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Private Equity Alert

EU Adopts Directive on Regulation of Alternative Investment Fund Managers

By Elaine O'Donnell and Oliver Williams

In April 2009, the European Commission published a draft directive on the regulation of alternative investment fund managers ("AIFMs") following the recent financial crisis. Nearly 18 months later, after intensive political negotiations and industry lobbying, the European Parliament formally approved the directive on November 11, 2010. Formal approval by the European Council is expected on December 7, 2010. The directive will then enter into force in early 2011 and must be implemented by member states within two years (i.e., early 2013).

Once implemented, the directive will create a framework for the authorization and supervision of European Union ("EU") AIFMs not already covered by existing EU legislation. It therefore applies to, among others, hedge fund and private equity fund managers. It also covers all non EU AIFMs managing and/or marketing funds within the EU. Certain entities are excluded from the scope of the directive, including national banks, securitization SPVs, certain holding companies and fund managers without outside investors. The directive does not prevent regulation and supervision of the underlying funds at the national level.

Although the directive is now in final form, political, legal, regulatory and industry pressures will no doubt continue as the directive is transposed and implementing measures developed.

Scope and Application to EU and Non EU AIFMs

All AIFMs within the scope of the directive must be authorized and regulated by an EU member state regulator. EU AIFMs will be regulated by their home member state and non EU AIFMs by their "member state of reference."

Managers of small funds (i.e., less than €100 million of assets under management) or unleveraged funds of less than €500 million of assets under management that are not redeemable within 5 years are exempt from the vast majority of the directive's provisions but must still register with and provide information to regulators.

Following authorization, EU AIFMs will be entitled to market EU funds to professional investors and provide management services in any EU member state (i.e., they will have an EU "passport").

A significant area of divergence of opinion surrounded the position that should be taken regarding the marketing, within the EU, of non EU funds by EU AIFMs, or EU or non EU funds by non EU AIFMs, and whether they could benefit from the passport regime. The final text envisages a continuation of national private placement regimes with a phased introduction of a passport for non EU funds or AIFMs from 2015, provided that certain provisions of the directive, including additional conditions, are complied with. This means that EU AIFMs of non EU funds and non EU AIFMs can continue to operate under national regimes and avoid full

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compliance with the directive until at least 2018 (provided they do not wish to use a passport) when the national regimes may fall away.

In addition to complying with national regimes non EU funds and fund managers will still need to comply with certain of the directive's provisions. EU AIFMs of non EU funds need to fully comply with the directive save in relation to depositaries and annual reports. Non EU AIFMs operating under national regimes are required to comply with the directive's provisions on transparency and reporting, i.e., annual reports, disclosure to investors, reporting obligations to authorities, notification and control of portfolio companies and asset stripping.

Grandfathering provisions mean AIFMs of closed funds that are fully invested and funds that are fully subscribed need not be authorized under the directive.

The chart at the end of this article gives an overview of the application of the directive to EU and non EU fund managers.

Disclosure by AIFMs

Prescribed information on funds must be made available to fund investors prior to investment and material changes notified. Certain periodic information on liquidity and the risk profile of the fund must also be disclosed, along with an annual report for each fund managed or marketed in the EU (including details of remuneration and "controlled" companies). The annual report must be made available within six months of the end of the financial year, although member states can impose a shorter period. Accounting information in the annual report must be prepared in accordance with home member state accounting standards and audited and made available to investors and the regulating authority.

AIFMs are also obligated to provide regulators with prescribed information on themselves and their funds, both on application for authorization and on an ongoing basis, along with information required by the regulator to monitor compliance with the directive.

Fund managers with leveraged funds (not leveraged portfolio companies) will be required to set and disclose limits on leverage to investors and regulators.

AIFMs will be required to disclose the acquisition of major voting rights in shares where holdings in any portfolio company fall below, reach or exceed thresholds of 10%, 20%, 30%, 50% or 75% and when they gain "control" of a large portfolio company. There has been a divergence of opinion on the companies that should be within the scope of these provisions. The final text means that broadly the provisions will only apply to large companies once the fund has achieved a controlling influence of a majority stake. Control is set at more than 50% in a company not listed on an EU regulated market, or, for companies listed on an EU regulated market, the control threshold specified by the relevant EU regulator for the purposes of the Takeover Directive (commonly 30%).

When a fund is in a position to exercise control of a company the AIFM will be required to disclose to the company, shareholders and the national regulator the AIFM's identity, communications and conflicts policy, financing of the acquisition and intentions with regard to the future business of the company and effect on employment.

Imposition of Remuneration Policies

Fund managers will be required to adopt certain remuneration policies and practices, including the requirement to defer at least 40% of variable remuneration for staff with a material impact on the risk profiles of managed funds.

Maintain Minimum Capital

All fund managers will be required to maintain minimum capital. The amount of capital required will be at least €125,000. Where assets under management are over €250 million, additional capital equal to 0.02% of the amount by which the value of the assets exceeds €250 million is required, subject to a cap of €10 million, up to 50% of which can be provided by way of a guarantee.

Valuation

AIFMs will be required to ensure appropriate procedures are established so that there is a proper valuation of the fund's assets at least annually. The valuation must be independent although not necessarily carried out by an external auditor.

Depositary

The directive requires the appointment of an independent custodian for each fund (e.g., an EU credit institution) to, among other things, verify title to assets and receive investor subscriptions in a fund and book them into a separate account. Private equity funds fulfilling certain requirements may be permitted by the relevant member state to appoint a notary, lawyer, registrar or another entity to carry out depositary functions.

Alternative Investment Fund Managers Directive Overview of Application to EU and Non EU Fund Managers[1]

	Passport available from?	National regimes available?	Exemptions from full compliance with directive?
EU fund manager **EU fund**	2013 Unless exempt manager then cannot benefit from passport regime unless fully opt in to the directive	No Unless exempt manager then must comply with national regimes unless fully opt in to the directive	No Unless exempt manager (exempt managers within the scope of the directive must still register and provide specified information)
EU fund manager **Non-EU fund**	2015 Provided compliance with additional conditions	Until 2018	Exempt from provisions on depositaries and annual report if marketed outside EU Exempt from certain provisions on depositaries if marketed in EU under national regime No material exemptions if marketed in EU under passport
EU fund manager **EU fund** **or** **Non EU fund marketed in EU**	2015 Provided compliance with additional conditions	Until 2018	Exempt from compliance save the provisions on annual report, disclosure to investors, reporting obligations to authorities and control of portfolio companies and asset stripping if marketed in EU under national regime No material exemptions if marketed in EU under passport

1 Summary presumes the fund manager falls within the scope of the directive and is not an exempt manager as described in the article.

Disclosure by/Restrictions on Portfolio Companies

EU companies defined as being under the control of funds, will be subject to additional disclosure requirements.

EU controlled companies must disclose additional information in their annual reports, such as important events since the last financial year and the company's likely future development unless the information is provided in the fund's annual report.

The directive notes that the obligation to provide information is not intended to put funds covered by the directive at a disadvantage to those outside its ambit (e.g., sovereign wealth funds) and therefore disclosure of information in certain circumstances is subject to a carve out where it would "seriously harm the functioning of the company concerned or would be prejudicial to it".

Importantly, to try and avoid asset-stripping practices, large controlled portfolio companies will also be subject to restrictions on distributions, capital reductions, share redemptions and the buyback of shares for two years following the fund's acquisition of control.

Conclusion

The ambitions of the directive will not be without cost to the alternative investment fund industry. The cost to European private equity funds alone of implementing the directive is estimated to be €756 million in one-time charges and €248 million in annualized costs according to a report commissioned by the UK's Financial Services Authority. The most vociferous opposition to the directive has come, unsurprisingly, from the UK (the center of the EU alternative investment fund industry). While full implementation remains two years away, the directive's impact is likely to be felt much sooner. We will continue to monitor implementation of the directive and to report in detail on its impact in each of the above areas as political, industry, regulatory and legislative matters progress.

Tax Lessons from the Downturn

By Jared Rusman, Michael Saslaw and Martin Sosland

It has become common practice for private equity acquisitions to be structured using pass-through entities, such as limited partnerships and limited liability companies, to avoid additional layers of federal income tax. In good times, this has had the intended results for domestic taxable investors.[1] In bad times, however, as described below, there may be unintended results which could have severe economic consequences for private equity investors. The downturn has reminded us of the importance of continually reviewing the impact of your choice of entity, especially when the underlying investment starts to encounter financial difficulties.

Impact of COD Income

In this downturn we have seen many Chapter 11 and out-of-bankruptcy court restructurings pursuant to which existing indebtedness is cancelled and in turn creditors receive some new debt or equity. The value of the equity and principal amount of new debt (if any) is often materially lower than the original debt being cancelled. The result is cancellation of debt ("COD") income under section 61(a)(12) of the Internal Revenue Code.[2]

In the corporate context, COD income can generally be excluded if a restructuring occurs in a bankruptcy or to the extent that the company is insolvent. In the context of a pass-though entity, however, the availability of these exclusions is tested at the investor level rather than the entity level and thus is generally not available when a portfolio company is restructured.

COD income is ordinary income to the applicable taxpayer. In the case of pass-through entities, the COD income is passed through to the investors. This income presents itself without a corresponding cash distribution to pay the taxes on COD income. In the restructurings that we have seen, the amount of COD income can dwarf the amount of the original equity investment made by the private equity firm, resulting in a risk of loss greater than what was contemplated when the original investment was made. Although the investors would normally have a corresponding tax loss on the cancellation of their equity interests in the restructuring, that loss would typically be a capital loss – which cannot be offset against the ordinary COD income.

Intuitively, if the business is so troubled as to get to this place, there should be substantial suspended losses from prior years to offset the COD income. While this is often the case, we have been involved in a number of situations where this is not the case. In some cases, this has been due to a mismatch of types of income and loss. Ordinary COD income cannot be offset by capital losses and some the businesses that we have restructured have had insufficient amounts of ordinary losses to offset the COD income.

What Can Investors Do About This?

The easiest way to avoid this problem is to have all investments made through a corporate blocker, which would prevent the COD income from reaching the investors. In a bankruptcy or insolvency context, COD income of a corporate entity remains at the corporate entity and is not passed through to the entity's investors. This solution, however, ignores the fact that successful investments are greatly benefited, including by enhanced economic returns, as a result of the absence of a corporate blocker and that investments are not typically made with failure in mind.[3] Specifically, a pass-through format offers the ability to have distributed profits taxed only once, provides a tax basis build-up for undistributed profits and may allow the private equity sponsor to command a higher price on exit as a result of the ability to provide a future buyer a step-up in tax basis.

A more realistic approach is to revisit the use of the pass-through investment vehicle upon the first signs of financial distress in the underlying business or its capital structure. At that time, an analysis should be done as to whether there have been or will be sufficient ordinary losses to offset any possible COD income that could be passed through to investors. If there are not sufficient losses, there are other actions that can be taken, such as an "incorporation" of the pass-through vehicle – either through an entity conversion or by electing to be taxed as a corporation. In order for this approach to be successful, it needs to be completed at a time when there is still demonstrable value in the equity of the company, and the company will need to confront a number of related tax issues.[4]

Assuming that the incorporation route is unavailable, for example because the company is unable to demonstrate that there is any equity value at the commencement of the restructuring process, if the debt constitutes "nonrecourse debt" under general tax law principles,[5] it may possible to avoid some of the worst tax results of a restructuring (i.e., COD income). Under *Commissioner v. Tufts*, 461 U.S. 300 (1972), if assets of the company are transferred to creditors in satisfaction of a nonrecourse debt, the transaction is treated as a sale or exchange rather than a cancellation of debt, notwithstanding that the fair market value of the assets is less than the face amount of the old debt. This approach still results in income recognition, but the income recognition typically comes at least in part in the form of capital gains, which generally can be offset against loss recognized on the cancellation of the old equity.

Finally, if neither of these approaches is available or practical, it may be possible to restructure the company in a manner that triggers a loss in the company's assets that can be treated as an ordinary loss under Section 1231 of the Internal Revenue Code. In bankruptcy, this can be done by transferring the assets of the company to a corporation, the stock of which is distributed to the creditors in satisfaction of their claims. This is treated as a taxable sale or exchange under Section 351(e)(2) of the Internal Revenue Code. Alternatively, the creditors of company can form a new partnership to "purchase" the assets of the company using the old debt as consideration. Careful planning is required to avoid having the new partnership being treated as a continuation of the company for tax purposes. Under either approach, investors need to be aware that there are related party rules in Sections 267(a) and 707(b) of the Internal Revenue Code that in some cases can disallow a loss on a sale of assets and that Section 1231 of the Internal Revenue Code contains a five-year recapture rule that could cause future trade or business gains, that would normally be taxable as capital gain, to be recharacterized as ordinary income.

With any of these potential approaches, it will be important for the private equity firm to have a clear understanding in advance of how its accountants, auditors and tax return preparers will view the restructuring.

What If Co-investors Cannot Agree on Approach?

An additional problem that we have seen is that the foregoing solutions may be advantageous to some but not all of the investors in an investment vehicle and a schism may develop over whether or not to take current income – an approach favored by investors who have sufficient ordinary losses available or who otherwise have some tax exemption or unused tax benefit – or defer, modify or otherwise seek to avoid the COD income because the implications of paying tax on the COD income could have disastrous financial consequences to such investors.

Further, if such a schism develops, a governance deadlock can occur if the competing views on how to proceed have equal voice in the governance of the entity. This can result in a capital restructuring – either in or out of bankruptcy court – coming to a complete standstill. Generally, normal corporate governance continues when a company is in Chapter 11. In the event of a governance deadlock, however, bankruptcy courts have very few tools for dealing with such a standstill other than to appoint an independent trustee to replace the governing body.

Lesson Learned

At the first sign of a downturn, investors should consult their legal and accounting advisors to review the investment's organizational structure and to assess how it may impact a potential restructuring.

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1 Foreign and tax-exempt investors typically require corporate blockers, to avoid pass-through income and loss.

2 COD income can also result where the principal amount of the new debt equals the principal amount of the old debt, if either the old debt or the new debt is "publicly traded" as defined for tax purposes. This is because the amount used to calculate the amount of COD income, if any, is the "issue price" of the new debt. Where the old debt or new debt is publicly traded during the 60 day period ending 30 days after the issue date of the new debt (the "Trading Testing Period"), the issue price of the new debt is not the principal amount of the new debt but its fair market value determined as of the issue date of the new debt. If the new debt is not itself publicly traded, but the old debt was publicly traded during the Trading Testing Period, the issue price of the new debt is deemed to be the fair market value of the old debt determined as of the issue date of the new debt. The definition of "publicly traded" for this purpose is much broader than the commonly understood sense of the term and includes levels of trading far short of that normally found on a national securities exchange.

3 For US individual investors, making the investment through an S corporation in the first instance may, in a restructuring scenario, avoid the worst consequences of the use of a pass-through (i.e., testing for the bankruptcy and insolvency exceptions at the individual level) while affording many of the benefits of pass-through treatment in an upside scenario (e.g., a single layer of tax on earnings).

4 Among other issues, the company and its advisors will need to need to consider whether there is a sufficient business purpose for the transaction, whether the "incorporation" involves an assumption of liabilities in excess of basis that is taxable under Section 357(c) of the Internal Revenue Code and whether transaction can be challenged under Section 269(a) of the Internal Revenue Code on the basis that its principal purpose is avoidance of federal income tax by securing the benefit of a "deduction, credit or other allowance" which would not otherwise be available.

5 We note that a debt instrument that a private equity fund or its investors may consider non-recourse in the ordinary sense of the term because they are not liable on the debt beyond their equity investment in the portfolio company may not be nonrecourse for this purpose because there is recourse to the portfolio company itself.

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