KIRKLAND & ELLIS Alert

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SELECTED ISSUES (INCLUDING THE EXECUTIVE LOAN PROHIBITION) UNDER THE SARBANES-OXLEY ACT OF INTEREST TO PRIVATE EQUITY FUNDS AND THEIR PORTFOLIO COMPANIES

Introduction

On 8/1/02 we sent you a K&E Alert ("President Signs Into Law Sweeping Accounting Reform and Corporate Governance Legislation") on the Sarbanes-Oxley Act of 2002 (the "Act"). As discussed in that Alert, the Act contains many provisions that are burdensome to public companies and their officers and directors. This Alert discusses in more depth than the general 8/1/02 Alert two issues of particular concern to private equity funds and their portfolio companies:

- Under what circumstances does a private equity portfolio company (perhaps such a company with stock held by only a few persons but with 1933 Act registered high yield bonds outstanding) become subject to the Act, including the absolute prohibition on loans to executive officers and directors?

- When is a portfolio company's sale of stock to an executive, in exchange in whole or in part for a note, prohibited by the Act's loan prohibition?

Discussion

Director and Executive Officer Loans

Act §402 prohibits a covered "issuer" (as defined below) from extending or maintaining credit, arranging for an extension of credit, or renewing an extension of credit (directly or indirectly, including through any subsidiary) "in the form of a personal loan" to or for any executive officer or director. The prohibition is effective immediately upon the Act's 7/30/02 enactment, but grandfathers an extension of credit existing on the 7/30/02 enactment date so long as not thereafter materially modified or renewed.

Where a portfolio company sells stock to an executive for a note, the note likely constitutes an extension of credit "in the form of a personal loan" and therefore appears to be covered by the Act's loan prohibition. This is because (absent favorable SEC interpretation) the note issued to the portfolio company by the executive in exchange for the company's stock generally bears interest and has a maturity date, which are the hallmarks of a "personal loan."

Applicability to Private Equity Financed Portfolio Company

Many of the Act's provisions (including the prohibition on executive loans) apply by their terms to an "issuer," defined by the Act as:

(1) a company with a class of <u>equity or debt</u> securities traded on a national securities exchange (a "§12(b) company"), <u>or</u>

(2) a company with a class of <u>equity</u> securities held by more than 500

holders of record (a "§12(g) company")[1], <u>or</u>

(3) a company which has previously sold <u>equity or debt</u> securities pursuant to a 1933 Act registration statement and hence is "required to file reports under §15(d)" (a "§15(d) company"), subject to an exception described below, <u>or</u>

(4) a company which has filed a 1933 Act registration statement covering <u>equity or debt</u> securities with the SEC that has not become effective but also has not been withdrawn.

If a private equity portfolio company is or becomes a covered "issuer" (as defined in (1) through (4) above), the company is generally prohibited from making a loan to an executive officer or director, or from continuing an outstanding loan, i.e., the executive must immediately repay any existing loan (other than a loan outstanding at the time of the Act's 7/30/02 enactment). As discussed above, this apparently includes a note given by the executive to the company as purchase price for company stock.

There are several circumstances where a portfolio company might become a covered "issuer" -- and hence subject to many of the Act's provisions, including the loan prohibition -- even though the portfolio company has no publicly traded equity securities:

(a) Under (2) above, a company with more than 500 holders of a class of <u>equity</u> securities is covered, even if there is no public trading in the company's equity securities.

(b) Under (4) above, a company which files a 1933 Act registration statement with the SEC to sell <u>equity</u> securities (even if the registration statement has never become effective) is immediately covered at time of filing, unless and until the company takes affirmative steps to withdraw the registration statement (and hence a company whose equity IPO is on hold should generally withdraw the registration statement, even though the resulting delay if the offering is restarted would be longer than if the registration had not been withdrawn).

- However, the company is nevertheless covered by the Act's loan prohibition from the date of the 1933 Act filing until withdrawal.

(c) Under (4) above, a company which files a 1933 Act registration statement to issue <u>debt</u> securities, including high yield bonds -- either for cash in the public market <u>or</u> in exchange for previously issued private placement debt securities in an A/B exchange -- is immediately covered at time of the 1933 Act filing (again even if the registration statement has never become effective unless and until the company withdraws the 1933 Act registration statement).

(d) Under (3) above, a company whose 1933 Act registration statement for <u>equity or debt</u> securities has actually become effective, so that the company is required to file §15(d) periodic SEC reports (e.g., 10-K, 10-Q, etc.) is covered.

- However, such a company with fewer than 300 holders of such 1933 Act registered security is no longer required to file §15(d) SEC reports (and therefore ceases to be a covered "issuer") after the end of the fiscal year in which the 1933 Act registration became effective.

- In this case the company is nevertheless covered by the Act's loan prohibition from the date of

[1] Under SEC interpretations, stock options may be such a class, so a company with more than 500 option holders may be a §12(g) company.

the 1933 Act registration statement filing (under (4) above) until withdrawal and from the date of the 1933 Act registration statement effectiveness (under (3) above) until the end of the fiscal year of effectiveness.

- If the company has agreed (e.g., in a high yield indenture) to continue filing SEC §15(d) periodic reports and does file such reports, there is risk the SEC may take the position that the company continues to be a covered "issuer," either on the ground that the company is "required" by the indenture (although not by law) to continue filing SEC §15(d) reports or on the ground that all companies filing periodic SEC reports (whether or not required by law) should be treated equally.

Where a portfolio company not previously covered by the Act's "issuer" definition is issuing high yield bonds, the alternative courses of action (and their ramifications) are as follows:

A. Issue the high yield bonds in the private Rule 144A market (rather than in a 1933 Act registered public offering) and do not agree to effect a subsequent 1933 Act registered A/B exchange of the private bonds for similar registered bonds.

    - High yield buyers/underwriters will generally resist this course of action, especially since many high yield investors are restricted in the amount of unregistered bonds they are permitted to own.

    - However, it may be possible to place such private bonds, perhaps by paying a slightly higher interest rate than if the bonds were 1933 Act registered.

    - In light of the Act provisions discussed above, it is possible that market practices may change so that more high yield bonds are privately placed in the future.

B. Where a company files a 1933 Act high yield bond registration but does not complete the offering, withdraw the registration immediately, so that the company is a covered "issuer" only from the date of the 1933 Act filing until withdrawal (although executive loans are prohibited during this period).

C. Where a company actually issues high yield bonds pursuant to a 1933 Act registration statement (or issues registered bonds in exchange for privately placed bonds in an A/B exchange) but the bonds are held by less than 300 holders, the company automatically ceases to be a covered issuer on the first day of its next fiscal year, so that the company is a covered "issuer" only from the 1933 Act filing until the end of the fiscal year in which the registered issuance took place (although executive loans are prohibited during this period).

    - As discussed above, if the company agrees in the bond indenture to file §15(d) periodic SEC reports, the SEC may take the position that the company continues to be a covered "issuer."

D. Where a portfolio company adopts a two-tier holding company/operating company structure -- with 1933 Act registered high yield bonds issued by the operating subsidiary -- the parent holding company never becomes a covered "issuer" at all.

    - For example, where executives buy holding company stock with notes payable to the holding company, the holding company is not an "issuer" covered by the Act's executive loan prohibition so long as the holding company's operating subsidiary issued the registered bonds (with no parent holding company guarantee).

    - This solution should not violate the spirit of the Act's executive loan prohibition, which is designed to prevent a covered "issuer" from risking assets that belong in part to the issuer's public holders by making risky loans to its executives. However, where only the operating subsidiary has public holders (the public bond holders), the parent holding company's loan to an executive (not guaranteed by the operating subsidiary) does not put at risk any of the operating subsidiary's assets (just as a loan from the private equity investor to the executives -- not guaranteed by the portfolio company -- would not put at risk any of the portfolio company's assets).

- However, if the holding company were to guarantee the subsidiary's public bonds, the holding company would then be a covered "issuer," since the 1933 Act treats the parent's guarantee of a subsidiary's 1933 Act registered security as a security which must itself be 1933 Act registered.

Application of Executive Loan Prohibition To Portfolio Company

A portfolio company executive is required immediately to repay any "loan" from the portfolio company when the portfolio company becomes a covered "issuer" (e.g., by filing a 1933 Act registration or by selling registered high yield bonds so that the portfolio company must file §15(d) SEC reports), even though in the cases described in B and C above the company remains a covered "issuer" for only a few months.

By contrast, under the two-tier structure described in D above, the portfolio company never becomes a covered "issuer" and hence the executive loans need not be repaid.

While it would have been logical for the Act to grandfather a loan outstanding when the company becomes a covered "issuer," the Act does not do so. Rather it grandfathers only a loan in existence on the Act's 7/30/02 enactment date and then only as long as the loan is not materially modified or renewed after 7/30/02. Thus, to ensure compliance with the Act, all executive loans created (or modified) after 7/30/02 should call for an accelerated due date immediately before the portfolio company becomes a covered "issuer."

Thus a portfolio company which has sold stock to an executive for a note and is then issuing high yield bonds has several courses of action:

(i) Issue privately placed bonds.

(ii) Issue 1933 Act registered bonds through the portfolio company's operating subsidiary (with no parent guarantee).

(iii) Wait to issue the executive stock (in exchange for a note) until after the 1933 Act registered bonds have been issued (to fewer than 300 holders) and the company's fiscal year has ended.

(iv) Have the private equity fund arrange for the executives to obtain third party financing (e.g., from a bank or from the private equity fund itself) so the executives can pay off their notes to the portfolio company, at least until the portfolio company ceases to be a covered "issuer."

Transfer of Stock Without Payment

Act §402 does not appear to cover a transfer of stock to an executive simply because the stock is subject to vesting (e.g., the executive must return the stock to the company if the executive quits prior to a specified date). For example, if a portfolio company issues shares ("free shares") to an executive without payment (or issues shares to an executive in exchange for a cash payment), the executive's conditional vesting obligation to return the shares to the company does not appear to create a "personal loan" since there is no interest, no obligation to pay money, and no fixed maturity.

However, where an executive receives free shares (subject to vesting) worth (e.g.) $100,000 and makes a Code §83(b) election, the executive suffers $100,000 of immediately taxable ordinary income

("OI"), i.e., an amount equal to the shares' value. On the other hand, if the executive issues a note (or pays cash) equal to the stock's value, (a) the executive suffers no such OI and (b) the company ultimately receives an amount equal to the stock's value, although (c) such a stock sale for a note presents the §402 issues discussed above.

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For a discussion of many other provisions of the Act affecting private equity financed portfolio companies once they become a covered "issuer," see the K&E Alert distributed on 8/1/02.

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