

PRIVATE EQUITY & VENTURE CAPITAL**Mid-Range Deals Take Private Equity's Center Stage**ABSTRACTED FROM: *Where The Deals Are*

BY: Danielle Fugazy

Dealmaker, June/July 2008, Pgs. 87-91

Deal size is shrinking. In the current tight credit market, companies can no longer rely on cheap money to fund ever bigger deals. Debt is hard to place and expensive, and fully leveraged deals have evaporated. However, mid-range deals—under \$1 billion—continue to get done, Danielle Fugazy reports. Private equity firms have begun setting up funds targeted for \$250 million to \$1 billion deals. Advent International raised \$10 billion for its mid-market fund, NEP attracted \$800 million, and TPG and Silver Lake each collected over \$1 billion. The Carlyle Group and other firms have funded mid-market deals by partnering with mid-market specialists and tapping existing investment funds not specifically targeted to deal size.

Big players move down market, quality moves up. Becalmed in the mega-deal category, the larger private equity houses are focusing their attention on the mid-market to maintain volume. This trend could squeeze those already active in the mid-range, predicts the author, toward even smaller deals. If private equity firms are forced to court companies and deals that would normally be beneath their interest level, what will happen when credit loosens up and bigger deals again become possible? Will the smaller-than-usual clients become neglected orphans in the firm's portfolio of investments? Certainly private equity has gotten much pickier about the deals to pursue. In the cheap credit days,

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private equity dealmakers would consider a prospect growing at 5%, but with more of their own capital required these days, they want to see projections of 20% annual growth. The consequence is that the quality of deals seems to be rising.

More cash, more creative financing. Debt is not the only way to get the deal done, the author reminds. The bigger private equity houses can simply write out a check for mid-range deals. Selecting the most promising target and then paying cash avoids the increasingly high costs and burdensome covenants associated with debt. While debt plays a part in many deals, it is far more restricted than in the recent past. Even when debt is the medium, companies are finding it in less traditional places. For example, Hellman & Friedman bundled financing from two hedge funds with loans from a few banks to take Getty Images private. Meanwhile, strapped lenders are trying to unload the debt that financed the recent boom in megadeals. Hard-pressed for cash amid heavy losses, lenders have written down debt and are selling it at heavily discounted rates. Private equity thus finds itself helping out lenders to free up capital by buying back debt (albeit at bargain prices).

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Banks Use Venture Capital To Cross-Sell For Future Business

ABSTRACTED FROM: *Building Relationships Early: Banks In Venture Capital*

BY: Prof. Thomas Hellmann, Prof. Laura Lindsey, and Prof. Manju Puri

University of British Columbia (TH); Arizona State University (LL);

Duke University and National Bureau of Economic Research (MP)

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Investing in later-stage venture capital. Although the use of venture capital by banks is not a common research topic, bankers have taken ample advantage of regulatory changes that allow banks to make private equity investments in startups. Although bankers naturally hope to profit from these investments, many of these serve to facilitate future business relationships rather than to succeed as a pure investment play. Finance professors Thomas Hellmann, Laura Lindsey, and Manju Puri compare banks doing venture capital with the more traditional sources of venture capital and find that bankers are avoiding early-stage investments. They tend to select less risky, later-stage companies that may already have financing from a more traditional VC firm. The companies are more developed businesses, closer to going public.

Capital investment now, loans later. Banks also pick startups and sectors where future banking business seems most likely. The authors' research shows that banks invest in startups which will want to use and will be able to carry debt in the future. The startup that receives venture capital investments from a bank is more likely to borrow money later, as it grows the business, and is more likely to borrow from its bank investor than from another bank. Thus investing in a stable startup cements an ongoing business relationship that may extend well into the future.

Bank/startup business funnel will benefit both. Banks clearly benefit from creating a stable of companies that will want to borrow in the future, but the startup benefits as well, the authors conclude. New companies often have trouble borrowing and tend to pay higher rates than well-established borrowers. Banks that have already invested in a company have more information about it than a bank with no prior relationship. Thus the investor/bank is more likely to make loans and to give good terms. Given this evidence, late-stage startups that anticipate a need for debt in the future might want to add a bank to their venture investors.

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MERGERS & ACQUISITIONS

Strengthening Protection For Shareholders Raises Merger Premiums

ABSTRACTED FROM: *The Value Of Investor Protection: Firm Evidence From Cross-Border Mergers*

BY: Prof. Arturo Bris and Prof. Christos Cabolis

IMD International and European Corporate Governance Institute, Lausanne, Switzerland (AB); ALBA Graduate Business School, Athens, Greece (CC); Yale International Center for Finance (AB and CC)
Review of Financial Studies, Vol. 21, No. 2, Pgs. 607-648

Melding accounting and governance standards. Under international law, acquiring 100% of a cross-border target generally converts the target into a national of the acquiror's home country, and the target's accounting, governance, and disclosure practices follow suit. Neither the nationality of the target shareholders, the country of operation, nor the location of assets dictates the applicable governance standards. With the switch in nationality comes a change in the legal protections covering the target's shareholders. The new governing laws may provide more (or less) protection for shareholders. Two noted business and finance professors, Arturo Bris and Christos Cabolis, used data from cross-border acquisitions to assess how the change in protection impacts market perception of the target's value.

Consolidation rules also come into play. Generally, the 100% acquisition results in a consolidation, which requires a change in the target's accounting rules. In practice, the authors note, the circumstances under which the target's accounting standards adjust can vary. Consolidation occurs in some mergers when the acquiror owns just 20% of the target, while in others, it never happens at all. Under US GAAP, an acquisition involving more than half of the voting shares triggers consolidation; international accounting standards require accounting consolidation when control changes, but local standards establish the percentage of voting shares that the acquiror must own for the shift to occur. Even if consolidation standards restrict adoption of the acquiror's accounting standards, targets can still assume better corporate governance practices voluntarily.

Better protection, increased value. To see whether investors value better accounting or governance practices in cross-border M&A, the authors compared the merger premiums in 506 cross-border deals conducted between 1989 and 2002 against the premiums for similar domestic transactions. They find that the adjusted merger premium is significantly larger for 100% acquisitions in which the acquiror's shareholder protections and reporting standards exceed those of the target's. The results suggest that improving the legal protections for target shareholders produces a positive valuation effect. Improved corporate governance expands the merger premium even if the target does not assume the acquiror's accounting standards. Merger premiums are larger where the acquiror's home country has more stringent reporting standards than the target's. Even when the shareholder protections deteriorate because the target is purchased by an acquiror from a country with weaker legal standards, or because it does not adopt stricter reporting requirements, the premium does not narrow significantly. (Further research is needed to explain this finding.) The results suggest that corporate governance standards should play a role in selecting the countries to target for acquisitions.

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GLOBAL MARKETS

Tips On Mining Cross-Border M&A Opportunities

ABSTRACTED FROM: *The Era Of Cross-Border M&A:*

How Current Market Dynamics Are Changing The M&A Landscape

BY: Marc Zenner, Matt Matthews, Jeff Marks, and Nishant Mago, J.P. Morgan Chase & Co.

Journal of Applied Corporate Finance, Vol. 20, No. 2, Pgs. 84-96

Mergers without borders. Cross-border M&A is picking up, even as domestic activity is waning in the year-long credit turmoil. Long before the current credit crunch, the integration of the global market was driving dealmaking in the developed markets and, more recently, the developing markets have entered the arena. Between 2003 and 2006, cross-border M&A accounted for less than 30% of global M&A activity; by 2007, 12 of the 15 largest non-private-equity deals were cross-border transactions, representing 40% of global M&A. Capital advisors Marc Zenner, Matt Matthews, Jeff Marks, and Nishant Mago remind dealmakers that cross-border M&A presents unique challenges as well as opportunities.

Priming the long-term well. A number of long-term influences have helped to fuel the surge in cross-border activity, the authors point out. Increased flow of capital and trade between countries promotes M&A activity by giving companies the opportunity to expand, to lower production costs, and to access ballooning markets through acquisition. More companies, particularly those in emerging markets, are seeking to increase their geographic diversification and to reduce what the authors term their “sovereign exposure” by purchasing foreign assets. By eliminating trade barriers and enhancing the flow of goods and capital, deregulation has also been a long-term driving force.

Short-term catalysts. The authors outline several short-term catalysts that have also been powerful drivers of cross-border M&A action. High relative valuations, particularly for companies located in emerging markets, provide easy access to capital and liquidity for expansion. The weak US dollar, relative to both emerging- and developed-market currencies, makes American assets appear inexpensive to foreign buyers and increases their purchasing power. Rising commodity prices, particularly in oil- and commodity-producing countries, have bolstered government sovereign wealth funds. Acquisitions fit well into the long-term investment strategies of many of these funds. In the United States, foreign buyers have stepped in to fill the acquisition gap left by domestic private equity buyers who can no longer arrange debt financing. Nevertheless, forces are also working against cross-border transactions, including the potential strengthening of the US dollar against foreign currencies (which would make assets appear more expensive) and local political forces promoting protectionism and domestic mergers.

Advice for successful deals. For dealmakers, completing a successful cross-border deal involves augmenting traditional M&A principles with strategies unique to cross-border activity. This may mean adjusting valuation metrics to take into account the tax, accounting, and risk differences in various jurisdictions; or recognizing that multiples cannot easily incorporate unique features such as synergies or unique risk attributes. A high level of liquidity is critical, because most cross-border M&A transactions rely primarily on cash; but, the authors advise, dealmakers should not rule out other financing alternatives. Dealmakers should also evaluate risk and assess how to manage it, particularly for major cross-border acquisitions. Anticipate the reaction of markets and shareholders, which is likely to be positive (academic studies suggest that cross-border acquirors tend to outperform domestic ones, at least in the short term). Rating agencies may react positively to geographic expansion and growth but

negatively to execution, political, and cultural risk. Be prepared to deal with some equity flowback from local target shareholders who may not wish to own foreign stock. Such situations may warrant dual listing or other solutions. Dealmakers also need to decide which currency to use for any debt, how to best hedge the currency risk and pre-closing fluctuations, and how to address transaction-related taxes and internal tax planning after the deal closes.

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Sovereign Wealth Funds Raise Concern Among Regulators

Abstracted from: *The Rise And U.S. Invasion Of Sovereign Wealth Funds: A Growing Source Of Concern*

By: Joseph Fleming, Christopher Christian, and Maureen Magner, Dechert, Boston MA
Review of Securities & Commodities Regulation, Vol. 41, No. 13, Pgs. 153-160

With success, a potential conflict. Sovereign wealth funds have grown dramatically in recent years. With up to \$3.5 trillion in assets held in about 40 funds, the sector is projected to reach as much as \$15 trillion by 2015. These funds are not responsible to shareholders for short-term performance, which gives them the freedom to invest for longer-term goals. In the fourth quarter of 2007, for example, they pumped over \$44 billion into financial institutions in the Western markets, thus providing much-needed global liquidity. Yet according to attorneys Joseph Fleming, Christopher Christian, and Maureen Magner, therein lies a potential conflict. These quasi-governmental investment vehicles have scooped up massive positions in significant economic institutions in key Western economies. Skeptics fear that a fund—and its overseeing sovereign—may hold too much control over the US economy and may exercise that influence for political purposes.

Sovereign wealth funds lack transparency. Sovereign wealth funds exist around the world, but the bulk comes from the Middle East and Asia, particularly China. As pools of assets owned by a sovereign government, the funds generally do not hold pensions or central bank assets, but foreign exchange reserves or revenues from natural resources such as oil are common. Proceeds from privatizations and various governmental enterprises are also possibilities. Although owned by the government, the funds are managed separately from regular treasury funds and seek to achieve specific economic benefits, which vary by fund and country. Even in the country where domiciled, the structure and goals usually remain murky to the public. Only the fund itself knows how much money it has, where the assets came from, and what purposes are to be served. Without transparency, the authors warn, investments may be selected with political as well as business agendas.

US regulators seek greater disclosure. No one wants to forfeit the availability of cash infusions from sovereign wealth funds, least of all the countries undergoing current credit problems, but most regulators want a clearer idea of who owns and manages the funds and to what purpose. While the SEC and the US Treasury, as well as witnesses before the Senate, all deny wanting to curtail fund investments, they do want global and domestic regulators to formulate reporting standards that would reduce political concerns about foreign control of financial markets. Entities cited by the authors, including Congress, the Treasury, the International Monetary Fund, and the Organization for Economic Co-Operation and Development, are examining ways to increase transparency. Currently only minimal reporting is required in the United States, and that cannot be verified for the sovereign wealth funds.

Forms 3, 13-D, and 13-F under the Securities Exchange Act require the disclosure of ownership interests at stipulated levels. However, whether the sovereign wealth funds are filing the forms on time and accurately remains uncertain.

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SECURITIES OFFERINGS

Avoiding Pitfalls When Drafting Registration Rights Agreements

ABSTRACTED FROM: *Key Considerations In Drafting A Registration Rights Agreement From The Company's Perspective*

BY: Valerie Ford Jacob, Stuart Gelfond, Michael Levitt, and David Kanarek

Fried Frank Harris Shriver & Jacobson, New York NY

Review of Securities & Commodities Regulation, Vol. 41, No. 10, Pgs. 113-122

The big easy. Changes to SEC Rule 144 now permit an issuer's nonaffiliates to sell unregistered securities after a six-month holding period (down from one year) and affiliates after a year, subject to volume and information requirements. Nonetheless, many initial investors—particularly private equity firms—still prefer specific commitments from the issuer to register their holdings, either on demand or whenever the company otherwise undertakes a public securities offering. By readily acceding to such requests, often in registration rights clauses or standalone agreements with vague wording, issuers risk compromising their ability to succeed in subsequent offerings and expose themselves to unnecessary administrative trouble and expense. Registration rights often become an issue in the context of an acquisition, where the M&A lawyers treat them as a subsidiary matter, leaving the securities lawyers to sort out the complications when the company later seeks public financing. Attorneys Valerie Ford Jacob, Stuart Gelfond, Michael Levitt, and David Kanarek strongly advise dealmakers to sweat the details in advance.

Taxonomy of registration rights. Registration rights come in two broad categories: *demand rights* and *piggyback rights*. Companies may find it difficult to resist demand rights when the investors have held shares for an appreciable time or if, as with private equity, the company's IPO is the investor's primary exit and payout strategy. The authors discourage giving any registration rights for non-affiliates, who need only hold them for six months; if rights are given, they should expire after six months (unless the issuer itself wants to continue preventing sales because they would interfere with a company offering). Piggyback rights give the holder an opportunity for registered shares whenever the issuer is otherwise registering shares for public sale. While less onerous for the company than demand rights, piggyback rights still entail administrative work and cost. If the holders can withdraw from an offering, they also complicate determining the issue's size and price structure. In the worst case, a flood of secondary sales accompanying an IPO could undermine the offering price.

Dead to rights. When envisioning an offering subject to registration rights, dealmakers should address several issues in the rights agreement that affect how the offering will take place. For example, the authors recommend that the company be able to withhold offering the investors' shares in situations where selling would disrupt the principal offering (e.g., in an acquisition issuance or when too many shares would dilute the price). The company should have free choice of underwriters and the ability to

reject—after due consideration—any investor comments on the prospectus. The authors also counsel that the rights agreement contain a single standard by which the company agrees to cause things to happen, such as “commercially reasonable efforts.” Avoid either a “best efforts” or an unmodified obligation. Costs can be contained through limiting the number of lawyers for investors that the company will pay. Dealmakers should also include confidentiality clauses in the rights agreement, carefully drafted to avoid Regulation FD’s public disclosure requirements.

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BANKRUPTCY & INSOLVENCY

Cheap Assets, But Few Buyers

ABSTRACTED FROM: *Under The Hammer*
The Economist, July 12, 2008, Pgs. 81-83

A shakeout in the offing. Conditions in the financial markets have been in turmoil. Yet *The Economist* has found a silver lining, if there is such a thing in this year of gloom: the fire sale of financial assets has produced a steady stream of fees. The sale of smaller institutions and peripheral assets such as insurance subsidiaries goes on apace. Bankers are awaiting all the really big deals, which thus far had been only the stuff of rumors. Until share prices recover somewhat, transactions done now are for the truly desperate. All banks are bracing for more stringent capital and liquidity requirements as they try to shore up weak balance sheets. Some are rueing the diversification binge that inspired them to expand into investment banking and insurance. Allianz is one such institution, which may jettison its Dresdner bank subsidiary. Two Spanish banks, Banco Sabadell and Banco Pastor, have put their insurance subsidiaries on the block. Citigroup is trying to unload its German retail operations, but buyers are scarce.

Pulling in their horns. For many of the bigger institutions, capital is an issue, and they have no desire to stretch already-thin capital bases. Some of the biggest names are in this predicament. Barclays, which managed to raise \$9 billion in capital in June, is still reeling. Deutsche Bank’s leverage ratio exceeds regulations. Smarting from the disastrous acquisition of Household Finance, HSBC is turning its attentions to emerging markets. Buyers, when (and if) they appear, are focusing on liquidity. They are further hamstrung by accounting standards, observes *The Economist*, which require them to assign fair market value to acquired assets. Meanwhile, as targets get cheaper and cheaper, the incentive to buy now evaporates. Some banks were able to manage their balance sheets in a conservative manner, but these banks are not likely to make a bad bet, even if it does seem cheap. In addition, foreign banks are limited to ownership of no more than 10% of US deposits.

Who is buying? As sources of capital dry up, bankers may have little choice but to cut back even further on lending, or take whatever price they can get in the open markets. The FDIC has already stepped in to bail out IndyMac Bancorp of California, but investors and bankers alike worry that medium-sized banks may be allowed to fail or may face rescue, like Fannie Mae and Freddie Mac, by the Federal Reserve. With banks in such desperate straits, buyers are scarce. Some bankers are looking to the sovereign wealth funds, which appear to have substantial liquidity, although many funds are still

absorbing losses on prior bank investments. Bankers wondering what to do may hear only the obvious answer: sell assets, including corporate and asset-backed bonds, often at fire sale prices.

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Surviving Corporate Restructuring, Before And After Chapter 11

ABSTRACTED FROM: *Mastering The Turnaround*

BY: Vincent Ryan

CFO, July/August 2008, Pgs. 63-68

Hobson's choice. Companies facing bankruptcy have a number of unpalatable options, reports Vincent Ryan. Filing for Chapter 11 bankruptcy may mean facing tight deadlines for formulating rescue plans, the exodus of key employees, nervous lenders seeking to recover debt quickly, and second-lien holders hungering for equity. Another option is to sell the company to distressed-debt investors. This choice exposes the company to bondholders (who may have little regard for the company's long-term health) clamoring to capitalize quickly on their investment. Rather than take the easy route with a quiet exit to a more stable situation, some dealmakers attempt to engineer a turnaround by restructuring the business's operations, finances, or both. Success in such endeavors is not assured, and the cost of bankruptcy can easily destroy an already struggling company. Of 450 bankruptcies by large public companies between 1998 and 2007, just one-third emerged from Chapter 11 as an ongoing concern. The odds of survival depend on a number of factors. A company with profitable operations but negative cashflow, for instance, could recover by refinancing its debt. Reorganizing operational structures is more difficult, but nonetheless also achievable.

Prepack the steps toward stability. CFOs and others who have been through the restructuring process offer advice for companies that wish to accomplish a turnaround. Because pressures from creditors can undermine the efforts to recover, companies sometimes take extreme actions at the last minute, hoping to avoid bankruptcy at all costs. While dodging bankruptcy may be admirable and perhaps advisable, do not rule out Chapter 11 as a last resort, urges the author. Many executives desperate to stay out of bankruptcy decimate the business by collateralizing or selling assets to raise cash, only then to pay exorbitant terms on debtor-in-possession financing. Instead, share information with senior lenders and creditors, and avoid creating an adversarial atmosphere. Explore the possibility of a *prepackaged bankruptcy*, in which creditors, bondholders, and other interested parties agree to support a reorganization plan before a Chapter 11 filing. This solution works best when the troubled company is operationally sound but requires some financial adjustments.

Setting the stage before the last curtain. During the weeks before a Chapter 11 filing, CFOs should already be working on ways to restructure and fix the business. One hospital CFO was faced with a high level of cash burn, a shrinking number of beds, and collection and revenue problems. After the filing, a turnaround expert minimized the corporate spending on consultants and other cash drains, evaluated large, critical receivables, and prioritized payables. Another company closed plants, instituted price increases, and worked on building market share. Do not avoid communication with employees and the outsiders, the author advises, about the situation and the possible solutions. Make sure the various parts of the company are talking to each other and have operational guidelines.

Plans for rescue. The author suggests several other strategies to promote post-turnaround success. For example, call the credit managers of large suppliers, explain the rescue plan, and work out terms that will keep vendors willing to continue the relationship. Try to work out the best terms possible with all parties. One company constructed a deal that let general unsecured creditors recover 85% or more while equityholders received warrants to buy new stock. Another company tapped debtor-in-possession

financing to save its underfunded defined-benefits plan, a move that boosted employee support and reduced possible claims. Fight for flexible capital to build a healthier balance sheet during and after the reorganization. This might involve steps such as consolidating and re organizing debt, or negotiating for new debt to refinance more expensive bonds. Try to avoid sending out distress signals. Once a company is slapped with the distressed label, investors who think it is undervalued may swoop in and try to control the reorganization strategy. Gaining insight into who owns and trades the company's debt through consent rights in lending agreements may raise costs but will increase certainty and control.

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