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April 20, 2004

The Re-Emergence of Business Development Companies

In recent weeks, a number of major private equity firms led by Apollo, KKR, Blackstone and Evercore have sought access to the public markets by filing registration statements for "Business Development Companies" (or "*BDCs*"). The confluence of an underserved middle market, the challenges faced by the private equity industry and the unique features of BDCs (highlighted by the successes of Allied Capital and American Capital Strategies) are fueling a surprising re-emergence of these investment vehicles.

SEC Registration. A BDC is a publicly registered closed-end investment company conceived under the Small Business Incentive Act of 1980 to provide capital and assistance to small, developing or troubled businesses. Unlike other closed-end investment companies, a BDC is subject to the Investment Company Act of 1940 (the "*1940 Act*") in a modified way and has greater flexibility to issue senior securities, incur leverage and pay performance fees to an investment manager. Moreover, a BDC must file a notice with the Securities and Exchange Commission ("*SEC*") and register a class of its equity securities under the Securities Exchange Act of 1934 (the "*1934 Act*"). A BDC's shares typically are listed on an exchange or quoted on Nasdaq. Unlike other closed-end investment companies, a BDC must file periodic reports (*i.e.*, Forms 10-Q and 10-K) and other reports (*e.g.*, Form 8-K) like those filed for publicly traded operating companies.

Qualifying Assets. A BDC may not acquire any investment other than "qualifying assets" unless, at the time of acquisition, qualifying assets represent at least 70% of the BDC's total assets. Qualifying assets generally include securities of private or thinly traded public U.S. companies, cash, cash equivalents, U.S. government securities and high quality debt instruments. Additionally, a BDC either must control the issuer of the securities or must "offer" to make available to the issuer significant managerial assistance.

Governance. A BDC typically is organized as a Maryland corporation and is governed by a board of directors. A majority of the directors must be persons other than "interested persons" of the BDC (*i.e.*, independent). A BDC either may be managed internally by its own officers or externally pursuant to an investment advisory agreement with an investment manager. Under the 1940 Act, a BDC's investment advisory agreement (and any amendments thereto) must be approved by its shareholders and, thereafter, annually by its board (including a majority of its disinterested directors). The 1940 Act requires certain terms to be included in the investment advisory agreement, including a provision for termination of the advisor upon 60 days prior notice.

Fees. Recent BDCs have provided for a 2% management fee on gross assets (including leverage) and a 20% performance fee on income and gains payable to the managers of the BDCs. For its part, the performance fee is only payable after a "hurdle rate" of 7% on interest and dividend income (and thereafter, a 100% "catch-up" to the manager). However, unlike traditional private funds, there is typically no "hurdle rate" relating to realized capital gains.

Capital Structure. A BDC generally is precluded from issuing shares at less than the current net asset value. A BDC is, however, authorized to issue multiple classes of indebtedness and one class of stock senior to its common stock if its "asset coverage" is at least equal to 200% immediately after each such issuance. (For example, if it has $2 million in assets, it can leverage up to $2 million.) A BDC is authorized to issue securities that are convertible to voting securities or which are accompanied by warrants, options or other rights to subscribe for voting securities if authorized by both investors and a majority of its disinterested directors.

Other Private Funds. A manager will need to evaluate how a BDC fits into its existing advisory business. A BDC is subject to significant restrictions on transactions with affiliates that could be problematic if its manager also advises other private funds. In cases where the investment objectives of the BDC overlap with those of the manager's other private funds, the BDC may need to seek a one-time SEC exemptive order to permit co-investments. Although the SEC has granted relief in the past for co-investments in the same securities, there can be no assurance that it will be granted and the process can take as long as 9 months. A BDC generally will not be authorized to invest in companies where a related private fund has a pre-existing interest (but may, in limited circumstances, make follow-on investments). Additionally, managers are advised to consider any contractual restrictions imposed by private funds on its professionals to commit time to, and to offer investment opportunities first to, the private funds rather than the BDC. A manager also may be contractually prohibited from forming other commingled investment vehicles with similar investment parameters (such as a BDC).

Tax Status. A BDC may elect to be treated as a regulated investment company or "RIC" under Subchapter M of the Internal Revenue Code. As a RIC, a BDC generally would not be required to pay corporate-level federal income taxes on any ordinary income or capital gains that it distributes to its shareholders as dividends (thereby avoiding double taxation). A BDC must distribute to its shareholders, for each taxable year, at least 90% of its "investment company taxable income" (generally, its ordinary income plus the excess of realized net short-term capital gains over realized net long-term capital losses). Further, to qualify as a RIC, a BDC must, among other things diversify its holdings so that at the end of each quarter (i) at least 50% of its assets consists of cash, cash equivalents, U.S. government securities, securities of other RICs, and other securities if such other securities of any one issuer do not represent more than 5% of its assets or more than 10% of the outstanding voting securities of the issuer, and (ii) no more than 25% of its assets is invested in the securities, other than U.S. government securities or securities of other RICs, of one issuer or of two or more issuers that are controlled by the BDC and that are engaged in the same or similar trades or businesses.

Conclusion. Despite the potential drawbacks associated with managing a publicly registered vehicle, the recent trend of using BDCs as a means for private equity firms to access the public markets appears to be gaining momentum. The opportunity to raise permanent capital in a relatively short period of time is very appealing for firms seeking to quickly build a business as a provider of middle market finance. Many private equity firms are increasingly viewing these registered vehicles as realistic alternatives for traditional mezzanine funds and collateralized debt obligations.

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The summary set forth herein is intended to be general in nature. This memorandum is not intended to provide legal advice with respect to any particular situation and no legal or business decision should be based solely on its content. Please contact any of the following lawyers with questions regarding this memorandum:

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