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Editors:

Kevin D. Burnett
kevin.burnett@klgates.com
503.226.5775

T. Richard Giovannelli
rick.giovannelli@klgates.com
704.331.7484

John W. Kaufmann
john.kaufmann@klgates.com
212.536.4009

Brendan R. McDonnell
brendan.mcdonnell@klgates.com
503.226.5710

Bruce A. Zivian
bruce.zivian@klgates.com
312.807.4434

In this Issue:

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INVESTOR'S CORNER

ILPA Adopts Private Equity Principles

By: Margaret A. Niles and Charles H. Purcell

On September 8, 2009, the Institutional Limited Partners Association ("ILPA") released its Private Equity Principles ("Principles"). The Principles describe a set of best practices that are applicable to the terms and conditions of private equity and similar funds.

The ILPA is a not-for-profit association composed of limited partner investors in the global private equity industry. ILPA has over 215 institutional member organizations that collectively manage approximately $1 trillion of private equity assets.

The Principles outline terms and conditions of funds that are intended to promote enhanced partnership governance, stronger alignment of interests and improved investor reporting and transparency for the private equity industry. The Principles deal with everything from distribution waterfalls to the terms governing advisory committees.

Interestingly, the Principles have been endorsed by numerous large investors including CalPERS, GIC Special Investments, Ontario Teachers Plan, UTIMCO, and the WSIB. We understand that in a number of cases, investors have incorporated the Principles into their fund review process. We understand that both institutional limited partners and the general partners that sponsor funds consider the Principles to be a living document -- both in that they are not intended to establish hard and fast rules but rather guidelines and preferred terms, and in that the Principles are expected to be modified and improved as the market develops.

The effect of the Principles on the terms and conditions that are offered in the market is yet to be seen, given the relatively small number of new funds on offer at this time. However, we would anticipate that their widespread endorsement will give rise to significant pressure on funds to comply with their terms.

For a copy of the Principles and a list of endorsing organizations, please visit www.ilpa.org.

FUND FORMATION

Raising a Debut Fund after the Financial Meltdown – Best Practices

By: John W. Kaufmann and Allison C. Joyce

Since the financial meltdown at the end of 2008, private equity fund raising has been sharply curtailed. Investors have been cautious since Lehman collapsed, generally sitting on the sidelines through 2009 to date. Many private equity sponsors have had to delay launching funds, or have extended their deadlines for initial fund closings. In the first half of 2009, funds raised by U.S.-based private equity firms dropped by 64% to $54.9 billion from the $152.7 billion raised in the first half of 2008. Globally, according to Preqin data, in the first three quarters of 2009 the number of funds with one or more closings declined to 349, from 751 in the same period of 2008 – a mere 46% of the 2008 results.

For new sponsors without solid track records from previous funds, it is especially difficult to raise a fund in today's marketplace. The following are some suggestions gleaned from placement agents, limited partners and successful general partners to help new private equity sponsors with their debut funds:

Have a well-articulated, focused strategy. A fund sponsor should have a coherent, fully-developed investment strategy before presenting its fund to investors. The strategy should also take into account the current financing environment, and the reduced availability of leverage. It should show how the fund in the short term will weather the aftermath of the financial meltdown, as well as providing for a viable long-term investment program.

Differentiate the fund. The fund should be clearly differentiated from the rest of the pack. Fewer funds being raised successfully means more competition, and investors are looking for "best of breed" funds that are a cut above others in the marketplace. Ways to differentiate a fund include highlighting industry focus and expertise, deal sourcing strengths, operating skills and experience, and other means of creating value in portfolio companies.

If you don't have a track record, build one. A fund sponsor must be able to show investors a track record that convincingly supports its ability to execute its investment strategy and earn the kind of returns targeted by its fund. Sponsors spinning out from other funds may use their previous records, but will need to be able to access information on their prior deals and disclose it to new investors. Other sponsors develop track records by investing on a deal-by-deal basis or through a small fund, with their own capital and capital raised from friends, family and other non-institutional investors. Without a prior history of investing, including positive exits and realizations, it may be necessary to postpone a fund until a track record can be developed these other ways.

Attract an anchor investor. A first-time sponsor should try to find one or more anchor investors for the fund. An anchor investor is typically an institutional investor that commits a significant amount of capital to the fund, and has sufficient prestige that its investment decision will validate the sponsor and its investment strategy for other investors. To attract an anchor investor, a sponsor should be prepared to offer special terms and benefits, which may include a share of the sponsor's carried interest, priority co-investment rights, special access to information through a seat on the advisory committee, and even a role in the investment decisions or other governance of the fund.

In the current market finding an anchor investor is more difficult than ever. Pension plans, foundations and endowments have reduced their commitments to private equity in order to reduce over-allocation and liquidity problems. A new sponsor might consider a group of anchor investors with smaller capital commitments in lieu of one larger anchor. This may mean offering even more special terms and perquisites to entice anchor investors to the group.

The general partner must commit real capital. Even in a robust market, investors like to see the general partner of a debut fund or its principals commit substantial amounts of their own assets to the fund. This demonstrates commitment, and alignment of interests. In the current market, investors view the general partner's capital commitment as a critical factor in their investment decisions.

Offer investor-friendly terms. Sponsors raising debut funds should offer simple, conventional fund structures with terms that are investor-friendly or at least reflect current market norms. Unusual or off-market fund structures, economics or other terms are deal-killers for many investors in today's conservative environment.

Be prepared for intensive due diligence. Investors are more risk-averse – no one wants to invest with the next Bernie Madoff. Sponsors must have references and track record back-up materials organized and ready for investors' due diligence investigations, which are now more in-depth and more detailed than ever.

The private fund marketplace has stabilized since last autumn's financial meltdown, but unique fund raising challenges remain, particularly for sponsors of first-time funds. This difficult market for raising private equity funds is likely to persist for many months, and may never recover to its previous peak. First-time fund sponsors must put forward their best offerings in order to raise a fund in this post-meltdown world.

PORTFOLIO OPERATIONS

D&O Insurance for Portfolio Companies: Why You May Need it and Five Key Coverage Provisions

By: Thomas M. Reiter and David P. Schack

Owners, officers and directors of portfolio companies of private equity firms may consider Directors and Officers ("D&O") liability insurance unnecessary where there is a single or limited number of owners of a private company. However, a number of insurers offer D&O insurance that is tailored to private companies and can offer significant benefits as a part of a private company's insurance portfolio.

The following are some of the benefits that D&O insurance may provide to portfolio companies:

- In "club" investments, the differing interests of multiple owners may still lead to claims against officers and directors. For example, one owner may allege that actions of the board or officers improperly favored one owner over another. Such claims would likely be covered under the D&O policy.
- In some states, the officers and directors owe duties to creditors to refrain from taking actions which prejudice creditors' rights. For example, individual officers and directors can be sued for fraudulent conveyances under broad standards that make any transfer to hinder or delay a creditor actionable. D&O insurance may protect officers and directors from such claims.
- Where a portfolio company files for bankruptcy (or is the subject of an involuntary bankruptcy), the trustee may assert claims against the board and officers in connection with the operations and governance of the company. Defending such suits can be costly and would not likely be covered by insurance unless the portfolio company had purchased D&O insurance.
- The basic liability coverage for businesses—commercial general liability ("CGL") insurance—provides limited protection (typically: bodily injury, property damage, advertising injury and personal injury). D&O policies generally offer much broader coverage of claims alleging a "wrongful act." This broad language is likely to sweep many more claims into coverage than the typical CGL formulation.
- D&O insurance for public companies normally limits coverage for claims against the company (as opposed to the officers and directors) to securities claims. However, many D&O insurance policies for privately held companies do not include this limitation on "entity coverage" and, as a result, any claim for a "wrongful act" against the company is potentially covered. For example, the company may be covered for defense costs for a breach of contract

claim where such a claim would not be covered under a CGL policy or under the typical D&O policy designed for a public company.

Given these advantages, portfolio companies may wish to carefully consider adding D&O insurance to their insurance portfolios. Unlike CGL coverage, D&O insurance is not written on standard forms, so it is advisable to analyze policies from competing insurers before making any coverage decisions.

Below, we identify some of the most important terms of coverage that should be considered in purchasing such D&O insurance:[1]

No. 1: Choice of Counsel. Seeking to minimize defense costs, insurers may argue that some D&O policies provide them with the right to reject the policyholder's choice of counsel or to require that the same counsel represent all insureds in the underlying claim. Policyholders may wish to consider seeking to obtain the right to choose their own counsel or at least obtain prior approval to use certain preferred law firms.

No. 2: Rescission. Many claims against directors and officers are based on alleged errors in financial statements. Policyholders often submitted these same statements to insurers as part of the policy application. Insurers increasingly are seeking to use the claimants' allegations of errors in financial statements as a basis to rescind D&O insurance policies. It is important to note that some insurers will contend that a misstatement—even if innocent—can support a rescission defense. To address this potential insurer defense, policyholders may wish to consider seeking to obtain broad form "severability" clauses that restrict the circumstances in which a "misrepresentation" coverage defense may be asserted.

No. 3: Investigations. The assertion of a vigorous and effective defense against a government investigation is often critical to eliminating or reducing the risk of formal proceedings. Yet, some D&O insurers take the position that their policies do not cover such investigations. Policyholders may wish to consider seeking to clarify the definition of "claim" to include government investigations.

No. 4: Fraud Exclusion. Many claims against directors and officers are based, at least in part, on allegations of fraudulent conduct. Most D&O policies contain "fraud" exclusions that, insurers may argue, eliminate or reduce coverage for fraud claims. Policyholders may wish to consider limiting the circumstances in which the exclusion may be invoked (*e.g.*, only in cases of "deliberate fraud") and then only if a final non-appealable adjudication in the underlying action establishes such fraud. This enhances the likelihood that the exclusion preserves coverage for defense costs and settled claims.

No. 5: Bankruptcy Issues. From the perspective of directors and officers serving portfolio companies, D&O insurance is perhaps most needed when the portfolio company is in bankruptcy and is unable to meet its obligation to advance defense costs and pay judgments or settlements. Many D&O policies contain potential impediments to accessing coverage in such circumstances. For example, as noted above, the D&O policy may also provide "entity" coverage to the entity or organization. As a result, insurers may argue that they cannot advance director and officer defense costs or pay settlements or judgments in connection with claims without bankruptcy court approval, lest such payments be deemed impermissibly to deplete a potential asset of the bankrupt estate. To address this issue, policyholders may wish to consider seeking to obtain a provision prioritizing the rights of individuals over those of the company. In addition, insurers may argue that the "insured versus insured" exclusion excludes "derivative suits" (sometimes brought in the bankruptcy context) alleging that directors and officers breached their fiduciary duties to the organization or entity. Policyholders may wish to consider seeking to obtain a policy specifying that the exclusion does not apply when a debtor-in-possession or a bankruptcy trustee, receiver or examiner (including their assignees) makes a claim against directors or officers.

[1] As a threshold matter, it may be advisable to ensure that the D&O insurance coverage is appropriately coordinated with any indemnification rights of covered insurance persons.

Potential Liability of Private Equity Firm Board Designees in Sale of Portfolio Companies

By: Cheryl A. Allaire, Dennis A. Peterson and Bruce Zivian

Summary of Decision

In a recent decision, *In re Trados Incorporated Shareholder Litigation*, the Delaware Chancery Court denied a motion by director defendants to dismiss breach of fiduciary duty claims. The claims arose from the board's approval of the sale of the company for $60 million, with approximately $8 million going to management under an incentive plan and the remaining consideration given to preferred stockholders in partial satisfaction of their liquidation preference. The common stockholders received nothing and filed a class action suit against six of the company's seven directors who approved the sale, claiming breach of the duty of loyalty to the common stockholders. Four of the directors were employees or owners of private equity firms that owned the preferred stock and were the designees of the preferred stockholders.

In their suit, the common stockholders alleged (i) the director defendants never considered the interests of the common stockholders; and (ii) the director defendants were not independent because they were entitled to receive material personal benefits as a result of the sale. In response to the first allegation, the court confirmed that preferred stock provisions are merely contractual rights. Where there is a conflict, it is generally the duty of the board to prefer the interests of the common stock to the interests and special rights typically associated with preferred stock, and it is possible that a director could breach his fiduciary duty by improperly favoring the preferred stockholders. As to the second allegation, the court noted that while simply designating a director to a board is not enough to cause the loss of director independence, alleging that four of the seven directors were designated to the board by preferred stockholders, had employment or ownership relationships with the preferred stockholders and were dependent on preferred stockholders for their livelihood was sufficient, under the plaintiff-friendly pleading standard on a motion to dismiss, to rebut the business judgment presumption with respect to the board's decision to approve the merger.

Significance of Decision

While the decision was rendered in the context of a ruling on the defendants' motion to dismiss, and was therefore not a final finding of liability, the decision could have implications for principals of private equity firms who are designated to serve on boards of portfolio companies. If ultimately determined to have acted out of self-interest and not in good faith, such directors may not be entitled to indemnification for the resulting liability and legal expenses or to recover under D&O insurance.

Practical Considerations and Precautions

The following are some precautions private equity designated directors may want to consider taking when considering a sale of their portfolio companies:

- Ensure that the board considers and discusses the potential impact of the sale on all equity owners, common and preferred, and that the board minutes reflect such consideration and discussion.
- When initially making the investment, be sure to include drag-along rights that afford preferred stockholders the right to force a sale and drag along the common stockholders. In *Trados*, the absence of drag-along rights was specifically noted by the court.
- Create a special committee of truly independent, disinterested directors to make decisions about whether and when to sell the company. In *Trados*, a special committee was formed but it included three of the private equity firm designees.
- Avoid statements and communications indicating a director is acting other than in the best interest of the company. For example, in *Trados*, one director stated that his fund did not own enough of the company to make a meaningful return. The court quoted this and similar communications and statements made by directors.

- Carefully consider common stock valuations and events that could trigger reconsideration of such valuations.
- Suggest that the board obtain a fairness opinion, even though costly, and potentially resulting in delay.
- Carefully review indemnification provisions and D&O coverage.

DEAL POINTS

The *Yellowstone* Decision: New Standards for Lender Liability in the Current Economic Climate

By: Jo Ann J. Brighton and Felton E. Parrish

This article examines the recent case of *In re Yellowstone Mountain Club, LLC*[1] in which a bankruptcy court equitably subordinated the claim of secured creditors under a syndicated loan facility. *Yellowstone* is novel for three reasons. First, equitable subordination has traditionally been an extraordinary remedy, rarely imposed by courts. Second, it is a lender liability decision resulting from a "kitchen sink" complaint filed by the creditors' committee (the "Committee") – generally, these cases settle well before litigation as part of a global settlement in the case. Finally, the court found in favor of the Committee and ordered the equitable subordination of the secured creditors' claim even though the underlying loan was an arm's-length syndicated loan transaction. For all of these reasons, *Yellowstone* may signal that in the current economic climate, courts will review lending transactions with greater scrutiny.

Background

The Debtor entities ("Debtors") in *Yellowstone* were created for the purpose of developing The Yellowstone Club (the "Club"), a membership-only, master-planned development situated near Yellowstone National Park. The Debtors were originally controlled by Blixseth Group, Inc. ("BGI"). In late 2004, Credit Suisse approached BGI to discuss the possibility of providing a syndicated loan to the Club. After several months of negotiation, the Debtors entered into a syndicated loan agreement with Credit Suisse in the amount of $375 million. Of that amount, approximately $209 million was transferred to BGI in the form of a loan.

The Case and Interim Order

Following the Debtors' bankruptcy filing, the Committee filed a complaint against Credit Suisse asserting claims for aiding and abetting breach of fiduciary duty, avoidance of fraudulent transfers, and disallowance or subordination of claims (the "kitchen sink" complaint). The Committee's primary argument was that the loan served no purpose other than to provide a distribution for the personal benefit of the shareholders of BGI and, therefore, the Debtors did not receive reasonably equivalent value in exchange for the liens provided.

In response, Credit Suisse argued that (i) the aiding and abetting claims were barred by the doctrine of *in pari delicto*, (ii) there was no evidence that the controlling shareholder of BGI intended to breach his fiduciary duties, and (iii) all expert witnesses, including the Committee's expert witness, concluded that the Debtors were solvent after entering into the loan. In addition, Credit Suisse contended that the terms of the original loan were not unreasonable given the fact that it was initially oversubscribed by 400% and the Debtors remained current on the loan for the three years prior to the bankruptcy filing.

In May, 2009, the bankruptcy court entered an order equitably subordinating the $232 million claim of the secured lenders to the claims of the DIP lender and the unsecured creditors. The court recognized that equitable subordination generally requires three findings: (1) that the claimant engaged in some type of inequitable conduct, (2) that the misconduct injured creditors or conferred unfair advantage on the claimant, and (3) that subordination would not be inconsistent with the Bankruptcy Code. The court further noted that when the remedy of equitable subordination involves a non-insider, non-fiduciary, the level of pleading and proof is elevated: gross and egregious conduct will be required before a court can equitably subordinate a claim. Although it concluded that the loan had been negotiated at arm's length, the court nevertheless found that the claims should be subordinated

[1] Case No. 08-61570 (Bankr. D. Mont.).

because "Credit Suisse's actions in the case were so far overreaching and self-serving that they shocked the conscience of the Court."

The court's conclusion was driven primarily by the fact that Credit Suisse was not going to be a long-term lender but, instead, was motivated by earning fees through the syndication process. The court also focused upon the fact that Credit Suisse had been the party to initiate the loan negotiations and concluded that Credit Suisse had done insufficient due diligence regarding the Debtors' ability to service the loan. All of this led the court to state: "The naked greed in this case combined with Credit Suisse's complete disregard for the Debtors or any other person or entity who was subordinated to Credit Suisse's first lien position, shocks the conscience of this Court…Credit Suisse lined its pockets on the backs of the unsecured creditors." Shortly after this strongly-worded order was entered, the parties entered into a global resolution that facilitated confirmation of the Debtors' plan of reorganization, and the court vacated its equitable subordination order.

A notable issue that the court did not squarely address was whether all the lenders in the syndicate should be held accountable for the actions of Credit Suisse that the court found so egregious. Without any discussion of the issue, the court equitably subordinated the entire claim held by the lending syndicate. This is a particularly concerning aspect of the decision for lenders who participate in syndicated loans because it suggests that any alleged misconduct by the arranger may be imputed to subsequent purchasers of the loan.

Key Considerations; Conclusion

Because the parties settled, and the decision was vacated, we will never know if this decision would have survived appeal. However, lenders of all types should take note of many questions it raises. For instance: Has the due diligence standard for lenders changed? Is there a minimum amount of time a lender must be in a deal to avoid being deemed to have committed gross and egregious conduct thereby warranting the equitable subordination of its claim? Is there a new fee structure that does not warrant equitable subordination and, if so, what is it and who determines what the structure should be? Are all lenders in a syndicated loan subject to the same exposure? What about post-closing changes in the make-up of the syndicate group? Does the failure of an initial lender to stay in the deal for the "long term" expose subsequent purchasers of the debt to additional liability? What about hedge fund lenders? Are all loans made by hedge funds with short-term strategies and higher fees subject to the same analysis used in *Yellowstone*?

These questions have no clear answers, but lenders, and their counsel, need to consider what the answers might be. Indeed, it does not appear that Credit Suisse did anything materially different than any other arranger of syndicated loans and, particularly disturbing, is the fact that it was the syndication process, in and of itself, that most concerned the court. Even though the *Yellowstone* decision was vacated and is no longer persuasive authority, savvy creditors' committees will likely brandish the *Yellowstone* decision to encourage settlement by showing lenders that rolling the dice with litigation is never completely safe regardless of the underlying facts.

Reconsidering Private Equity and Venture Capital Investments in LLC Portfolio Companies

By: Warren P. Kean*

Private equity and, to a lesser extent, venture capital firms have become increasingly comfortable with investing in portfolio companies that are organized as flow-through tax entities, such as limited liability companies ("LLCs"). The principal reason for this is that LLCs and other entities that are treated as partnerships for tax purposes can enhance the returns and the timing of returns for investors.

LLCs are not subject to federal income taxes and generally are not subject to state income taxes. Instead, the owners are taxed on their respective shares of the LLC's taxable income. As a result, cash that a portfolio company would otherwise use to pay company-level income taxes may be used to deleverage or may be distributed to the company's owners (whether as tax or regular distributions), with a favorable effect on their IRRs. In addition, because distributions from an LLC usually may be made tax free, LLCs are preferable to corporations

for recapitalizing a portfolio company with debt, a distinguishing characteristic of LLCs that will become increasingly meaningful as credit markets thaw and become more robust.

Because an LLC portfolio company generally is not subject to U.S. income taxes and because LLCs generally are governed by contract, there is much more flexibility in the manner in which transactions involving these companies may be structured or restructured to adapt to changes and other developments in the business, legal, regulatory, tax, and financial landscapes. For example, unlike shareholders of a corporation that must sell stock to avoid two levels of income tax, members of an LLC generally are indifferent, from a federal income tax perspective, to whether they sell their ownership interests in the company or the company sells its assets. In addition, a tax election is available to allow the buyer of ownership interests in an LLC to receive substantially the same tax treatment had the buyer purchased assets.

As a result, the buyer of an LLC portfolio company generally is able to "step-up" the tax basis of the company's assets to correspond with the purchase price that it pays for the company. This step-up in tax basis usually generates tax deductions, typically over a 15-year period for intangible assets such as goodwill, thereby lowering the buyer's income tax liability and allowing the cash savings to be employed by the buyer for other purposes. This enhanced cash flow for a buyer then may be (and usually is) emphasized in connection with the auction or other sale of the portfolio company to support a higher sales price (often in the range of a half or full turn of EBITDA).

An LLC also yields a better result than a corporation in connection with a failed investment. Losses from an LLC portfolio company usually may be deducted sooner than losses relating to an investment in a corporation. Those losses also may be deducted as ordinary losses, allowing for a 35% federal income, after-tax recovery. In the corporate context, investors typically realize capital losses that, generally speaking, may only be used to reduce their capital gains, and for individuals allow only a 15% federal income, after-tax recovery. Because capital losses generally may be used only to offset capital gains, an investor often must carry them forward for one or more years until the investor recognizes sufficient capital gains to absorb those losses. Moreover, corporate investors have a limited recovery period. They can only carry capital losses back three years and forward five years, otherwise they will expire unused.

Founders and managers who receive a significant part of their compensation in the form of equity incentives often prefer to have portfolio companies organized as LLCs or be organized under an LLC holding company. Using an LLC allows members of management to receive "profits interests" that are taxed more favorably (to both the portfolio company and the executives) than their corporate counterparts (such as stock options and restricted stock). In addition, LLC portfolio companies generally facilitate the founders' ability to roll over all or part of their ownership interests in their company into a new platform tax free (particularly in connection with roll ups) and to realize the other tax and economic benefits described above.

LLCs have certain disadvantages and shortcomings. The principal disadvantages include (1) tax-exempt investors being subject to tax (unrelated business taxable income tax or UBTI) on their direct or indirect, through tiers of flow-through entities, investment in LLCs; (2) foreign investors having to file U.S. income tax returns and pay U.S. income taxes; (3) investors having to pay state income taxes for the states in which the portfolio company conducts business; (4) the need to convert to a corporation to access the public equity markets; (5) the inability to merge into or otherwise exchange membership interests in an LLC for stock in an acquiring corporation tax free; and (6) the delays LLC structures tend to cause investors in filing their own tax returns. The flexibility of LLCs, however, allows procedures, structures, and techniques to be employed to minimize or eliminate the objectionable aspects of their tax treatment. Being able to structure around those disadvantages, while retaining their advantages, is what makes investing in LLC portfolio companies appealing.

**This article is a digest of a paper that is to be published by Practising Law Institute in two sets of course handbooks: (i) Tax Strategies for Corporate Acquisitions, Spin-offs, Joint Ventures, Financings, Reorganizations & Restructurings, and (ii) Tax*

Planning for Domestic and Foreign Partnerships, LLCs, Joint Ventures and Other Strategic Alliances. A copy of the unabridged text may be obtained by contacting the author at warren.kean@klgates.com.

DC PULSE

House Passes Private Fund Investment Advisers Registration Act

By: Daniel F. C. Crowley, Justin D. Holman, and Karishma Shah Page

On December 11, 2009, the U.S. House of Representatives passed H.R. 4173, the "Wall Street Reform and Consumer Protection Act of 2009" (the "Wall Street Reform package"), by a vote of 223-202 (see Wall Street Reform amendments). Twenty-seven Democrats voted against the bill and no Republicans voted in favor of the bill. The Wall Street Reform package includes the "Accountability and Transparency in Ratings Agency Act," the "Consumer Financial Protection Agency Act," the "Financial Stability Improvement Act," the "Investor Protection Act" and the "Over-the-Counter Derivatives Markets Act." For additional information about the broader regulatory reform effort, please see previous K&L Gates updates, including *Congress Builds on Obama Financial Regulatory Reform Approach, as Reform Efforts Proceed* and *House and Senate Take Expedited But Divergent Approaches to Financial Regulatory Reform Plan*. In addition, please see the K&L Gates Global Financial Market Watch Blog for detailed analysis on many of the individual proposals and for future updates.

Title V, Subtitle A of the Wall Street Reform package mirrors H.R. 3818, the "Private Fund Investment Advisers Registration Act," which was reported favorably out of the House Financial Services Committee (the "HFSC") on October 27, 2009 by a 67-1 vote (see HFSC amendments). The "private fund" portion of the Wall Street Reform package would require private advisers to hedge funds and other private pools of capital to register with the U.S. Securities and Exchange Commission (the "SEC"). The private advisers would also be subject to new recordkeeping and disclosure requirements.

Background

HFSC Capital Markets Subcommittee Chairman Paul Kanjorski (D-PA) first released a discussion draft of the "Private Fund Investment Advisers Registration Act" on October 1, 2009, which he described as significantly enhancing the draft legislation released by the Obama Administration in July 2009 (see the Administration's Proposal; for information on the Administration's proposal, see the K&L Gates alert *The Obama Administration's Proposal for the Registration of Investment Advisers to Private Investment Funds: The Private Fund Investment Advisers Registration Act of 2009*). Chairman Kanjorski later introduced the discussion draft as H.R. 3818. After favorable reporting out of the HFSC, HFSC Chairman Barney Frank (D-MA) and the Democratic leadership of the House consolidated the "Private Fund Investment Advisers Registration Act" with the other financial regulatory reform bills into the omnibus Wall Street Reform package.

Key Provisions

Key provisions of Title V, Subtitle A include:

- Defining "private fund" as an investment fund;
- Requiring that onshore and offshore private funds register with the SEC;
- A blanket carve-out for advisers to certain foreign private funds and small business investment companies ("SBICs");
- An exemption from SEC registration for advisers to venture capital funds and private funds with less than $150 million in assets (both would still be subject to SEC recordkeeping and reporting requirements);
- Requiring the SEC to take into account the risk profile of different types of private funds when it determines the registration requirements for private funds;
- Clarifying that the fund, not the individual investor, is the investment adviser's client;
- Requiring that advisers maintain and file records with the SEC in order to determine whether a particular fund poses a systemic risk;

- Requiring information sharing among the SEC, the Board of Governors of the Federal Reserve System and any other entity the SEC identifies as having systemic risk responsibility;
- A one-year transition period for investment adviser registration; and
- An asset amount test that is adjusted for inflation.

Family Funds
One issue that remains an area of controversy is family offices or family trusts (collectively, "family funds"), which are funds that manage investments and trusts for a single wealthy family. A recent study by the Wharton School at the University of Pennsylvania suggests that there are 1,000 such family funds around the world.

The "private fund" portion of the Wall Street Reform package would exempt any private fund with less than $150 million in assets from SEC registration. However, family funds traditionally have assets of $100 million or more, presumably bringing at least some family funds under the purview of the legislation. Doing so would subject these funds, whose beneficiaries have thus far maintained relative privacy, to disclosure obligations.

In the context of the financial regulatory reform debate, family funds have been arguing that they should be fully exempted from SEC registration because they do not pose a systemic risk. Family funds argue that they do not invest aggressively; rather their aim is maintaining wealth.

Carve-Outs
Groups that have traditionally been exempt from SEC registration, such as family funds (as discussed above) and commodity trading advisers, have been advocating for carve-outs. However, Chairman Kanjorski has indicated an unwillingness to allow further carve-outs. Chairman Kanjorski is concerned that further carve-outs would weaken the "private fund" portion of the Wall Street Reform package and potentially mute its effectiveness.
It is unclear going forward how this will play out. As mentioned earlier, SBIC advisers have a blanket exemption and advisers to venture capital and private funds under $150 million in assets are exempted from SEC registration. Remaining points of contention include determining the proper asset threshold for an exemption, who determines the asset threshold and how regulators guard against systemic risk if many pools of capital remain exempt under the "private fund" portion of the Wall Street Reform package.

Sharing of Proprietary Information Among Agencies
Some HFSC members, including Ranking Member Spencer Bachus (R-AL), have expressed concern that proprietary information may not be properly protected with interagency sharing. Given that the funds are private, and not public, there is concern that the information may be used for purposes other than intended.

Looking Ahead
In the U.S. Senate, Senate Banking Committee Chairman Christopher Dodd (D-CT) (who announced his retirement from the Senate on January 6, 2010), after months of bipartisan negotiations with Ranking Member Richard Shelby (R-AL), on his own released a discussion draft on November 10, 2009. On the issue of private funds, Dodd departs from the approach taken by the HFSC, focusing mainly on the registration of advisers to hedge funds. Toward that end, the Dodd discussion draft not only exempts venture capital advisers from SEC registration but also private equity advisers (although SBICs do not get a carve-out). In addition, the threshold for SEC registration of advisers is raised to $100 million, advisers are required to use an independent custodian to hold client assets, the definition of "investment adviser" is changed to exclude "family funds" and "private fund" is defined as an issuer rather than an investment fund.

Recently, Chairman Dodd reopened negotiations with Ranking Member Shelby and has assigned Senators to bipartisan working groups. Chairman Dodd has indicated he hopes to begin substantive markup of his financial regulatory reform legislation when the Senate comes back from recess in late January. However, with health care reform still dominating both chambers of Congress, the full

Senate will probably not take up financial regulatory reform until the spring at earliest.

House Passes Bill Modifying Tax Treatment of Carried Interest

By: Patrick G. Heck, Michael W. Evans, William A. Kirk, Karishma Shah Page, Roger S. Wise, Daniel F. C. Crowley and Cindy L. O'Malley

On December 9, the House of Representatives passed H.R. 4213, the "Tax Extenders Act of 2009," by a vote of 241 to 181. The bill would extend a number of tax provisions which are currently set to expire at the end of the year, continuing what has become a regular year-end practice of Congress. Notably, the $31 billion package is largely offset by a revenue-raising provision that would require investment fund managers to treat carried interest as ordinary income (in the same manner as amounts received for the performance of services), rather than capital gains, to the extent that carried interest does not reflect a reasonable return on invested capital. The provision would raise $24.6 billion over ten years.

Under current law, the net income from an investment services partnership interest, often referred to as "carried interest," is taxed at capital gains rates (to the extent the partnership's income would be so treated) rather than at ordinary income tax rates. H.R. 4213 would recharacterize a service partner's share of income from the partnership as ordinary income, and would also subject this income to self-employment tax. The bill, however, does contain an exception for income that is attributable to a partner's qualified capital interest, provided certain requirements are met. The bill would define qualified capital interest as the amount of a partner's interest in partnership capital attributable to: (1) money or other property contributed in exchange for the partnership interest; (2) the amount included in the partner's gross income with respect to the transfer of the partnership interest for services; or (3) the partner's distributive share of cumulative net income and gain of the partnership included in the partner's income. A similar provision was in the President's FY 2010 Budget (although that would have applied to all partnerships, not only those providing investment services) and has previously passed the House on two occasions (as part of H.R. 3996 and H.R. 6275, both in the 110th Congress).

It is unclear how the Senate will move forward on H.R. 4213, due, in large part, to the inclusion of the carried interest provision. Senators on both sides of the aisle have indicated they oppose the modification of the tax treatment of carried interest in the absence of a broader corporate tax reform effort.

However, the House's inclusion of the carried interest proposal in the bill is significant as Congress and the Administration look ahead to 2010. First, with a record FY 2009 federal deficit of $1.42 trillion, Congress and the Administration will be aggressively searching for ways to lower the deficit. Second, the tax cuts enacted in 2001 and 2003 are scheduled to expire at the end of 2010, setting the stage for a comprehensive tax reform debate. Given the confluence of these factors, the Administration and Congress are likely to be engaged in an aggressive search for revenue in 2010. In this context, the tax treatment of carried interest is likely to be a targeted area for additional revenue.

TAX ADVANTAGE

Maximize Deductions for Success-Based Fees Paid in M&A Deals

By: J. Stephen Barge

In today's challenging market conditions, sellers and buyers must utilize every tool at their disposal to maximize investment returns on the purchase or sale of a company. One underutilized strategy is saving taxes by deducting certain investment banking fees.

Most investment banking fees for M&A transactions are contingent on a successful closing. These "success" fees are often the largest fees paid in a transaction. Although the general rule is that taxpayers must capitalize such fees and cannot deduct them immediately, favorable tax rules allow success fees to be deducted in substantial part if certain requirements are met. Successfully

navigating these rules requires taxpayers not only to structure success fees carefully, but also to satisfy certain stringent documentation requirements when the investment banker is first engaged and upon closing of the transaction. A taxpayer's ability to fight off an IRS challenge in this area will stand or fall on the documentation that the taxpayer has in hand at the time that its income tax return is due.

What are the basic rules?

The IRS has set forth the Transaction Cost Rules that address when a taxpayer must capitalize costs incurred to facilitate certain transactions. These rules apply to acquisitions of ownership interests in a business entity, or assets that comprise a trade or business, as well as restructurings, recapitalizations and reorganizations of a business entity's capital structure (each, a "Covered Transaction"). Although the general rule is that success fees in connection with a Covered Transaction must be capitalized, special rules provide that some (or all) of a success fee can be deducted if two requirements are met.

First, a success fee can be deducted to the extent that the fee is allocable to services that do not "facilitate" the Covered Transaction. Services performed after a bright-line date (the "Bright-Line Date") automatically "facilitate" the Covered Transaction and thus costs incurred for those services must be capitalized. The Bright-Line Date is the date on which a letter of intent, exclusivity agreement or similar agreement is signed by the parties to the transaction, or the date on which the taxpayer's board of directors (or governing officials) authorize or approve the material terms of the Covered Transaction. Also, amounts that are paid for the following specified services are "inherently facilitative" and must be capitalized even if these amounts are for activities performed prior to the Bright-Line Date:

1. obtaining a fairness opinion, appraisal or written evaluation of the transaction,
2. structuring the transaction, including negotiating the structure and obtaining tax advice,
3. preparing and reviewing the merger agreement, purchase agreement or other document that effects the transaction,
4. obtaining regulatory approval,
5. obtaining shareholder approval such as proxy costs, solicitation costs, etc., or
6. conveying property between the parties to the transaction.

Second, the taxpayer must maintain documentation that establishes the portion of the success fee that is properly allocated to activities that do not facilitate the Covered Transaction. This documentation must be completed on or before the due date of the taxpayer's tax return. The documentation must be more than a mere allocation between services that facilitate the Covered Transaction and services that do not. Although time records are not required, there must be a principled and documented basis on which to allocate the success fee.

How to apply these rules successfully in the real "deal" world.

In many M&A deals, the vast majority of services that investment bankers perform as part of a Covered Transaction (and thus the bulk of the success fee) are related to services performed prior to the Bright-Line Date. For example, preparation of teaser pieces and deal books, contacts with prospective purchasers, evaluation of competing bids and proposals, preparing and attending road show and management presentations, creation and monitoring of data rooms, etc. are all services typically performed by investment bankers prior to the Bright-Line Date. These services are not inherently facilitative and thus the portion of a success fee attributable to these activities can be potentially deductible.

As a practical matter, there are several things that taxpayers and their advisers can do to maximize the availability of deductions for success fees:

- Break out the costs of a fairness opinion. Costs incurred to obtain a fairness opinion must be capitalized. The engagement letter or some other document can provide a stand-alone cost for a fairness opinion, which provides evidence of the amount of the fee that should be allocated to the fairness opinion. Purely from a deductibility standpoint, it is optimal to allocate as little value to the fairness opinion as possible.

- Be clear that financing fees are separate from deal fees. Investment bankers often offer "stapled" financing as a part of certain transactions. Any such offer of stapled financing must be carefully and separately documented so that the IRS is not misled into thinking that a portion of the success fee can (or should) be recharacterized as a hidden financing fee. Along these lines, the investment banking deal team and the investment banking finance team should be as separate as practicable.
- Be careful with exclusivity. Entering into an exclusivity arrangement with a prospective buyer or seller creates a Bright-Line Date. Accordingly, otherwise deductible costs incurred for services that normally could be deducted if performed prior to an exclusivity period can be transformed into capital expenditures. As a result, an auction process that delays exclusivity as long as possible is optimal from a tax deductibility standpoint. This lesser-known tax consequence is yet another factor to weigh when considering whether and when to go exclusive.
- Carefully document the amount of investment bankers' time spent on the agreements. To the extent that the investment bankers spend time reviewing merger agreements, the portion of the fee payable for this service must be capitalized. Accordingly, time spent on this activity (which usually is limited) should be carefully documented. Investment bankers often do not keep detailed time records, but secondary evidence (e-mail chains, phone logs, calendars, for example) can reflect time spent.
- Immediately after the deal closes, create and maintain a separate file with appropriate documentation. Documentation that reflects the entire range of work performed by the investment bankers must be maintained by the taxpayer and it must be completed by the due date for the taxpayer's tax return for the year in which the transaction closes. Some taxpayers engage a third party to perform a transaction cost study to supplement this documentation. It is critical to maintain copies of all work product, together with e-mails and other documentation reflecting what was done and when.

Conclusion

A large portion of success fees in many M&A deals can be deducted if proper attention is given to the structuring and documenting of the taxpayer's relationship with the investment banker. The deductibility of these fees is an easy target for IRS examiners and a poorly prepared taxpayer can be a sitting duck for an IRS challenge. But a properly prepared taxpayer, with a strong documentary record, can successfully withstand such a challenge and enjoy the benefits of this deduction.

To ensure compliance with requirements imposed by the IRS, we inform you that any U.S. federal tax advice contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed within.

DEAL SPOTLIGHT & NEWS

Education Management Corporation's Successful PE-Sponsored IPO

Education Management Corporation (EDMC), one of the largest providers of post-secondary education, completed its initial public offering in October 2009. The IPO, consisting solely of primary shares, raised $414 million in gross proceeds, representing approximately 16 percent of EDMC's common stock. EDMC used $355 million of net proceeds to retire publicly held senior subordinated notes through a tender offer. EDMC was acquired in 2006 by private equity firms Providence Equity Partners, Goldman Sachs Capital Partners and Leeds Equity Partners, in a $3.4 billion leveraged buy-out, the first of any publicly-held education company.

Goldman, Sachs & Co. and J.P. Morgan, along with BofA Merrill Lynch, Barclays Capital, Credit Suisse and Morgan Stanley, acted as joint bookrunners for the IPO. K&L Gates served as issuer's counsel on the IPO and the debt tender offer (and previously represented EDMC in the 2006 LBO). The K&L Gates team was led by Bob Zinn, along with securities partners Ron West and Jeff Acre and private equity partners David Edgar and Bill Axtman.

Multibillion Private Public Investment Partnership with Treasury

Scott Bernhart and Michael Caccese led a team of lawyers who formed a private public investment partnership (PPIP) with the U.S. Treasury for one of the firm's financial institution clients. This was one of only nine PPIPs formed to purchase and workout "toxic" assets. The team designed a structure, negotiated terms with Treasury, worked on all phases of documentation for the fund and the loan package with Treasury, and ultimately conducted several successful closings. The fund raised over $1 billion in private capital, which was matched with over $1 billion in Treasury capital and over $2 billion in Treasury leverage.

K&L Gates' Global Government Solutions Help Businesses Deal with Government's Expanding Role

Worldwide, the economic crisis has transformed the relationship between business and government. Governments are stimulating their economies, reforming areas such as health care, financial services, taxation, and employment, and attempting to prevent future crises through aggressive new regulations and enforcement actions. In an effort to help businesses around the world manage the threats and opportunities presented by government authorities, K&L Gates launched its Global Government Solutions initiative in October. Our lawyers are advising clients on opportunities and threats ranging from funding, grants, licensing and approvals to investigations, prosecutions, legislation and taxation.

K&L Gates has deep knowledge of the key decision makers and government processes around the world. More than 400 of our lawyers and professionals have previously held positions in government. Our colleagues include a former U.S. Attorney General, U.S. Senator, state Governor, and U.S. Congressman, more than two dozen former federal and state prosecutors, former senior Congressional and White House staff members, and former federal and state executive branch and administrative agency staff members. They include both Democrats and Republicans who have worked under the previous seven U.S. Presidents.

Outside the United States, our lawyers have served with a number of agencies including the European Court of Justice, Germany's Treuhandanstalt, Hong Kong's Department of Justice, and the U.K.'s Department of Trade and Industry.

To learn more about how K&L Gates is helping companies find solutions to government-related challenges, please visit the firm's website at www.klgates.com or email governmentsolutions@klgates.com.

M&A and Securities Rankings for 2009

K&L Gates is ranked among the top law firms in the world for M&A and securities deals closed in 2009. Here you will find a summary of the firm's 2009 fourth quarter and annual league table rankings from *Thomson Reuters* and *Bloomberg*.

Thomson M&A Review

- #9 US Target Completed (based on number of deals)
- #22 Worldwide Completed (based on number of deals)
- #21 Any US Public Involvement Completed (based on number of deals)
- #23 Any Canadian Involvement Completed

Bloomberg Global

- #12 US Equity Offerings Issuer Advisers (based on volume and number of deals)
- #7 US Equity Offerings Issuer Advisers (IPO) (based on number of deals)
- #7 US Equity Linked Issuer Advisers (based on number of deals)
- #2 Canadian Equity Offerings Issuer Advisers (IPO) (based on volume and number of deals)

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