K&L GATES

Structuring Funds for Illiquid Investments - Distressed Debt, Real Estate, Private Equity, Trade Finance, MicroFinance and Hybrid Hedge Funds

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Introduction

Optimal Structuring Of Illiquid Funds

- When To Use Corporate, Partnership, Contractual and Other Structures
- Choosing The Most Appropriate Domicile
- Hybrids - Combining Illiquid and Liquid Strategies
- Fee Structures - Carried Interests v Incentive Fees; Use of Founder Shares; Management Fee calculations
- Tax Considerations - Withholding Taxes; Efficient form of distributions; Use Of Double Tax Treaties
- Particular Issues Relating To Debt, Real Estate, Trade Finance and MicroFinance and Private Equity Funds

Key Differences

- Hedge funds have historically invested in assets that are liquid and easily valued
- PE, RE, Infrastructure, (some) Debt funds invest in assets that are not liquid and not easily valued (at least on a regular basis)
- More recently, there has been substantial crossover and formation of ‘Hybrid’ funds, e.g.:
  - “Side Pockets” in hedge funds
  - Increased allowances for public equity investments in private equity funds; and
  - Investment in commodity companies and exchange traded commodity futures contracts

Optimal Structuring of Illiquid Funds

Choosing the Right Vehicle

- European Hedge Funds typically structured as corporations
- European PE and Real Estate Funds typically partnerships
- US Hedge, PE and Real Estate Funds designed for US taxable investors typically partnerships
- US Hedge, PE and Real Estate Funds designed for US tax exempt investors typically (offshore) corporations
- Debt, Trade Finance, Infrastructure and MicroFinance Funds – depends on exact nature of underlying; and investment and realisation strategy

Optimal Structuring of Illiquid Funds

Choosing the Right Vehicle - Tax

- Optimising tax position of investors
- Hedge Funds often ‘traders’ producing ‘trading income’
- Income usually taxed at higher rates than capital gains
- Corporations potentially convert income into capital gains
- PE, Infrastructure, Trade Finance and Real Estate funds typically do not ‘trade’, so no need to convert income into gains
- But Infrastructure, Real Estate, Debt, Trade Finance and MicroFinance funds likely to have interest, rental or other income

Optimal Structuring of Illiquid Funds

Choosing the Right Vehicle - Tax

- But NB anti-avoidance rules may counter conversion of income into gains – e.g. UK Offshore funds rules; German Investment Tax Act; US Passive Foreign Investment Company (PFIC) rules

- So – corporate vehicles with interest, rental or other income may need to comply with local rules to obtain capital gains treatment - e.g. UK reporting funds registration/US ‘check the box’ elections/use of offshore corporate blocker for US tax exempts; provision of compliant tax information to German investors

Optimal Structuring of Illiquid Funds

Choosing the Right Vehicle – Tax Position of Fund/Manager

- Trading funds need to be concerned not to be taxable onshore through activities of onshore managers
- E.g. comply with UK ‘investment manager exemption’
- Position less clear in many other onshore jurisdictions
- Non-trading funds may not have this issue and manager can be onshore as long as not a branch/PE of offshore fund
- Taking investment decisions offshore easier – less frequent than with trading funds – e.g. Jersey/Guernsey manager
- But NB local FSA type regulation

Optimal Structuring of Illiquid Funds

Choosing the Right Vehicle – Domicile Issues

- Partnerships typically not taxable vehicles – tax charged at partner level, not partnership level
- So onshore (e.g. English and US) partnerships sometimes used
- Contra, corporations are taxable entities so never formed in high tax jurisdictions
- But if partnership 'trades' then even if investors and investments are offshore, onshore tax may be payable as income may be deemed to arise through activities carried on 'onshore' by partnership/general partner etc – i.e. as local source income or gains and/or as a local branch or permanent establishment

Optimal Structuring of Illiquid Funds

Choosing the Right Vehicle – Domicile Issues

- Non-trading (and trading) funds may have interest, rental or other income resulting in withholding tax issues – consider use of DTT feeders/SPV vehicles
- international investors in onshore partnerships may also have to make local tax returns
- So even if no tax payable, international investor funds tend to be formed offshore
- Typically funds targeted only at domestic investors use onshore partnerships – vis UK VC funds

Optimal Structuring of Illiquid Funds

Choosing the Right Vehicle – Domicile Issues

- Partnerships are a common law concept so non-common law jurisdictions like Luxembourg may not offer a partnership option – consider use of contractual structures (e.g. FCPs – Fonds Commune de Placement) but these may not be familiar to common law investors; and tax effect of contractual structures may need analysis
- Also regulated partnerships less common; and/or detailed rules not always user friendly – e.g. Ireland. So consider use of unit or other trusts

Optimal Structuring of Illiquid Funds

Choosing the Right Vehicle – Domicile Issues

- Conversely, non-common law jurisdictions may not recognise trusts/common law partnerships and may be treated as corporations
- Even some common law partnership structures are not treated as partnerships – e.g. Scottish limited partnerships have legal personality but taxed as partnerships
- NB also, where master feeder structure required for US taxable investors, master fund must not be formed as a public company (e.g. Ireland), as public companies cannot ‘check the box’ for US tax purposes

Optimal Structuring of Illiquid Funds

Choosing the Right Vehicle – Investor Exit Strategy

- End of life of fund only – 5-7 years or more?
- Interim distributions – return of capital plus prospect of some profits within 2-3 years?
- Annual income distributions?
- Best efforts redemption/repurchase option?
- Listing/creation of secondary market?
- Creation of liquid and illiquid portfolios -'hybrid' funds?

Optimal Structuring of Illiquid Funds

Choosing the Right Vehicle – Impact of Distribution Policy

- Distribution Policy – income and/or gains as they arise/annually?
- PE/RE/Infrastructure funds usually distribute income annually; and proceeds of sale upon realisation
- Partnership distributions easier – underlying income or gains passed on in original form for tax purposes; and original capital can be repaid first, tax free
- In a corporate structure this has to be achieved by paying dividends (income taxable); or redeeming/repurchasing shares – but repayment of capital may be limited by local laws; redemption/repurchase at a premium in whole or in part instead
- use of accumulation and distribution share classes; and/or raise funds partly as debt
- Tax position of investors

Optimal Structuring of Illiquid Funds

- **Choosing the Right Vehicle – Impact of Investment Strategy/Nature of Underlying Investments**

- Fixed life and evergreen funds
- Reinvestments within fixed life funds – generally or for an initial fixed period only?
- ‘Follow On’ Investments
- Realisations with no distributions in a partnership structure result in mis-match of tax liabilities and cash distributions
- Corporate structures solve this issue

Optimal Structuring of Illiquid Funds

Choosing the Right Vehicle – Hybrid Funds

- Combining illiquid and liquid strategies
- To provide a degree of liquidity for investors
- Combining typical hedge fund and PE style investors – different time horizons/desire for early exit if necessary
- To reflect managers strategy
- Provision of direct interest in capital assets/converting trading/other income into gains where possible
- Recognising possibility of liquid investments becoming illiquid - gates and side pockets
- But gates and side pockets do not achieve tax results desired, viewed as ‘emergency’ methods

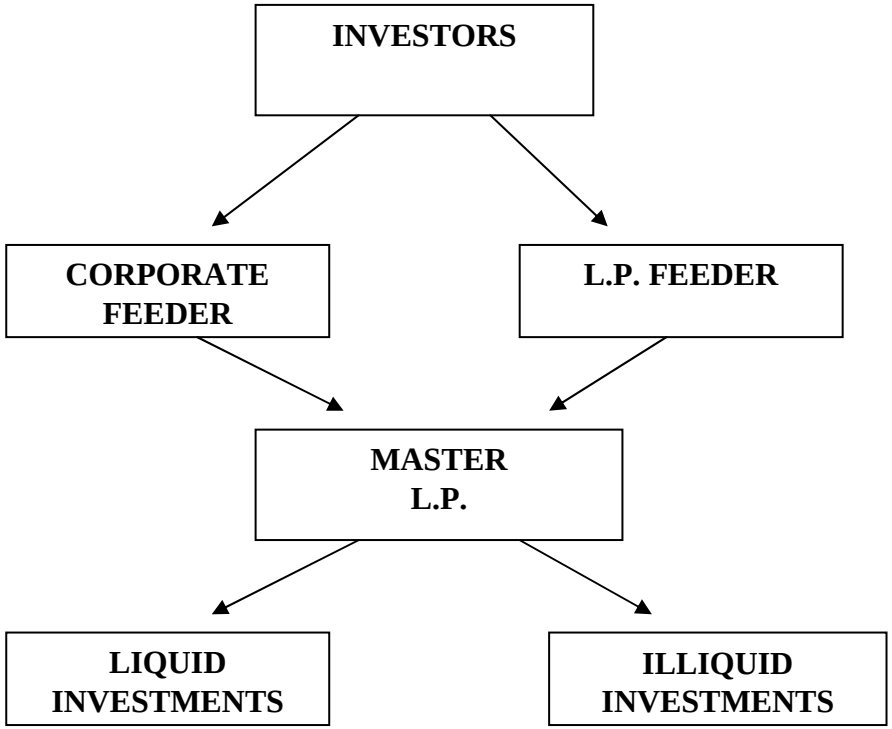
Optimal Structuring of Illiquid Funds

Choosing the Right Vehicle – Hybrid Funds

- Best of both worlds would be: corporate structure for liquid investments; partnership (other tax transparent vehicle) for illiquid investments
- Can be combined in a master feeder type structure – see next slide

Optimal Structuring of Illiquid Funds

Choosing the Right Vehicle – Hybrid Funds



Optimal Structuring of Illiquid Funds

Choosing the Right Vehicle – Hybrid Funds

- Investors hold units in two feeders, one a partnership, the other a corporate vehicle
- Master fund is a partnership and issues two classes of units, one linked to the liquid investments and the other the illiquid investments
- Partnership feeder returns linked only to illiquid investments and secures capital gains tax treatment for investors; but offers no or limited liquidity to investors

Optimal Structuring of Illiquid Funds

Choosing the Right Vehicle – Hybrid Funds

- Corporate feeder returns linked only to liquid investments and offers regular redemption rights
- Liquid assets/income from illiquid sub-fund can be transferred/deemed to belong to the liquid fund if desired to avoid current year taxation/make available for regular redemption

Optimal Structuring of Illiquid Funds

Choosing the Right Vehicle – Marketing

- Rules on marketing can be different for closed end v open ended funds
- ‘Collective Investment Scheme’ definitions
- Closed end corporate vehicles may be publicly marketed under EU Prospectus Directive
- Or privately placed subject to uniform set of rules in the EU

Optimal Structuring of Illiquid Funds

Choosing the Right Vehicle – Carried Interest/Performance and Management Fees

- Frequency of carried interest/incentive fee payments – at end of life of Fund; 'deal by deal'; monthly/quarterly/annual based on valuations or commitments (drawn down or promised?)
- Carried Interest Waterfall - 100% to investors until return of capital plus a preferred return (say 8%)
- 100% to manager until agreed carried interest/incentive fee level reached
- Carried Interest on deal by deal or whole fund performance?
- If whole fund basis, 'clawback' issues arise – use of escrow account?

Optimal Structuring of Illiquid Funds

Choosing the Right Vehicle – Carried Interest/Performance and Management Fees

- Management fee – on committed capital or only capital actually called?
- Including underlying leverage at investment level or just commitments?
- Increased desire to align investors and managers interests in hedge funds by introducing “clawback” features/equalisation structures; hurdles; management and performance fees reducing as AUM increases/performance exceeds agreed levels; performance measured over 3-4 years

Optimal Structuring of Illiquid Funds

Choosing the Right Vehicle – Carried Interest/Performance and Management Fees

- Remuneration of manager's staff to be aligned also
- Requirement to reinvest a percentage of fees into the fund
- Retention of staff and financial reserves to cover periods of financial difficulty
- Expenses caps – as % of AUM/Commitments

Optimal Structuring of Illiquid Funds

Structuring and Contract Issues Relating to Illiquid funds

- Termination of Manager
- ‘Bad Acts’
- Key Man Issues
- Change of control of GP/manager
- Suspension v termination
- Investment/Advisory Committees – powers; investor participation
- Valuation methods and independence
- Transaction fees – benefit of manager or fund
- Offset of transaction fees against management fees

Optimal Structuring of Illiquid Funds

Structuring and Contract Issues Relating to Illiquid funds

- Step down in fees on launch of successor fund; and/or after fund fully invested
- Step down or termination of fees during extension periods
- Voting rights
- Investment restrictions – geographic spread; sector diversification; RE – construction, office, residential, exploration; Debt – loans, performing, stressed, distressed
- Incentives to invest before initial closing; lower fees; subsequent investors may invest at higher of cost (plus % for deemed interest charge) and fair market value (but difficulties in valuation); consider excluding subsequent investors from initial investments

Optimal Structuring of Illiquid Funds

Structuring and Contractual Issues Relating to Illiquid funds

- Secondary markets/sales
- Soft redemption rights
- Listing of closed end funds
- Launch of 2nd, 3rd funds in parallel with original fund – only after 1st fund fully committed; how to deal with competing for same assets; distraction of management

Particular Issues Relating To Debt, Real Estate, Infrastructure, Trade Finance, MicroFinance and PE Funds

Real Estate Funds

- single property funds - “simplified” model with no commitments and all investor money contributed on day 1
- return of funds and performance fee on wind-up – although possibly different where significant income flow; annual fixed fees based on NAV or commitments; issues concerning certainty and cost of valuations
- manager often takes fees additional to management fee – e.g. property management, development, acquisition and disposal fees; by contrast in private equity practice has been to offset all or part of an ancillary fee benefits (e.g. transaction fees) against management fees

Particular Issues Relating To Debt, Real Estate, Infrastructure, Trade Finance, MicroFinance and PE Funds

Infrastructure Funds

- Typically have high level of long term debt secured on underlying assets
- May have capital in the form of equity and debt
- Borrowing at asset level typically incurred by local SPV or DTT SPV and offset against rental/other income
- Fund may lend to local SPV resulting in need to avoid/reduce local withholding taxes – again use of SPVs and DTTs
- Offering co-investment opportunities to investors in projects/underlying assets

Particular Issues Relating To Debt, Real Estate, Infrastructure, Trade Finance, MicroFinance and PE Funds

Debt, Trade Finance and MicroFinance Funds

- ‘Stressed’ and ‘Distressed’ Debt Funds – usually listed tradable securities (although listing may be suspended in ‘distressed’)
- May or may not be investing for income
- Certainly looking for capital gain
- DTT tax planning to minimise local withholding taxes
- Need to understand existing debt structure – priorities, secured/unsecured lenders/preference/other sharerholde rights

Particular Issues Relating To Debt, Real Estate, Infrastructure, Trade Finance, MicroFinance and PE Funds

Debt, Trade Finance and MicroFinance Funds

- ‘Loan to own’ – i.e. acquire debt with intention to convert into equity, force junior debtors to accept 100% loss and equity holders to dilute
- Need to understand local insolvency laws; whether court enforced administration/insolvency would result in loss of control
- Outside UK and US typically need to avoid insolvency and establish creditor committees to agree any restructuring
- Usual to identify lead creditor and remainder piggyback off their lead

Particular Issues Relating To Debt, Real Estate, Infrastructure, Trade Finance, MicroFinance and PE Funds

Debt, Trade Finance and MicroFinance Funds

- MicroFinance - ‘lending’ and/or investing in equity of local microfinance lenders/institutions; or direct to end borrowers
- May involve technical or other assistance (e.g. ‘social investing’)
- MicroFinance funds typically quite liquid as loans often short term; so can sometimes be structured as open ended funds with quarterly/other liquidity, subject to gates/suspensions

Particular Issues Relating To Debt, Real Estate, Infrastructure, Trade Finance, MicroFinance and PE Funds

Debt, Trade Finance and MicroFinance Funds

Instruments many and varied including:

- Certificates of deposit and similar term deposit instruments (“CDs”).
- Senior loans, notes or bonds, from 1-5 years term, generally requiring periodic payments of principal and interest
- Unsecured loans/trade finance
- Equity-linked or equity-like debt instruments, including subordinated debt, convertible debt, income participation notes, or fixed coupon, redeemable preferred shares
- Common or preferred shares

Particular Issues Relating To Debt, Real Estate, Infrastructure, Trade Finance, MicroFinance and PE Funds

Debt, Trade Finance and MicroFinance Funds

- Invest in emerging markets, resulting in challenging local law issues
- Enforceability of loans/obtaining security
- Capital commitments can be quite long where ‘social investing’ is involved – 3 or even 5 - 7 year periods
- And may be ‘evergreen’ type funds or project specific
- Some fund of microfinance funds now appearing
- Geographic and other diversification

Particular Issues Relating To Debt, Real Estate, Infrastructure, Trade Finance, MicroFinance and PE Funds

Debt, Trade Finance and MicroFinance Funds

- Emphasis on local knowledge/operations and/or connections
- Risks often akin to VC plus emerging market with even less reliable information!

Particular Issues Relating To Debt, Real Estate, Infrastructure, Trade Finance, Micro Finance and PE Funds

Debt, Trade Finance, Infrastructure and MicroFinance Funds

- Trade finance funds proliferated following debt crisis and withdrawal of some banks from the market
- Previously some Islamic trade finance funds also
- May provide direct finance to sellers – effectively replacing need for typical bank letter of credit financing (LCs) arranged by buyer
- Or act as guarantor of buyer thus enabling buyer to procure LCs from banks
- Or “transactional equity” to fund deposit required by LC issuer

Investing in Illiquid Debt

Strategy

- hold to maturity?
- trade
- debt to equity
- other distressed strategies
- regulatory arbitrage

Asset

- syndicated senior investment grade
- other syndicated debt
- sovereign
- bilateral
- portfolio trades
- consumer assets

Investing in Illiquid Debt

Form of purchase

- transfer: The Argo Fund Ltd v Essar Steel Ltd
- what do we mean by “transfer”?
- LMA/LSTA forms
- sub-participation
- credit default swaps
- total return swaps

Information

- confidentiality
- insider dealing/market abuse
- conflicts of interest

Investing in Illiquid Debt

Due diligence: overview

- understanding scope and purpose of due diligence
- what is available? Security documentation? Legal opinions and reports?

Scope of due diligence requires a clear understanding of client's objectives

Investing in Illiquid Debt

Basic due diligence

- is the documentation consistent with purchaser's understanding of the asset?
- assignability, confidentiality, further advances, set-off
- withholding tax

Further due diligence

- comparison against market/standard reporting template
- strategic advice/enforcement options
- security review
- Other laws: governing law, law governing security and issuer/borrower COMI

Investing in Illiquid Debt

- Regulatory issues: authorisation, data protection
- Tax issues
- Valuation issues
- Corporate/employment
- Exit Strategies
- How can we help?

CONCLUSION

- Critical to identify nature of underlying and investor and manager commercial objectives and requirements
- Illiquid investments often mean closed ended structure – can be achieved within partnership and corporate/other vehicles
- Tax considerations crucial – avoid timing mis-match; seek to achieve capital gains tax treatment where possible
- Minimise local withholding and other taxes on interest/rental income
- Borrowing at local/SPV level common in RE and Infrastructure funds
- Lending raises completely different considerations – security, creditworthiness, knowledge of borrower, collection etc.
- Trade finance raises letter of credit and bank intermediation issues

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