so-called *Revlon* duty) to pursue the best transaction reasonably available, but that "there is no single path that a board must follow in order to reach the required destination of maximizing stockholder value." However, two recent cases suggest that courts may apply a different yardstick in evaluating a target board's satisfaction of its *Revlon* duties depending on whether the acquirer is a financial buyer or a strategic buyer. To learn more, see the recent *M&A Update* authored by David Fox and Daniel Wolf.

Treatment of Prepayment Prohibition in Bankruptcy is Proving to be a Tough Call for Courts

When a borrower files for bankruptcy, courts uniformly refuse to enforce loan agreement prohibitions against prepayment (a "no-call" provision), and in those circumstances lenders are generally also not able to enforce related make-whole premiums. In those situations lenders argue that they nevertheless are entitled to contract damage claims—independent of a make-whole premium—for their "dashed expectations" when their outstanding debt has been paid prior to its original maturity. Recent decisions highlight the difficulties courts have faced in addressing the lenders' claims. To learn more, see our recent *Kirkland Alert.*

PENnotes

Illinois Venture Capital Association 2010 Awards Dinner
Chicago, Illinois
December 6, 2010

Kirkland & Ellis is the presenting sponsor at the 2010 IVCA awards. Lester B. Knight, the founding partner of RoundTable Healthcare Partners, will be honored with the Stanley C. Golder medal, which acknowledges individuals who have made profound and lasting contributions to the private equity industry in Illinois. For more information, please visit: www.illinoisvc.org.

The Urban Land Institute's Keepers of the Castle: Real Estate Executives on Leadership and Management Program
New York, New York
December 9, 2010

Kirkland & Ellis will host a ULI panel discussion on "Keepers of the Castle: Real Estate Executives on Leadership and Management" on December 9, 2010, in Kirkland's New York office. Bill Ferguson, Chairman and CEO of real estate executive recruiting firm Ferguson Partners Ltd and Co-Chairman and Co-CEO of FPL Advisory Group will share the results of his study of leadership and cultural attributes of the best and brightest organizations in real estate. In addition, Bill will moderate a panel of senior executives that will discuss human capital needs, top operating issues, as well as strategic challenges and opportunities ahead in the real estate industry. Kirkland partner Stephen G. Tomlinson, P.C., will be a panelist. For more information, or to register, please visit: www.newyork.uli.org.

The Practising Law Institute's Drafting and Negotiating Corporate Agreements 2011
New York, New York
January 5, 2011

This PLI program will focus on fundamental drafting and negotiating principles common to all corporate agreements. Panelists will discuss key terms of standard transactional agreements; when and how to use letters of intent, confidentiality and standstill agreements; the wide range of M&A agreements, both public and private, and special agreements such as equity agreements and licenses. Kirkland partner Andres C. Mena will speak on "Credit/Indenture Agreements." For more information, or to register, please visit: www.pli.edu.

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
333 South Hope Street
29th Floor
Los Angeles, CA 90071
+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

Shanghai
11th Floor, HSBC Building
Shanghai IFC
8 Century Avenue
Pudong New District
Shanghai 200120
P.R. China
+8621 3857 6300
+8621 3857 6301 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. The Firm was named "Law Firm of the Year" in *Buyouts* magazine's "2010 Deal of the Year Yearbook," and was also honored with the 2010 "Award for Excellence" in Investment Funds by Chambers & Partners at its annual Chambers USA Awards. Kirkland was ranked in the first tier among law firms for both Private Equity Buyouts and Private Equity Funds by *The Legal 500 U.S. 2010*. Additionally, *Pitchbook* named Kirkland as one of the most active law firms representing private equity firms in its 2009 "Private Equity Breakdown."

The Lawyer magazine recognized Kirkland as one of the "The Transatlantic Elite" in 2008, 2009 and 2010, 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."

KIRKLANDPEN

KIRKLAND & ELLIS LLP

EDITORS
Jack S. Levin, P.C.
Margaret A. Gibson, P.C.
Norbert B. Knapke II

SUBSCRIPTIONS
To subscribe to *KirklandPEN*, please e-mail
kirklandpen@kirkland.com
+1 (312) 862-2894