WALL STREET MEETS MAIN STREET

Congress Examines the Economic and Social Effects of Private Equity Transactions

Introduction

Hardly a day passes when a story does not appear about the growth of private equity investing in the United States. Earlier this week, for instance, newspapers were filled with reports of a major private equity firm's bid to buy 80% of Chrysler Group for $7.4 billion. The Chrysler transaction is representative of a recent trend in private equity deals; transactions increasingly involve companies in businesses - automotive, restaurant and the like - that affect everyday life in the United States.

The meeting of Wall Street private equity investors and Main Street industries set the stage for a hearing conducted by the House Committee on Financial Services on Wednesday, May 16. Representative Barney Frank (D-MA), the Chairman of the Committee, presided over the hearing, which was the second in a series by the Committee, and which was intended to examine public policy implications related to private equity deals, and what, if anything, Congress can do to address any concerns. Among specific subjects addressed at the hearing was potential tax legislation aimed at private equity investors, the possibility of unionization of workers in industries ripe for private equity deals and representation of workers at the bargaining table as private equity deal-makers negotiate with their targets. The witnesses at the hearing included Andy Stern (President, Services Employees International Union), Douglas Lowenstein (President, Private Equity Council), Robert H. Frank (Professor, Johnson Graduate School of Management, Cornell University) and Jon L. Luther (Chairman & CEO, Dunkin' Brands Inc.).

Economic Effects of Private Equity

Most of the hearing centered on the effects of private equity investing on U.S. companies and their workers. The hearing can best be characterized as a debate on the topic with partisan overtones. Chairman Frank set the tone of the debate when he said that he believed it was "morally wrong" for a small group of players to enjoy a substantial increase in wealth that would widen the gap between the top income-earners and the vast majority of American workers. He wondered aloud whether private equity investments increase the well-being of a company and its employees, and questioned whether any of the increased value created by private equity accrues to the workers of the target company.

The Private Equity Model - Does it Create Long-Term Value? Mr. Lowenstein and Mr. Luther emphasized the constructive nature of private equity investing. Both indicated that the operating model of private equity firms is to attract future buyers, which can only be accomplished by growing and adding value, rather than the piecemeal sale of company assets at the expense of workers and consumers. Representative Deborah Pryce (R-OH) voiced her view that many companies are acquired by financial buyers, like private equity firms, as opposed to strategic buyers, precisely because they are "short-term losers" with no alternative access to capital or resources. She said that "a healthy long-term private company is better than a stagnant public one," and maintained that the focus of government policy should be on decreasing the burdens on public companies and not increasing those on private firms. Representative Edward Royce (R-CA) echoed the sentiment, suggesting that the recent popularity of private equity investment is a by-product of the difficulties saddling public companies, such as burdensome Sarbanes-Oxley regulation and abusive shareholder lawsuits.

Private Equity - Does It Provide A Sharing of Value? Union representative, Andy Stern, acknowledged the value created by private equity investment, but asked whether we are "*sharing* value." He spoke of today's world as "America's gilded age," noting a negative trend in middle-class wages and savings, despite workers' higher overall productivity. He also cited increases in transaction fees received by investment bankers and fund managers in connection with private equity deals. Representative Michael Castle (R-DE) responded to Mr. Stern's concern by noting the lack of empirical evidence showing private equity deals to be responsible for such economic inequality. Professor Frank alluded to research suggesting a long-term increase in jobs with companies acquired by private equity firms in the European markets. Mr. Stern in response conceded a need to "keep watching" before taking any legislative action.

Although many interesting themes were articulated at the hearing, none seemed to have consensus support of the witnesses. Perhaps more importantly, no consensus emerged among the witnesses and the Committee members for a need to regulate private equity investing.

The hearing ended somewhat abruptly with Committee members leaving for a vote on legislation. In concluding, Chairman Frank reminded all in attendance that the Committee would deliberate on legislative action, if any, after the conclusion of the third and last of its scheduled hearings. That hearing will consider the use of derivatives in the financial sector.

We expect to cover the derivatives hearing and will report on any further actions taken by the Committee with respect to hedge funds and the private equity business.

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If you have any questions regarding this memorandum, please contact Russell L. Smith (202-303-1116, rsmith@willkie.com), Jane H. Kim (202-303-1242, jkim@willkie.com), or the attorney with whom you regularly work.

Willkie Farr & Gallagher LLP is headquartered at 787 Seventh Avenue, New York, NY 10019-6099 and has an office located at 1875 K Street, NW, Washington, D.C., 20006-1238. Our New York telephone number is (212) 728-8000 and our facsimile number is (212) 728-8111. Our Washington, D.C. telephone number is (202) 303-1000 and our facsimile number is (202) 303-2000. Our website is located at www.willkie.com.

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