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US Edition — Current Legal Issues for Private Equity Investors

Mezzanine Financing – An Alternative to High-Yield?

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Over the last several years, mezzanine funds have become an increasingly popular source of acquisition financing. The increase in popularity is a result of several global factors, including the decline in popularity of the small high yield deal, the proliferation of mezzanine funds and increases in interest rates and merger and acquisition activity generally. This article explores some of the driving factors behind the recent surge in popularity of mezzanine debt as a source of acquisition financing, and in particular as an alternative to the small high yield deal.

Decline of the Small High Yield Transaction

Even with the recent slowdown, the high yield market remains a reliable source of acquisition financing. The number of high yield financings and the aggregate principal amount raised in high yield financings have steadily increased since 2002. Moreover, over the last five years, the average size of a Rule 144A high yield financing has significantly increased. From 2001 to 2005, the average size increased more than 64 percent, from $230.1 million to $369.1 million. Over the same period, however, the number of "small" high yield transactions has dropped off precipitously. From 2001 to 2005, the number of high yield financings involving under $100 million dropped 64 percent, under $200 million dropped 47 percent, and under $300 million dropped 42 percent.[1]

Although it is difficult to identify all the reasons for this decline in the number of small high yield financings, we believe the decline has been driven – at least in part – by increased competition from the term loan "B" market (particularly the second lien market)[2] and the increasing costs associated with issuing and maintaining public debt securities as a result of the Sarbanes-Oxley Act of 2002.

A typical high yield financing is conducted as if it were a public offering of debt securities. The banks involved in the financing conduct due diligence, receive comfort letters from accountants and prepare a detailed offering memorandum that is modeled on a registration statement for a public offering of securities. After the offering is completed, issuers (typically, the target in an acquisition financing) are required to consummate a registered exchange offer for the high yield securities. As part of the exchange offer, the issuer prepares and files a registration statement with the Securities and Exchange Commission

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and, after completion of the exchange offer, the issuer is required to file the annual, periodic and current reports required of public companies.[3]

The decline in the number of small high yield transactions has tracked a corresponding increase in the cost to reporting companies of preparing the annual, periodic and current reports required of companies with public securities. According to one recent survey, expenses associated with preparing and filing these reports and maintaining the registration of securities with the Securities and Exchange Commission has increased more than 223 percent since the passage of the Sarbanes-Oxley Act.[4]

Mezzanine funds have responded to these increased costs by offering to finance ever larger mezzanine deals as an alternative to a high yield bond financing.

Issuers in small high yield financings are often not already subject to these ongoing periodic reporting requirements. As a result, the costs (and potential liability under the securities laws) associated with preparing and filing such reports are new and directly affect the bottom line.

Growth of Mezzanine Funds

Mezzanine funds have responded to these increased costs by offering to finance ever larger mezzanine deals as an alternative to high yield bond financings.

Historically the province of insurance companies, pension funds and endowments, the number and size of mezzanine financing providers have grown substantially over recent years. In 2005, 159 buyout/mezzanine funds raised approximately $86.2 billion, a 67 percent increase over the previous year and the highest yearly total ever recorded for these funds.[5]

This increase in the size of mezzanine funds has enabled mezzanine financing providers to fund larger transactions and compete directly with the high yield market for small high yield deals. For example, Goldman Sachs Mezzanine Partners has publicly announced its intention to focus on "large scale" mezzanine investments as an alternative to high yield, noting its belief that companies will encounter difficulties in efficiently accessing the high yield market for issues of less than $150 million.

Unlike a typical high yield financing, a mezzanine deal is not conducted as if it were a public offering. No detailed offering memorandum is prepared; no comfort letters are required; no road show is conducted; and issuers are not required to conduct a registered exchange offer for the mezzanine notes or thereafter file the annual, periodic and current reports required of public companies. As a result, financial sponsors and their portfolio companies are often able to consummate a mezzanine financing more quickly than they would a similarly sized high yield financing, and the ongoing administrative costs associated with maintaining mezzanine notes is often much lower than the costs of maintaining comparable high yield notes. Historically, these lower administrative costs of mezzanine debt have been more than offset by the much higher overall cost of mezzanine capital – but that is beginning to change.

Acquisition Financing and Interest Rates

While the popularity of smaller high yield transactions has been declining, the volume of acquisitions financing has surged. Leveraged buy out volumes are up almost 200 percent since 2003, and an increasing amount of acquisition consideration is being funded with debt. From 2001 to 2005 the ratio of senior secured bank debt to EBITDA in the average acquisition financing increased from 2.5x to 3.8x, and the ratio of non-bank debt to EBITDA increased from 1.2x to 1.8x.[6] For the reasons set forth above, much of this non-bank debt financing is being done outside the high yield market.

Over the same period, an increase in LIBOR has caused interest rates on floating rate senior debt to rise, while interest rates on fixed rate mezzanine debt appear to have remained flat. According to Standard & Poor's Middle Market Lending Review, senior coupons increased from an average of 5.2 percent in 2003 to 7.9 percent in the first quarter of 2006. Over the same period coupons on mezzanine debt have decreased from 12.6 percent in 2003 to 11.6 percent in the first quarter of 2006. The proliferation of mezzanine funds has increased competition for deals and brought down the cost of mezzanine capital. The reduction in mezzanine interest rates and the increased cost of floating rate senior debt have made fixed rate mezzanine financing more attractive.

Additionally, the covenants contained in mezzanine financing documents have been gradually becoming more attractive as they have become more akin to covenants contained in high yield debt instruments. Traditionally, mezzanine debt covenants were modeled

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Private Equity Deal Highlights

Our comprehensive experience in all aspects of private equity investment enables us to service the full array of legal needs of fund sponsors and investors alike, from fund formation to investment acquisition, structuring, financing and disposition. The following is a selection of US deals.

Apollo Management LP

Acquisition by Apollo Management LP of International Paper Co.'s coated-paper business to CMP Holdings LLC

2006

$1,400,000,000

Dex Media, Inc. The Carlyle Group Welsh, Carson, Anderson & Stowe

Acquisition of Dex Media, Inc. by R.H. Donnelley Corporation

2006

$9,800,000,000

Energy Capital Partners (ECP)

Acquisition by Energy Capital Partners of Northeast Utilities' competitive generation business in Connecticut and Massachusetts

Pending

$1,340,000,000

Kelso & Company

Acquisition by Kelso & Company of all ownership interests of Hallmark Entertainment, LLC from Hallmark Cards

2006

Not Public

Kohlberg Kravis Roberts & Co./Silver Lake Partners

Acquisition by Kohlberg Kravis Roberts & Co. (KKR) and Silver Lake Partners of Agilent Technologies, Inc.'s Semi-conductor Products Group (SPG)

2006

$2,660,000,000

LS Power Equity Partners

Acquisition by LS Power of Duke Energy's DENA Power Generation Assets

2006

$1,600,000,000

Odyssey Investment Partners LLC

Acquisition by Odyssey Investment Partners LLC of York Insurance Services Group

2006

$105,000,000

Silver Lake Partners

Acquisition by Silver Lake Partners of Serena Software, Inc.

2006

$1,200,000,000

The Carlyle Group

Acquisition by The Carlyle Group, and other investors, of Kinder Morgan Inc.

Pending

$21,000,000,000

The Carlyle Group

Sale by The Carlyle Group of Rexnord Corporation to Apollo Management LP

2006

$1,830,000,000

The Goldman Sachs Group Inc.

Sale by The Goldman Sachs Group Inc. of East Coast Power, LLC, to General Electric Capital Corporation

2006

Not Public

The Yucaipa Companies LLC

Representation of The Yucaipa Companies LLC as plan sponsor in connection with the acquisition of Aloha Airlines through a plan of reorganization

2006

Not Public

VNU Acquisition Consortium

Acquisition by a consortium of six private equity firms including AlpInvest Partners N.A., The Blackstone Group L.P., The Carlyle Group, Hellman & Friedman LLC, Kohlberg Kravis Roberts & Co. and Thomas H. Lee Partners, L.P. of VNU NV

2006

$11,300,000,000

Welsh Carson Anderson & Stowe

Acquisition by Welsh Carson Anderson & Stowe of a majority interest in Axesa Servicios de Informacion (formerly known as Verizon Information Services - Puerto Rico) from Verizon Information Services, Inc.

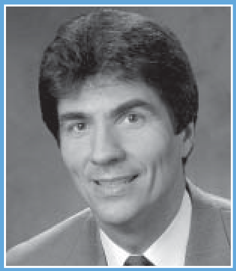
2006

Not Public

Deal Talk with Jose Fernandez and Antonio Del Pino

By David S. Allinson

This issue's *Deal Talk* interview features Jose Fernandez and Antonio Del Pino. Jose and Tony joined Latham & Watkins LLP's New York office as partners in the Corporate Department. Both are members of the firm's Latin America practice group, where Jose is also the global co-chair of the practice.



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Question: Jose and Tony, describe the current state of the Latin American M&A market. It seems that deal flow was pretty heavy 6 months to a year ago. How is current deal flow? Have potential buyers become nervous about political developments in the region.

Answer (Tony): While there is no question that the political situation in certain countries, particularly Bolivia and Venezuela and to a certain extent Argentina, has had an impact on foreign investment in those countries, much of the rest of the region has seen an increase in foreign investment over the last year or so. Given all the attention that Bolivia and Venezuela have received in the media and the fact that there were more than half a dozen Presidential elections this year in Latin America, many of which were very hotly contested, it is easy to jump to the conclusion that investors have become nervous. That hasn't necessarily been the case, however. Despite all the political activity this year, the M&A markets are looking fairly robust. I read a recent article that indicated that M&A activity so far this year was up more than three times compared to last year in terms of value. There have been a number of large deals in the financial services industry, and we're seeing renewed interest (principally from private equity funds) in energy, telecom and other infrastructure sectors. Just a couple of weeks ago the Wall Street Journal reported that Conduit Capital Partners successfully raised another fund in the ballpark of $400 million to invest principally in energy projects in the region and we've seen a number of other funds actively focused on the region, including the likes of Carlyle, which recently raised a fund for Mexico. In the past year or so more money has been raised by funds than during any period since the boom years before the turn of the century. While the political activity over the last year has made some cautious, investors have generally been bullish on the overall economic outlook of the region.

Question: Elaborate on the effect political developments are having on deal making. Although potential buyers may be concerned, do you think some are distinguishing between Venezuela and a country like Colombia, or is there a spill over affect? Also, do you think that any of the investors in assets that are slated to be nationalized will recoup any money through political risk insurance and/or some payment by the host country?

Answer (Jose): In my view the spill over effect has been fairly limited. Investors have generally become more sophisticated in the way they approach political risk analysis and seem to be making distinctions between the situation in Venezuela and a country like Colombia, where there has been a lot of interest of late. Colombia has had several years of economic stability and taken a number of steps to reform the legal system making it more attractive for foreign investors. While it still has a ways to go on the issue of security, it has made great strides to bring back investors, as well as encourage new investors.

Despite President Chavez' efforts to extend his influence beyond Venezuela's borders, in reality he seems to be having little impact on the investment climate in neighboring countries. Brazil, Colombia, and Peru have all been through several years of economic stability and seem to be attracting more interest than they have in years. While there is no question that the elections in Peru and more recently in Mexico have made some investors nervous, most investors seem to

"Any investor in the region needs to be focused on the volatility of the markets and the difficulty of exiting certain types of investments in Latin America."

be optimistic about the results in Peru and the deal pipeline in Mexico seems fairly robust right now despite the political instability caused by Lopez Obrador's refusal to accept the election results.

Question: Focusing on your previous answer about who the buyers and sellers are in Latin America, do you think private equity buyers will continue to be more active than strategic acquirers? Will we see more private equity firms focusing on the region?

Answer (Tony): Outside of the banking and financial services industry, I would say that right now the leading buyers seem to be the strong local groups and private equity and hedge funds. Currently it seems like the strategic entities are all sellers.

Over the last several years local family based groups, such as the Slim group in Mexico, the Cisneros group from Venezuela, the Santo Domingo group in Colombia and others throughout the region, have played a much more important role in M&A activity across the region. In part this is the result of many of the multi-nationals retrenching in their home countries during the lean years following September 11th and the corporate scandals in the U.S. The other reason for this is that many of the local Latin American groups had reached unprecedented levels of buying power resulting from the privatization phase and economic prosperity of the '90's. When combined with their greater appetite for risk during the tough years, the local groups really seemed to dominate much of the M&A activity for a while and have remained an important source of M&A activity since then.

Private equity and hedge funds have again been an important factor in the region. In my view, this is attributable to a number of factors. The first that comes to mind is that competition for deals in the U.S. and increasingly Asia has become so extreme that private equity investors are looking elsewhere. Latin America is a natural choice given that competition and valuations are both substantially less than in the U.S. and Asia. A second reason is that there have been several years of stable economic growth and legal reform in several countries, most notably Brazil and Mexico (where much of the private equity money has been focused). A third is that many funds are looking at Latin America as a way to diversify their portfolio. Finally, I think it has helped that in recent years we have seen some real success stories for private equity investors in Latin America. Any investor in the region needs to be focused on the volatility of the markets and the difficulty of exiting certain types of investments in Latin America. During the '90's several funds aggressively invested in the region and some got burned badly. Since then, we've seen some very successful exits by AIG, Advent, Darby, JPMP and others, receiving attractive returns on their Latin American investments. ■

Bradd L. Williamson
Partner
Tax Department

New Pension Law Makes Favorable Changes to the ERISA Plan Asset Rules

By Bradd L. Williamson

On August 17, 2006, President Bush signed into law the Pension Protection Act of 2006 (the Act). The Act represents the most comprehensive overhaul of the Employee Retirement Income Security Act, as amended (ERISA), since ERISA's original enactment in 1974.

Of particular importance to private equity funds, the Act makes it easier for many private equity funds and similar investment entities to structure their investments without complying with the complex and sometimes onerous venture capital operating company (VCOC) and real estate operating company (REOC) requirements.

Relaxation of 25 Percent Benefit Plan Investor Test

Under ERISA, a non-publicly traded limited partnership, LLC or other investment entity (a Fund) that is treated as holding "plan assets" must comply with ERISA's fiduciary duty and prohibited transaction rules. Since such rules could expose a Fund's general partner or other manager to potentially significant liability in connection with its ordinary course management of the Fund, the Fund will typically take great care to make sure it is structured so that it does not hold plan assets (e.g., by making sure that the investment by "benefit plan investors" is not significant or by operating as a VCOC or REOC).

A Fund is treated as holding plan assets if "benefit plan investors" own 25 percent or more of any class of equity securities in the Fund. Conversely, a Fund is not treated as holding plan assets if benefit plan investors own less than 25 percent of all classes of equity securities in the Fund. Thus, how the universe of benefit plan investors is defined is important in determining whether a Fund holds plan assets for purposes of ERISA. In a major positive development for the investment fund industry, the Act significantly relaxes the definition of benefit plan investor in two ways.

- First, the Act narrows the definition of benefit plan investor. Under pre-Act regulations, the definition of benefit plan investor included both employee benefit plans subject to ERISA or Section 4975 of the Internal Revenue Code (such as IRAs) and non-ERISA plans such as governmental pension plans, foreign pension plans and church pension plans which have not elected to be subject to ERISA.

  The Act limits the definition of benefit plan investor to only employee benefit plans subject to ERISA or Section 4975 of the Internal Revenue Code (ERISA Plans). A Fund may permit investment in any amount by governmental, foreign and church plans without violating the 25 percent test. Private equity funds may thus find that they are able to offer additional investment opportunities to non-ERISA Plans. Moreover, since non-ERISA Plan investments no longer count against the 25 percent test, there will often be additional room for ERISA Plan money under the 25 percent test which in many cases may allow private equity funds to accept additional ERISA Plan investments as well.

- Second, the Act allows a Fund that invests in another Fund to pro-rate its investment for purposes of the 25 percent test. Under pre-Act rules, if at least 25 percent of any class of equity in a Fund is held by benefit plan investors (as determined under the broader pre-Act definition), then 100 percent of the Fund's investment in another entity would be considered a benefit plan investor investment in such other entity. This rule was particularly burdensome for fund-of-funds and other feeder fund structures.

Under the Act, a Fund with a class of equity securities held at least 25 percent by benefit plan investors will be considered to hold plan assets only to the extent of the percentage of equity interests held by benefit plan investors (utilizing the Act's narrower benefit plan investor definition). This means that if 60 percent of Fund A's only class of equity securities is held by benefit plan investors and Fund A invests $10 million in the only class of securities of Fund B, then $6 million of the Fund A investment is counted as benefit plan investor money for purposes of determining whether at least 25 percent of Fund B's equity securities are held by benefit plan investors. By contrast, under pre-Act rules, all $10 million of Fund A's investment was counted as benefit plan investor money.

Private Equity Fund Considerations

As mentioned above, the changes made by the Act now allow a Fund that wishes to satisfy the 25 percent benefit plan investor test to accept additional investment from both non-ERISA Plans (such as governmental plans, foreign plans and church plans) and ERISA Plans (because more capacity is available for ERISA plan investment when non-ERISA Plans are removed from the definition of benefit plan investor). Moreover, many existing Funds that do not satisfy the 25 percent test under pre-Act rules, and which are operated as VCOCs or REOCs may find that they satisfy the 25 percent test as revised by the Act. It is important to note, however, that the 25 percent test is performed on a class-by-class basis. It is unclear under current law whether rights provided to some but not all investors (e.g., rights provided to an individual investor in a side letter) may result in the creation of a separate class of securities for purposes of the 25 percent test.

Because the 25 percent test allows more flexibility than operating as a VCOC or REOC, an existing Fund operating as a VCOC or REOC may wish to consider relying on the 25 percent test if possible. However, before operating under the new rules, the Fund should examine all applicable contractual obligations, governing documents and outstanding disclosure documents to make sure the Fund has no operating restrictions designed to comply with pre-Act rules. Such restrictions could include obligations to maintain VCOC or REOC status, to exclude benefit plan investors, or to otherwise limit the Fund's ability to rely on the 25 percent test. Depending on the applicable documentation, the Fund may be required to obtain investor or third party consent in order to modify such limitations. In addition, the Fund should be aware of any applicable non-ERISA restrictions (e.g., state or foreign law restrictions) that may apply with respect to any investor plans. Also, since a VCOC must qualify as such on the date of its initial investment and during each annual valuation period thereafter, it may not be possible to convert a Fund relying on the 25 percent test into a VCOC at a later date. Accordingly, a Fund that wishes to rely on the 25 percent test should carefully monitor its investors and this test during the life of the Fund and should reserve the right to restrict transfers and redemptions.

Effective Date

The relaxation of the benefit plan investor test applies to all transactions that occur following August 17, 2006 – the date the Act was signed into law by President Bush.

Conclusion

The revisions to the ERISA plan asset rules contained in the Act – in particular the relaxation of the 25 percent benefit plan investor test – will be welcomed by most private equity funds. The new rules should provide private equity funds with additional flexibility in attracting investors while removing many of the more onerous requirements that often applied to employee benefit plan investments in private equity funds prior to passage of the Act. ■

Latham News

Awards & Rankings

USA

Latham tops the 2006 *American Lawyer* Corporate Scorecard, receiving the highest number of top 10 rankings recorded in 15 important finance and corporate categories. The firm's top ranking reflects its global platform and the size and breadth of its transactional practice. With respect to specific categories, the firm ranked #1 as Issuer's Counsel in IPOs, Issuer's Counsel in High Yield Debt and Issuer's Counsel in REIT Debt. In addition, Latham garnered top-10 rankings in Mergers & Acquisitions, Private Equity Acquisitions, All Equity Issuances, Investment Grade Debt, Mortgage-Backed Securities and Project Finance.

Europe

Latham & Watkins scooped the "**International Firm of the Year**" accolade at leading French legal magazine *Décideurs Finance & Droits*' annual awards ceremony. The award recognises the firm's full service capabilities in Paris and the team's involvement in many of the most high profile, market-defining deals and cases in 2005. In addition, Latham was awarded "**Private Equity Team of the Year**."

Southeast Asia

Latham & Watkins was awarded the highest number of trophies in the 2006 *Asian Legal Business* Southeast Asia "Deals of the Year" Awards, including the prestigious **International Deal Firm of the Year** for its outstanding client service and "ability to combine rigorous analysis with astute judgment to give clients a competitive edge." Latham picked up an additional seven deal awards including: **Southeast Asia M&A Deal of the Year** and **Southeast Asia Deal of the Year** for the P.T. Adara Indonesia deal, recognised by the judges as one of the largest and most complex LBOs in the Asian market in recent history; **Singapore M&A Deal of the Year** for the firm's work on the landmark Colony Capital acquisition of the hotel business of Raffles Holdings Limited, with Latham acting on behalf of the lead arrangers. Other awards included **Equity Market Deal of the Year**, **Debt Market Deal of the Year**, **Singapore Deal of the Year** and **Singapore Insolvency and Restructuring Deal of the Year**.

Latham & Watkins' Private Equity Finance Practice News

Latham & Watkins LLP is pleased to announce that New York partners **I. Scott Gottdiener** and **Dennis Lamont** will serve as Co-Chairs of the New York office's highly regarded Private Equity Finance Practice Group. The team comprises attorneys from across practices, particularly corporate finance and leveraged finance, with a focus on providing sophisticated financing services to private equity clients and their portfolio companies at all stages of the investment cycle, from acquisition through exit.

I. Scott Gottdiener, a partner in the firm's Finance Department, will co-lead the Private Equity Finance Practice Group from the leveraged finance side, representing private equity sponsors and consortia, and their portfolio companies, in a range of financings for acquisitions, restructurings and recapitalisations.

Dennis Lamont, a partner in the firm's Corporate Department, will co-lead the Private Equity Finance Practice Group from the corporate finance and capital markets side. ■

on the covenants contained in a borrower's senior secured bank facility, with negotiated setbacks. As such, they often included financial maintenance covenants that imposed minimum EBITDA requirements, maximum leverage multiples and caps

While the market for high yield financings remains robust, financial sponsors and their portfolio companies have increasingly viewed mezzanine debt as an attractive alternative to smaller high yield transactions.

on capital expenditures. As covenants in mezzanine financing documents begin to migrate towards a high yield model, these financial maintenance covenants are being dropped, making the overall covenant package in a mezzanine deal more attractive. This development in the mezzanine debt market is paralleling a similar development in the Term Loan B market where "covenant light" packages are becoming more and more common.

Conclusion

While the market for high yield financings remains alive and well for larger more seasoned issuers, financial sponsors and their portfolio companies have increasingly viewed mezzanine debt as an attractive alternative to smaller high yield transactions. Increasingly, mezzanine financing is viewed as an efficient and inexpensive way to tap the debt markets without much of the process involved in a high yield transaction. Increases in the size and number of mezzanine funds have allowed mezzanine financing providers to offer increasingly larger mezzanine deals on increasingly more favorable terms that compete directly with the high yield market. With the amount of acquisition financing on the rise, we anticipate that mezzanine debt will continue to be a popular source of acquisition financing.

Endnotes

[1] Source: Thompson Financial.

[2] Source: Standard & Poor's.

[3] The high yield market has sought to address the increased costs associated with an issuer's ongoing SEC reporting obligations by offering "144A for life" notes. Issuances of these notes involve all the same attributes as other high yield notes (a detailed offering memorandum, diligence, comfort, etc.), but the ongoing reporting obligations are limited, typically excluding the more burdensome Sarbanes-Oxley requirements (including the requirements of Section 404).

[4] Source: Foley & Lardner.

[5] Source: Thompson Financial.

[6] Source: Standard & Poor's Leveraged Buyout Review.

Sean Finn
Partner
Tax Department

The Development of the REITs Market in the UK

By Sean Finn and former of counsel Andrew Longmate

"UK REITs are coming!" is the loud and very clear message to come out of Gordon Brown's March budget. Initially developed for the US market for both private and institutional investors, REITs offer a high-profit, low-tax investment vehicle via a broad property portfolio that is traded on the stock market. Will they turn out to be the holy grail of the British property industry, or are they nothing more than a work of fiction?

Champagne corks have been popping all over the City since Gordon Brown's plans to introduce tax efficient real estate investment trusts (REITs) to the UK were confirmed in his March budget. As a result, analysts predict that Britain's listed property market will treble in worth to £100 billion over the next five to 10 years, and on budget day itself, property share prices soared in their biggest ever one day rise.

But What Is It All About?

Effective as of January 1, 2007, companies and groups of companies whose main business is property investment, and who meet the necessary conditions, will be able to elect for special rules to apply to their property business and to their distributions. Those who elect will be classified as REITs.

With many market analysts forecasting a significantly increased number of listed real estate companies in Europe, which will increase alternative real estate investment opportunities for individuals and institutional investors, it is easy to understand the market's excitement.

The proposed REIT will provide a corporate structure for real estate investment which is effectively only taxed at a shareholder level. Typically, REITs will be equity-oriented tax efficient vehicles that will allow investors to pool funds for indirect participation in real estate ownership or financing. It is expected that the new REITs regime will be most likely to appeal to the following groups:

- Existing property investment groups that may want to convert to REIT status in order to take advantage of the potential increase in liquidity.
- New funds investing in UK property that plan to target individual investors.
- Property rich businesses that might want to raise money through a sale and lease back of properties. Therefore, REITs might provide an alternative exit route for private equity backed companies with property rich businesses.

A key advantage of REITs from a tax perspective is that the qualifying rental income of a REIT and gains made by a REIT from disposals of qualifying investment properties will be exempt from UK tax. Proceeds from the sale of a qualifying property should be reinvested within 24 months before those proceeds become treated as a non-qualifying asset.

Distributions from a REIT to its shareholders will be taxed (currently at 22 percent), and this tax will be deducted at source. HM Revenue and Customs, however, have indicated that this tax will either be refundable or will not be deducted in the first instance in the case of shareholders who are UK tax exempt (*e.g.* pension funds and charities) or who are UK resident companies. Non-UK resident investors are generally unlikely to be able to receive distributions from a REIT without tax being deducted at 22 percent, but they may be able to rely on an appropriate double tax treaty for relief.

Often described as a "win-win" during the UK government's lengthy consultation process, it is important to remember that there are a number of conditions that a REIT will have to satisfy in order to fall within the proposed legislation. The most prominent of these are:

- Existing property companies that convert to REIT status will be required to pay a conversion charge of 2 percent of the market value of its investment property at the time it becomes a REIT. Where a REIT acquires a company that owns property, the conversion charge will be payable on the investment property owned by the target company.
- A REIT must ring-fence property investments forming a tax exempt business and must distribute at least 90 percent of the net income profits from this tax exempt business.
- A REIT must be a UK tax resident company that is listed on a recognized stock exchange.
- At least 75 percent of a REIT's total income profits and at least 75 percent of the value of its assets must relate to its tax exempt business.
- REITs will be subject to a tax charge if the interest cover ratio (essentially the ratio of profits to interest) in respect of the tax exempt business falls below 1.25:1.
- If a REIT pays a dividend to a person who is entitled to more than 10 percent of the REIT's issued share capital, dividends or voting power, a tax charge is likely to arise.

All in all, the Treasury appears to have listened to the industry although it is clear that it is treading a fine line between encouraging liquidity in the UK real estate market, and creating a windfall for the government. For this reason, we may see a number of real estate players leaving their real estate off-shore for now. We will be watching closely with interest to see how this plays out over the coming months.

Latham's strong transactional corporate practice, together with its tax and real estate expertise, has combined to create a transactional team that is expert in all phases of REIT work. The firm has completed numerous transactions for REITs in the US and recently for their equivalent in France (SIICs) representing both issuers and underwriters. Latham ranked as the top law firm in US REIT debt transactions (including preferred stock) in *The American Lawyer* Corporate Scorecard 2005 and 2006. ■

Country Updates

France

New Legislation Reforming French Law Governing Security Interests

On 25 March 2006, the French law governing security interests was substantially changed. The new regime should allow more flexibility in the granting of security interests and more efficiency in their enforcement, in particular in the case of pledges over movable assets, which may now be granted simply through registration on a public registry. Enforcement would now be possible without the requirement for a court order, simply on the basis of a valuation by an expert appointed by the parties. In addition, a new type of pledge over inventory (for the benefit only of financial institutions) was created.

United Kingdom

New Edition of the Takeover Code

A new edition of the City Code on Takeovers and Mergers was published on 20 May 2006, reflecting the implementation of the Directive on Takeover Bids and other changes resulting from the Takeover Panel's consultation on dealings in derivatives and options and abolition of the Substantial Acquisition Rules (SARs). This new edition contains many changes including placing the Takeover Panel on a statutory footing in relation to most takeovers, the abolition of the SARs other than the rule relating to tender offers (which will give greater freedom in stakebuilding) and the extension of the definition of "interests in securities", which is used to determine whether key shareholding thresholds have been reached, to cover not only ownership of shares but also certain derivatives and options and, in limited circumstances, irrevocable commitments to accept the takeover offer. ■

Industry Focus

Industry Focus

Latham is one of the few full-service law firms capable of delivering seamless representation at a global level with 1,800 attorneys in 22 offices around the world. Our attorneys work collaboratively across legal disciplines and geographic boundaries and specialize in a multitude of industries. For more information on our industry expertise, please contact Meloudy Sadat at +1-212-906-1200.

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Private Equity Finance

Project Finance

Real Estate

Tax

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