

message from partner in charge

As the third quarter draws to a turbulent end, this issue offers vital information:

Mr. Ames' article on middle-market transactions notes that investors are increasingly interested in them due to the tightening credit markets. He illustrates three factors driving deals and four issues that make the deals unique. His article is a must-read.

Mr. Bortnick and Mr. Nickel discuss an Internal Revenue Service response to the current financial crisis—a temporary Revenue Procedure designed to shelter certain debt instruments from AHYDO rules.

In cyberspace, our recent webinar looked ahead to what the financial services industry might expect from either a McCain or an Obama administration.

Back in the brick-and-mortar world, we note several events in the business and legal communities, in which Pepper plays major roles.

As always, we welcome your comments and suggestions.

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Middle-Market Memo on M&A

This article first appeared in The Deal on August 5, 2008. It is reprinted here with permission.

The tightening of the credit markets and the resulting sharp decline in high-leverage megadeals has generated strong interest in middle-market transactions — a trend that is expected to continue at least throughout 2008.

Middle-market transactions are projected to remain in focus because they do not depend on syndicated debt, according to PricewaterhouseCoopers' transaction services group's midyear mergers and acquisitions forecast for 2008.

In addition, according to the forecast, three regulatory factors may drive an increase in middle-market deals — and possibly all deals — before year's end:

- the possible increase in the capital gains tax, which may motivate private equity firms to cash out wholly or in part by fourth quarter
- the new business combination accounting standard, FAS 141(R) — Business Combinations, which will no longer allow certain transaction costs to be capitalized into the purchase price, instead requiring them to be expensed
- changes in how companies account for noncontrolling interests or minority investments, FAS 160 — noncontrolling interests in consolidated financial statements, which may cause firms to take control of their minority interests before being required to record them in equity and lose gain and loss recognition for transactions with a parent.

As private equity firms deploy more capital in the midmarket, and because middle-market deals are unique, getting the right fit and the right experience can be critical to success. Four basic issues make these deals unique.

Social issues. Midmarket deals frequently involve founders or family operators who are key to a private equity target's success and growth. It's important to match the financial expertise of the investor with the operating expertise of the

owner-operator with sensitivity, whether it involves the introduction of a new finance officer, the addition of debt to the target's balance sheet or the creation of incentive-based compensation plans where there were none.

Changes in senior management also require a sensitive touch. These changes are often characteristic of the mid-market deal, and implementing any of them suddenly and without a clear understanding of the benefits could spell disaster.

Structure issues. Middle-market targets may be organized in a way that is not tax-efficient for investors. Therefore, understanding the use of creative and flexible flow-through structures for making an investment, such as LLCs, is important. Experience matters when it comes to understanding the alternatives these structures offer for the allocation of profits, losses and distributions to target owners and investors alike, and for creating critical incentives for management to drive growth.

Special skill also is required to address and balance the economic and tax concerns of the target owner's rollover equity — such as maintaining a single-level of tax and maximizing capital gains — and the investor's goals — such as qualifying for consolidated return filing, or a step-up in tax basis and amortization of the investment.

Capitalization issues. Growth through add-on transactions often drives returns in midmarket investments, while high leverage drives the megadeals. In fact, many midmarket deals are initially funded entirely with equity, sometimes later refinanced.

The result is that the post-money capitalization of a mid-market target follows its own pattern, and creates its own dynamic — all with a profound effect on valuations and returns — and all requiring a different approach to financial modeling.

Most important, because add-on transactions are so crucial in the middle market, the ability to complete them quickly and in a cost-efficient manner with positive effects on the target's balance sheet and P&L statement takes deft handling.

Supporting players. The accounting firms, lenders, investment bankers, lawyers and others that source midmarket opportunities for investors are all cast from a special group focused on the middle market. Dealing with any one of these advisers will put all the necessary experience and

Obama and McCain: What Would They Do For (Or To) You Webinar

Whatever choice the voters make in November, it's likely that the current federal regulatory approach to the financial services industry will change, perhaps dramatically. We've all heard the campaign rhetoric, but few have probed deeply into the specifics of both candidates' positions on matters affecting the financial services business.

What would Sen. Barack Obama's proposal for a foreclosure prevention fund mean for mortgage lenders already struggling for survival? What would Sen. John McCain do to address the financial issues at Fannie Mae and Freddie Mac, or other aspects of the ongoing credit crisis?

Listen as we examine the policies of both candidates regarding financial services regulation and related issues.

Visit Pepper's webinar section at www.pepperlaw.com to view the webinar recording and download the PowerPoint slides from this online event.

resources of the other advisers within the reach of investors, enabling them to close the deal quickly. This special group also is best suited to stay ahead of market trends and solutions that can create commercial efficiencies.

It is worth noting that this "fit" is as important to cost control as it is to overall success. Successful midmarket deals demand advisers who staff their deals with lean-and-mean teams, and provide the same partner and team from deal to deal.

So getting the right fit and the right experience can make the difference between closing the deal and losing it.

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IRS Releases Certain Debt Instruments from AHYDO Grip

Recent IRS guidance has given comfort to corporate borrowers that certain financing commitments obtained before January 1, 2009 will not become subject to rules that limit the deductibility of interest on debt instruments.

On August 8, 2008, the IRS issued Revenue Procedure 2008-51, which specifically exempted three types of debt obligations from being treated as applicable high yield discount obligations (AHYDOs). Given the current shakiness of financial markets and the resultant increased likelihood that debt instruments will be sold at deep discounts by issuers, without this guidance certain corporate borrowers may have seen their debt instruments swept into the AHYDO rules due to circumstances beyond their control.

Original Issue Discount Rules

A detailed discussion of original issue discount (OID) is beyond the scope of this article. However, some discussion is necessary to understand how and why the IRS notice is a help to taxpayers.

OID is the excess of a debt instrument's stated redemption price at maturity over its issue price. The stated redemption price at maturity generally is the total of all payments required to be made over the life of the debt instrument, other than stated interest required to be paid in cash or property other than debt instruments at least annually. For example if a bond is issued for \$80, pays no interest prior to maturity and is redeemable at maturity for \$100, the bond has \$20 of OID. This OID accrues over the term of the instrument at the yield on the bond. The holder (even if otherwise on the cash method of accounting) must take the OID that accrues into income over the holder's holding period. On the other hand, the issuer (even if otherwise on the cash method of accounting) of the bond generally is permitted to deduct, as an interest expense, the OID that accrues over the term of the bond, subject to some very complex rules.

Because OID is the excess of the stated redemption price at maturity of a debt instrument over its issue price, the determination of the issue price is critical. The OID rules contain specific rules for determining the issue price of

Revenue Procedure 2008-51 provides some relief and certainty for taxpayers against potentially adverse tax consequences arising solely as a result of current poor market conditions.

a debt instrument. In the case of a publicly offered debt instrument issued for cash, the issue price is the offering price to the public (ignoring bond houses and brokers) at which a substantial amount of the debt instruments were sold. In the case of a non-publicly issued debt instrument issued for cash, the issue price for each instrument is the price paid by the first buyer. The issue price of a debt instrument that is either publicly traded or that is issued for property that is publicly traded is the fair market value of the traded property.

Treasury Regulations provide that if the debt instrument is materially modified (e.g., the term or interest rate is changed more than an amount specified by the Treasury Regulations), the debt instrument is treated as being reissued for a new debt instrument. The issue price of the "new" debt instrument is determined under the OID rules described above. Accordingly, if the issue price of the new debt instrument is lower than the stated redemption price at maturity (e.g., because it is publicly traded and has dropped in value), the new debt instrument will have OID, which may be in excess of the OID on the original instrument.

AHYDO Rules

The AHYDO rules limit a taxpayer's ability to deduct OID as interest on certain corporate debt instruments. When the AHYDO rules apply, no deduction is allowed for the "disqualified portion" of the OID, which is treated

as a corporate distribution for purposes of the dividends received deduction available to corporate holders. The disqualified portion is the portion of the yield in excess of the applicable federal rate plus 6 percentage points. The remaining OID on any AHYDO is deductible only when paid. This obviously raises issues for the borrower, which would like a deduction for what is, in essence, an interest expense. It also poses an issue for lenders, because more taxes mean less cash flow with which to pay debt service. Accordingly, it usually is important both to the borrower and lender to ensure that, consistent with economic terms to which the parties agreed, the AHYDO rules are not brought into play.

In general, an AHYDO is a debt instrument that:

1. is issued by a corporation (or a partnership having one or more corporate partners, though the AHYDO rules are only applicable to the corporate partner(s))
2. has a term exceeding five years
3. has a yield to maturity that equals or exceeds the sum of the applicable federal rate plus 5 percentage points¹
4. the instrument has “significant OID.”²

IRS Relief - Revenue Procedure 2008-51

With the above background, you start to see some of the concerns created by current market conditions.

The IRS specifically highlighted two situations where worsening market conditions could dramatically affect the issue price of a financing commitment.

First, in a situation where a corporation issues debt with terms that are essentially permanent (i.e., not subject to renegotiation after the expiration of temporary “bridge” terms), the lender, acting as an underwriter, may be unable to sell the debt to third parties for a price that is equal to the amount the corporation received pursuant to the financing commitment. If this is the case, the result could be that the lender deeply discounts the debt obligations and causes a resultant drop in issue price (because the price paid by the lender in its capacity as an underwriter is ignored in determining issue price), compared to the money advanced to the corporation.

Second, in a situation in which a corporation issues debt that is subject to “bridge” terms established in the financing commitment, the corporation may be only be able to refinance this debt under less favorable “permanent” terms. Thus, the corporation and the lender may negotiate to amend the terms of the debt so that it can be marketed. In this case, certain amendments may end up constituting material modifications, and thus the debt would be treated as reissued for a new debt instrument. The issue price of the “new” debt instrument may, as discussed above, have an issue price lower than the amount initially advanced to the corporation. For example, if the debt instrument is publicly traded and the fair market has gone down.



Peppercast: Success Fees Under Section 328; Be Reasonable and Be Specific

In complex business reorganizations, debtors and other major parties-in-interest, such as trustees, examiners and creditors committees, will typically retain a small army of professionals – attorneys, financial advisors, accountants – to assist in the case. Not surprisingly, these professionals are entitled to compensation from the bankruptcy estate.

This podcast with **Francis J. Lawall**, a partner in Pepper’s Corporate Restructuring and Bankruptcy Practice Group, discusses the importance of thoroughness regarding Section 328 success fees and the Northwest Airlines case.

Listen today by visiting the Corporate Restructuring and Bankruptcy section of Pepper’s podcenter at www.pepperpodcasts.com.

Each of these cases potentially results in the creation of OID as a result of adverse market conditions. If the OID is significant, the instrument may be an AHYDO. The IRS wanted to alleviate uncertainties generated by current market conditions. Revenue Procedure 2008-51 covers three specific types of debt instruments issued under a financing commitment, that are generally: (1) debt instruments issued for money; (2) debt instruments exchanged for debt instruments issued under a financing commitment; and (3) debt instruments indirectly exchanged for debt instruments issued under a financing commitment.

Specifically, under the terms of Revenue Procedure 2008-51, the following debt instruments will not be treated as AHYDOs:

1. A debt instrument issued for money if (a) the terms of the debt instrument are consistent with the general terms of a binding financing commitment obtained by the corporation from an unrelated party before January 1, 2009; and (b) the debt instrument would not have been an AHYDO if the issue price were equal to the net cash proceeds actually received by the issuer.
2. A debt instrument issued in exchange (including a deemed exchange resulting from a material modification) for a debt instrument if (a) the terms of the original debt instrument are consistent with the general terms of a binding financing commitment obtained by the corporation from an unrelated party before January 1, 2009; (b) the new debt instrument is issued within 15 months following the issuance of the old debt instrument; (c) the debt instrument would not be an AHYDO if the issue price of the debt instrument were the net cash proceeds actually received by the issuer for the old debt instrument; (d) the maturity date of the new debt instrument is not more than one year later than the maturity date of the old debt instrument; and (e) the stated redemption price at maturity of the new debt instrument is not greater than the stated redemption price at maturity of the old debt instrument.
3. A debt instrument issued in exchange (including a deemed exchange resulting from a material modification) for a debt instrument if (a) the old debt instrument is described in 2; (b) the new debt instrument is issued within 15 months following

the issuance of the old debt instrument; (c) the debt instrument would not be an AHYDO if the issue price of the debt instrument were the net cash proceeds actually received by the issuer for the original debt instrument; (d) the maturity date of the new debt instrument is not more than one year later than the maturity date of the original debt instrument; and (e) the stated redemption price at maturity of the new debt instrument is not greater than the stated redemption price at maturity of the original debt instrument.

Pepper Perspective

Revenue Procedure 2008-51 provides some relief and certainty for taxpayers against potentially adverse tax consequences arising solely as a result of current poor market conditions. It is encouraging to see the IRS take a more commercial, less technical view under these circumstances. Taxpayers must remember, however, that the IRS clearly marked the limited cases covered by the Revenue Procedure. Taxpayers are specifically instructed that they may not use this guidance to infer other rules regarding whether a debt instrument would be within the scope of the AHYDO rules. Moreover, the “fix” effected by the Revenue Procedure is temporary (as we hope the conditions necessitating the Revenue Procedure will be).

Corporate borrowers intending to modify debt instruments, or whose debt is being sold by brokers or other intermediaries, should closely consider (with their tax advisors) whether the conditions described herein apply to their debt instruments, in order to determine whether the relief set forth in Revenue Procedure 2008-51 may apply.

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ENDNOTES

- 1 Once a debt instrument is determined to be an AHYDO, all OID is subject to the deductibility limitations, not just the portion of the OID representing yield in excess of the AFR plus five percentage points.
- 2 “Significant OID” is by far the most complex criterion. A debt instrument has “significant OID” if, at the end of an interest accrual period at least five years after the issue date, the cumulative accrual of interest and OID on the instrument exceeds the sum of: (i) the actual interest paid from the issue date until the end of that accrual period, and (ii) the product of the yield to maturity and the instrument’s issue price. In essence, this means that a debt instrument will have significant OID if following the first interest accrual period after the fifth anniversary of the debt instrument, unpaid interest and OID exceeds one year’s simple interest determined by multiplying the original issue price of the debt instrument by the yield to maturity thereon.

Upcoming Events

The Capital Roundtable: PE Investing in Financial Services Companies - Turning Hard Times into Hard Profits

Timothy R. McTaggart
Masterclass | October 16, 2008
www.capitalroundtable.com

Mergermarket: Global Midmarket M&A Trends

James D. Rosener
October 23, 2008
W Hotel | New York, New York

Financial Research Associates: 8th Annual Tax Practices For Private Equity Funds Seminar

Steven D. Bortnick
October 23 - 24, 2008
The Harmonie Club | New York, New York
www.frallc.com

The Capital Roundtable: Where to Place Your Healthcare Investment Bets

Workshop: November 12, 2008
Christopher S. Miller and Christopher A. Rossi

Masterclass: November 13, 2008
Christopher S. Miller
www.capitalroundtable.com

The Deal's M&A Outlook 2009

November 11-12, 2008
Grand Hyatt New York
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www.maoutlook2009.com

Financial Research Associates: 9th Summit on Valuation of Hard-to-Value Securities & Portfolios

November 17-18, 2008
The Flatotel | New York, New York
Gregory J. Nowak
www.frallc.com

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