DEBEVOISE & PLIMPTON

PRIVATE EQUITY REPORT

Volume 4 | Number 4 | Summer 2004

Avoiding the Whipsaw in Acquiring Foreign Companies — The Impact of U.S. Economic Sanctions Laws

When a private equity firm acquires a non-U.S. business, compliance with U.S. economic sanctions laws may not be high on the list of post-closing concerns. Those U.S. laws need to be considered, however, whenever U.S. citizens or companies come to own — directly or indirectly — a foreign company or become involved in its management or operations. Economic sanctions issues are of greatest concern in the import-export and financial services industries, but they can affect other businesses as well. A foreign company's continuation of its previously lawful practices could run afoul of U.S. law once the company comes under the ownership or control of U.S. citizens or companies. The U.S. owners of a foreign company also need to be wary of being whipsawed by the relationship between U.S. laws imposing economic sanctions and foreign laws prohibiting compliance with some U.S. economic sanctions.

The Cuba Dilemma

The furthest-reaching of the U.S. trade restrictions are undoubtedly the sanctions against Cuba. The principal restrictions on trade with Cuba are embodied in the Cuban Assets Control Regulations administered by the Treasury Department's Office of Foreign Assets Control (OFAC) under the Trading With the Enemy Act (TWEA). Like most of the other regulations administered by OFAC, the Cuba regulations apply to U.S. citizens and residents, U.S. companies, and persons located within the U.S. But in addition, the Cuba regulations uniquely extend to any corporation, partnership or association that is "owned or controlled" by such U.S. persons. That can include, for example, a foreign subsidiary of a company owned or managed by U.S. citizens.

The Cuban Assets Control Regulations not only bar imports to or exports from the U.S., but also prohibit (among other things) all dealings abroad in Cuban-origin goods — including goods that contain only partial Cuban content — as well as sales of most types of goods and services to Cuba. A preexisting contract does not excuse a violation of the regulations.

Consider, for example, a Spanish company owned by an investment fund organized in Bermuda or Guernsey, which in turn is owned or controlled by U.S. citizens. If the Spanish company knowingly buys Brazilian goods manufactured with Cuban raw materials, the Spanish company may be subject to penalties under U.S. law. The investment fund company and the U.S. citizens may also be subject to penalties if they participated in the violation. Willful violations of TWEA are crimes punishable by up to 10 years' imprisonment and fines of up to $100,000 per violation for individuals, or fines of up to $1,000,000 per violation for corporate entities. Even violations that are not willful can give rise to civil penalties of up to $55,000 per violation — and each unlawful purchase or sale is a separate violation. OFAC actively investigates suspected violations of

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"Yeah, I got grounded for three weeks, but at least no trade sanctions were imposed."

letter from the editor

Private equity has been making major headlines in the past quarter. Not only has a real rock star (Bono) joined the ranks of private equity firms, but both fundraising and deal activity have rebounded. The private equity industry has seen its share of bad news, including the *Forstmann Little* verdict (on which we offer a few comments), but, for the most part, the outlook for private equity is more optimistic than it has been in some time.

On our cover, Carl Micarelli warns of the peril to U.S. purchasers of foreign companies of being whipsawed by U.S. trade sanction laws. In our Guest Column, Josh Lerner of the Harvard Business School and Antoinette Schoar of the MIT Sloan School of Management continue the dialogue on business development companies we began in our last issue, providing some recommendations for private equity funds entering the public arena.

The *Private Equity Report* strives to make the legal landscape slightly clearer for our private equity clients without drowning you in legal detail. To that end, in this issue we have provided a "Tax Cheat Sheet" to help you translate those pesky acronyms your tax lawyer is always bandying about. (You may even want to pull it out for future reference.) Steve Hertz has distilled the recent discussion of the Sarbanes-Oxley Act into The Top 10 Things Private Equity Sponsors Need to Know about S/OX. While Rebecca Silberstein gives a few pointers on how to minimize potential liability from investor lawsuits following the *Forstmann Little* decision

We have two articles focusing on recent positive developments in German tax legislation for private equity funds. First, Friedrich Hey and David Hickok explain changes to the taxation of carried interest; and Marcia MacHarg and Patricia Volhard also reflect on the non-applicability of the detailed public reporting requirements of the German Investment Tax Act to most private equity funds.

From London, our tax team outlines the distinctions between being resident, ordinarily resident, or a domiciliary of the U.K. for purposes of taxation of employment compensation and carried interests. Elsewhere in this issue, Greg Gooding describes the special issues to be considered if the target of your acquisition is, in fact, another private equity fund. And Mark Goodman tries to clarify the recent case law on how purchasers of businesses with products liability claims should quantify such future liabilities in order to avoid the risk of having their acquisition later deemed a fraudulent conveyance.

We are always looking for ways in which to make the Private Equity Report more useful for our readers. Our Fall issue hopes to focus on issues of particular interest to our foreign readers. Please use our reader survey on page 24 to let us know of any topics or issues of interest that you would like us to discuss.

Franci J. Blassberg
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Future Products Liability Claims Pose Fraudulent Conveyance Risk

At the mere mention of the words "potential asbestos liabilities," even the most bullish private equity buyer can turn skittish. Private equity buyers and other acquirers are understandably nervous about transactions involving future product liability claims, especially in light of the endless stream of recent horror stories about acquisitions gone bad when asbestos liabilities ballooned after the fact (*e.g.*, Federal Mogul, Halliburton, Sealed Air). Attempting to quantify liabilities is not only necessary for evaluating a potential acquisition, but also for avoiding a fraudulent conveyance finding that would void a restructuring or sales transaction together with the loans that made them possible. While liabilities for presently filed claims generally can be calculated simply by multiplying the number of such claims by a range of likely settlement averages, calculating liabilities for yet unfiled claims and determining how such liabilities might be factored into a fraudulent conveyance analysis presents a much more complex array of issues.

Unfortunately, the state of the law is confusing. Only three cases (all of them recent) have analyzed the process of estimating future asbestos liabilities in the context of fraudulent conveyance analysis.[1] In each case, the defendant company had undertaken a complex restructuring that reduced its net worth to the benefit of affiliated companies and/or shareholders. And, in each case, asbestos creditors moved to void the transactions as fraudulent, contending that asbestos claims unasserted at the time of the restructuring transactions represented future liabilities not accounted for by the companies that would have rendered the companies insolvent prior to or as a result of the restructurings had they been properly accounted for at the time.

A company cannot transfer assets for less than fair consideration if it is insolvent or if the transaction would make it so, without risking "constructive" fraudulent-transfer liability. Potential acquirers and sellers of businesses need to consider a company's future asbestos liabilities when evaluating its solvency as of a particular point in time. Following the recent decision in *Bairnco* and the defendant's motion to vacate the decision in *Grace*, the central outstanding questions for companies are: (1) What constitutes a liability or debt for purposes of the fraudulent conveyance analysis? and (2) Should those liabilities or debts be quantified based on a reasonable assessment as of the time the transaction occurred or with the benefit of hindsight? Getting to the right answers to these questions can make or break a deal.

Attempting to quantify liabilities is not only necessary for evaluating a potential acquisition, but also for avoiding a fraudulent conveyance finding that would void a restructuring or sales transaction together with the loans that made them possible.

Defining Future Liabilities

Fraudulent conveyance analysis is a creature of state law and it differs from one jurisdiction to another. Accordingly, although all three courts used similar approaches in conducting their respective solvency analyses, each was required to apply distinctive fraudulent conveyance law to determine *when* a debt had arisen for purposes of estimating future liabilities. In other words, each had to determine when and whether a future asbestos claim — a claim not yet filed and perhaps not yet even known by the future putative plaintiff to exist — constituted a "debt"

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1 The cases are: In re Babcock & Wilcox Co., 274 B.R. 230 (Bankr. E.D. La. 2002) (B&W), In re W.R. Grace & Co., 281 B.R. 852 (Bankr. D. Del. 2002) (Grace) and Lippe v. Bairnco Corp., 2004 WL 1109846 (2d Cir., May 17, 2004) (Bairnco).

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To BDC or Not to BDC: The Promise and Perils of "Public Private Equity"

In the past few months, there has been a surge of interest on the part of private equity groups in raising funds from the public market. The appeal of "public private equity" is easy to understand: public market investors represent a huge and largely untapped source of capital for private equity firms, and "public private equity" can provide a way for investors to more easily access this attractive asset class. But we believe that "public private equity" can also pose some hidden dangers for private equity organizations. In this article, we'll explore some of the challenges associated with using public funds for private equity, and highlight some strategies that private equity groups can employ to minimize these potentially detrimental effects.

The current enthusiasm was sparked this April, when Apollo Advisors raised $930 million for senior and subdebt investments in private firms. To do so, they established a business development company (BDC), a fund structure that has existed in its current form since the Small Business Incentive Act of 1980 but has been largely ignored by private equity groups. They were soon joined by a host of others, including Evercore Partners and Kohlberg, Kravis, Roberts.

Much of the discussion of BDCs in the business press and industry conferences has revolved around the details of these investments. For instance, are the fees and incentive payments associated with these investments too large to make this an attractive investment for retail investors? Are the disclosure requirements demanded by the U.S. Securities and Exchange Commission too onerous for private equity groups?

We believe, however, that a more fundamental issue has been neglected in these discussions. These securities pose a fundamental issue: To what extent does it make sense for private equity funds to raise funds from the public markets? What are the potential challenges associated with this source of capital? When might it be appropriate to employ public funds, and when does it not make sense?

These issues have an importance that extends beyond BDCs. Over the next decade, it is likely that entire private equity groups may seek to undertake public offerings, much as Britain's 3i Group did in 1994. For instance, press accounts have repeatedly speculated that the Carlyle Group might consider such a transaction.

In this essay, we briefly explore these issues.[1] To better understand the challenges of "public private equity," we'll first consider an episode from the history of the industry. We'll then discuss some of our recent work about the challenges that liquidity poses for private equity funds. We'll end by highlighting some lessons for private equity groups as they consider raising public equity from the public market.

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Looking Backwards

Despite the impression that the breathless tone of much of the recent press coverage may give, raising funds from the public markets for private equity investments is not a new idea. Indeed, the historical experiences are very relevant for today: a look backwards can illustrate some of the challenges that today's efforts are likely to face.

The pioneering private equity funds after World War II raised money almost exclusively from public investors. This fundraising strategy was undertaken by necessity rather than choice: when these groups approached the universities and foundations that they had initially targeted, they were told that private equity was too risky and unproven an asset class. (At this time, many pension funds were still trying to become comfortable with investing in public equities, much less private securities.) As a result, they had little choice but to sell shares to the public.

The challenges of being a public entity proved to be many-faceted. Consider, for instance, the experience of the first — and probably the most successful — of these funds, Georges

1 Readers who want to learn more about these issues may find our recent article to be of interest: "The Illiquidity Puzzle: Theory and Evidence from Private Equity," Journal of Financial Economics, vol. 74 (April 2004), pages 3-40.

Doriot's American Research & Development (ARD):

- First, the firm's share price proved to be highly variable. While the shares initially traded above the net asset value of the investments, the valuation fell sharply, and traded at well below asset value for much of the 1950s. Much of Doriot's time during the decade was spent assuring individual investors that the share price would eventually recover.
- Raising new capital proved to be extremely dilutitive for existing shareholders. While ARD had an "evergreen" structure — just like today's BDCs, they did not need to return capital to investors — they eventually required additional capital to make new investments. For instance, when ARD needed to raise capital in 1958 to finance its investment into Digital Equipment Corporation (which ultimately accounted for the majority of its capital gains over the life of the fund), it was required to sell shares at a price that was nearly 40% below the fund's net asset value (and even further below its true value).
- When investors in the fund sought to liquidate their positions, it sent shockwaves through the investor base. For instance, when American Express sought to sell its holdings in 1948 due to a change in its investment policy, the fund's partners were so concerned about the impact of the decision that they arranged to buy back the shares, even though the decision substantially depleted the fund's remaining uninvested capital.

Similar cautionary tales could be offered regarding many of ARD's contemporaries. Equally troubling stories emerged from the efforts to create publicly traded venture funds in the late 1990s, such as CMGI and MeVC.

The Promise and Perils of Liquidity

In our recent article published in the *Journal of Financial Economics*, we argue that liquid securities — such as those sold to public investors — are a mixed blessing for private equity funds. Private equity investors, we recommend, should think carefully about how liquid they want their securities to be.

This claim might seem initially puzzling. We generally think of liquidity as a good thing for everyone. The buyers of a liquid security benefit because they have an exit avenue: if an investor has a liquidity crisis (a "cash crunch"), he can generate needed financial resources with minimal costs. (Contrast this experience with that of many high-technology executives who invested in illiquid private equity funds in the late 1990s. Many ended up selling these partnership interests for pennies on the dollar — or even walking away without any compensation — when they encountered financial difficulties in 2001 and 2002.) The seller benefits because the buyers are willing to pay more for a liquid security.

But private equity is different, because of the "information gap" that surrounds the funds' activities. Potential investors in a mutual fund can readily obtain a performance report on how the fund managers are doing every day. But it can take many years to figure out how successful the managers of a private equity fund are. Not only does it take a long time for private equity funds to harvest their illiquid holdings, but typically funds only invest in a small number of companies, which can have wildly different returns.

Just looking at a fund's private placement memorandum is often inadequate to assess how well a private equity fund is doing. This gives previous investors in private equity funds a big advantage over potential new investors, since they will have had numerous opportunities to see the general partners discuss their strategy, to meet with portfolio companies' managements at annual partnership meetings, and so forth. While new investors can attempt to contact those who know the fund managers, this is unlikely to substitute for the detailed interactions that an existing limited partner has enjoyed.

As a result, the existing limited partners' reinvestment decisions can have a lot of sway over potential investors. Numerous examples exist where the failure of one or more limited partners to reinvest meant that raising a new fund was much harder, or even impossible, for a private equity organization. Potential new limited partners may not understand why the existing investors did not reinvest, but may see their failure to do so as a warning to avoid the fund.

If all investors were equally likely to reinvest, liquidity might not be an issue. But we know that this is not the case. Some investors are particularly inclined to encounter cash crunches,

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Private equity investors . . . should think carefully about how liquid they want their securities to be . . . . [P]rivate equity is different, because of the "information gap" that surrounds the funds' activities.

Taxation of Carried Interest in Germany

The tax outlook for German private equity professionals is looking good. The German legislature seems poised to resolve the controversy over the taxation of carried interests. Pursuant to a new law approved on June 18 of this year by the German Bundestag, a carried interest would essentially enjoy the same personal income tax treatment as capital gains from the sale of stock — which means that only one half of the "gain" will be includable in taxable income. The includable capital gain will then be taxed at ordinary progressive rates. (Conversely, only one half of capital losses will be deductible, but they can be used to offset ordinary income.)

The new German legislation awaits approval by Germany's Second Chamber (*Bundesrat*), where the states are represented. Approval is widely expected, not the least because some of the states actually introduced the legislation. The new law, if enacted, will apply to all distributions of carried interests with respect to equity funds founded after March 31, 2002 or with respect to dispositions by equity funds of investments in portfolio companies acquired after November 7, 2003.

Pursuant to a new law approved on June 18 of this year by the German Bundestag, a carried interest would essentially enjoy the same personal income tax treatment as capital gains from the sale of stock — which means that only one half of the "gain" will be includable in taxable income.

Following last minute amendments, it is expected that the new law will apply to both funds not engaged in trading (vermögensverwaltende Gesellschaften or Gemeinschaften) and funds engaged in trading (gewerbliche Gesellschaften or Gemeinschaften). Because the distinction between private equity funds that are considered to be engaged in trading (business funds) and those which are not, is controversial and somewhat confusing, this development is particularly favorable for the private equity industry. According to a circular issued by the German Tax Administration in 2003, private equity funds must comply with certain requirements in order to be considered not engaged in trading, including, among other restrictions, not using debt capital (bank loans) and not engaging in public offerings.

The tax treatment of carried interests of funds not engaged in trading was heavily debated because of the absence of statutory provisions on their tax treatment. Generally, Germany recognizes disproportionate interests in a partnership if there is an agreement among unrelated partners. Based on this principle, private equity sponsors historically argued that they should not be taxed at all on the capital gain because (1) a private equity fund is not engaged in a trade or business with respect to the shares it holds, and (2), as a general rule, Germany does not tax personal capital gains provided that shares have been held for more than one year (not long ago the holding period was only six months) and that a maximum shareholding threshold is not exceeded. Only very recently this maximum shareholding threshold for exemption from capital gains taxation was reduced to 1% from 10%. After reduction of the threshold to 1%, the potential tax savings were significantly reduced since sales in excess of 1% would be taxable. The critical question was whether gains on carried interests were fully taxable as ordinary income or as capital gains where a 50% exclusion applied. The issue of a 50 % exclusion was significant enough to warrant lobbying by the private equity industry. However, in a shock to the industry, in December 2003 the German Tax Administration issued their long awaited revenue ruling on the taxation of private equity funds (more than two years after issuance of a draft), and took the position that a carried interest always constitutes service income subject to full ordinary tax. It is against this background and the threat that the private equity community would relocate to tax friendlier jurisdictions that the German government felt the need to adopt the legislation passed in mid-June.

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Top 10 Things Private Equity Sponsors Need to Know about Sarbanes-Oxley

There has been no shortage of articles on the Sarbanes-Oxley Act (S/OX or the Act) since its enactment in 2002. However, we have yet to see the impact of S/OX on private equity transactions and portfolio companies summarized in the user-friendly way favored by our private equity clients. In an effort to fill that void, here is our list of the "Top Ten Things Private Equity Professionals Need to Know about Sarbanes-Oxley."

1. Keep Your Auditors Independent

Issuers in registered offerings have always been required to produce and file financial statements audited by an "independent" accounting firm. But S/OX has significantly expanded the nature and scope of the non-audit services that can taint an auditor's independence and thereby impede an offering involving a portfolio company.

The list of barred services includes items such as financial information systems design and implementation, appraisal or valuation services, investment adviser or investment banking services, certain tax services and other expert services unrelated to an audit. The full list of prohibited services is extensive and issuers will be well advised to evaluate the impact of particular services with counsel on a case-by-case basis.

These "independence" requirements could complicate or even defeat the ability of a financial sponsor to finance an acquisition of a portfolio company with registered debt (*e.g.*, a 144A offering followed by an A/B exchange) if the target's auditors flunk the new independence standards under S/OX. They could also impair a sponsor's ability to exit in an IPO or in a sale to a public buyer, since in most cases a public buyer will need to be able to file S/OX compliant financial statements immediately following any such acquisition.

2. Impact of Cross-Affiliations Among Portfolio Companies

Separate portfolio companies of a particular private equity fund, and even separate portfolio companies held in separate funds managed by the same core group of investment professionals, typically constitute "affiliates" of one another under the securities laws because the portfolio companies are under the sponsor's "common control." One open question under S/OX of particular importance to sponsors is whether the provision of non-audit services by an accounting firm to one of a sponsor's portfolio companies taints that firm's independence with respect to the sponsor's other portfolio companies.

On the one hand, such a construction of the rules seems wholly untenable since it could preclude any of the remaining "Big Four" accounting firms from being "independent" with respect to any of a large sponsor's portfolio companies, given the wide range of relationships that are bound to exist between the current and prospective portfolio companies of a particular sponsor and the "Big Four" firms. On the other hand, read literally, the rules bar the provision of non-audit services to the audit client *and any of its affiliates*, and the term "affiliate" is defined to include any entity under "common control" with the audit client.

The SEC has not provided any written interpretative guidance on this issue, so it is difficult to provide unequivocal advice in this area. Our impression based on our deal experience so far is that most sponsors are taking the position that cross-affiliations of this type do not taint an auditor's independence so long as no prohibited services are provided by the auditor to the portfolio company to be audited. Indeed, under the rules, many of the listed non-audit services will not taint independence if "it is reasonable to conclude that the results of these services will not be subject to audit procedures." Thus, if two affiliated portfolio companies have no direct commercial relationship with one another, the provision of at least some non-audit services to one portfolio company should not affect the auditor's independence with respect to the other portfolio company. And in informal conversations with members of the SEC's accounting staff, we were similarly advised that if there is no interrelationship between the two sister portfolio companies, it is very unlikely that the cross-affiliation would taint an auditor's independence. Nevertheless, pending more definitive guidance from the SEC, we are advising clients to proceed cautiously here, particularly if there are circumstances that raise particular questions about an auditor's independence.

3. Prohibition on Insider Loans

The Act bans virtually all loans from a registered issuer to any of its directors or executive officers. Loans made prior to July 30, 2002 are grandfathered, but this status is forfeited if the loan is modified in any material respect after July 30, 2002.

These rules have no impact on any loan made by any portfolio company for so long as the company is private. But the ban will apply retroactively to any such loans made by any portfolio

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Top 10 Things Private Equity Sponsors Need to Know about Sarbanes-Oxley (cont. from page 7)

company which is subsequently taken public, including via a registered debt exchange offer or an IPO. Sponsors thinking IPO will need to either avoid such loans entirely or structure them so that they are due upon any public offering.

Due to a "quirk" in the rules, this ban ceases to apply to most high yield-only issuers within one year after they go public. It may thus be possible for such a portfolio company to implement an executive loan program shortly after that one year period. In practice, however, we suspect this will be of limited utility since it "kicks in" only after the time a loan is most likely to be needed — *i.e.*, at the time of the initial investment in the target by the sponsor and its management team — and, in any event, all loans extended under the program would have to be repaid if the high yield debt were subsequently refinanced publicly or the company filed for an IPO.

4. Alternative Credit Arrangements

The ban on insider loans under S/OX does not preclude a sponsor, in its capacity as a stockholder of a public company, from extending credit to, or arranging credit for, executive officers of a public portfolio companies so long as the portfolio company does not provide any credit support whatsoever. We also understand that some banks have begun to set up programs under which loans are made available to selected, qualifying employees of a sponsor's portfolio companies, on a non-recourse basis to the sponsor and the portfolio company.

5. Officer Certifications Complicate Acquisition Activities

S/OX requires that the CEO and CFO of a public company certify the accuracy of all annual and quarterly reports filed by the issuer with the SEC, thereby making the CEO and CFO personally responsible for their company's public disclosure.

As with insider loans, these requirements will not apply to a sponsor's purely private portfolio companies. But if a sponsor wishes to acquire one or more private businesses or divisions through a portfolio company that already files or will begin to file periodic reports following an acquisition, as would be the case in an acquisition or roll-up transaction financed with an A/B exchange offer, the sponsor will need to ensure that the issuer's CEO and CFO are able to make the required certifications under S/OX.

This will require diligencing the acquired business's internal control structure and designing new controls to ensure S/OX compliance going forward. Depending on the experience and sophistication of the management team, it may also involve educating management about S/OX. And most delicately, it may entail persuading the new management team to accept responsibility — through the certifications — for the past disclosure of the acquired business.

6. Audit Committees

S/OX requires each *listed* company to have an audit committee comprised entirely of "independent directors." To be independent for this purpose, a director must not accept directly or indirectly *any* consulting, advisory or other compensatory fee (other than director fees) from the company (excluding fixed retirement compensation for prior service) and must not be an "affiliate" of the company. All such audit committees must, among other things, be responsible for the appointment, compensation, retention and oversight of auditors and approve all audit and permissible non-audit services.

Because these audit committee requirements apply only to *listed* companies, a sponsor would not have to comply with them for debt-only filers. But if a sponsor wants to IPO a portfolio company, it would be required to comply with these requirements immediately upon the IPO – there is no "phase-in" period.

S/OX also imposes a separate obligation on *all* reporting companies, including debt only, voluntary filers, to disclose whether or not they have an "audit committee financial expert," as defined under the Act. This provision does not require a 10-K filer to have such an expert, but only to disclose in its 10-K if it does not have one.

7. New NYSE and NASDAQ Requirements

Both the NYSE and NASDAQ have now significantly revised their listing standards to comport with the Act. Each requires listed companies, subject to certain exceptions, to maintain a board comprised of a majority of independent directors. The NYSE also requires audit, compensation and nominating/corporate governance committees to be comprised entirely of independent directors. NASDAQ companies are required to have an audit committee consisting only of independent directors.

Both the NYSE and NASDAQ provide for phase-in periods of these rules following an IPO. For each board committee, the company is required to have one independent member at the time of the IPO, a majority of independent members within 90 days thereafter and all independent members within one year. Listed

companies must also have a majority of independent directors within one year of the IPO.

As with the S/OX rules applicable to audit committees, these rules, by definition, apply only to *listed* companies; non-listed companies, such as debt-only registrants, are not required to comply with these requirements. For that reason, these rules are likely to be of little immediate relevance to most sponsors at the time of an acquisition of a portfolio company. These requirements, however, will obviously be of great significance to sponsors when evaluating an exit of a portfolio investment via an IPO.

8. Selecting Independent Directors

As noted above, publicly listed companies are now required to have two types of "independent directors": directors who meet the NYSE's or NASDAQ's definition of independence and directors who must meet the Act's more stringent independence requirements for purposes of serving on an audit committee (see paragraph 6 above).

For a director of a NYSE or NASDAQ listed company to qualify as independent, the board must affirmatively determine that the director has no material relationship with the listed company. The NYSE and NASDAQ rules also each list a set of enumerated relationships which would cause a director not to be independent, and impose "look-back" periods applicable to these relationships.

Of particular relevance to private equity firms, the SEC has adopted a safe harbor providing that a stockholder owning less than 10% of the vote of a listed company may appoint a director who is qualified to serve on that company's audit committee. Both the NYSE and NASDAQ have also made clear that a large shareholding position does not by itself preclude a board finding of independence. Although the SEC has expressly stated that the 10% safe harbor is not intended to be a ceiling, a sponsor owning over 10% of the vote may find it problematic to appoint independent directors from their firms if other relationships exist between the firm and the portfolio company.

Even though these rules will not apply to portfolio companies which do not have publicly traded equity, they will require sponsors to budget more time to search for independent directors for any portfolio company it intends to IPO.

9. Controlled Company Exemption to Independence Requirements

The NYSE and NASDAQ both provide for a "Controlled Company" exemption for companies where more than 50% of their voting power is held by an individual or group. A Controlled Company is largely exempt from the independence requirements as to its board, nominating/corporate governance and compensation committees (but not as to its audit committee). This exemption may be particularly significant for financial sponsors because it would insulate a publicly traded portfolio company which is majority owned by the sponsor from many — but not all — of the more burdensome governance provisions associated with S/OX. On the other hand, the "controlled" portfolio company would still be subject to most of the disclosure obligations associated with the Act.

10. Enhanced Disclosure Obligations

The Act increases the breadth and complexity of required disclosure while simultaneously shortening the permitted time to make such disclosure. Among the new rules that public portfolio companies, including voluntary debt-only filers, may need to grapple with: (1) new 8-K requirements, scheduled to become effective on August 23, 2004, requiring disclosure within 4 days of material developments; (2) extensive disclosure concerning company "disclosure controls and procedures" and "internal controls for financial reporting"; (3) the ability to use non-GAAP financial information; and (4) new rules governing the disclosure of any material off-balance sheet transactions and contractual obligations.

So, what's it all mean?

The good news for private equity firms is that their purely private portfolio companies will be exempt from the corporate governance and disclosure requirements of the Act for all intents and purposes. The less good news is that a large chunk of the Act — but not all — will apply to debt-only filers, including voluntary filers. The bad news is that the full weight of the Act will apply to any portfolio company which is taken public in an IPO or in many instances, one that is sold to a public company buyer. Moreover, evolving best practices may make compliance with much of the Act de rigueur for most companies, even for those to whom the Act does not technically apply.

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Compensating UK-Based Executives of Private Equity Sponsors

Planning on working for a stint in the UK? Bring your passport and call your tax lawyer. The UK tax rules have rewards for the well-advised, but reaping the benefits requires some planning — in advance.

UK Tax Status

At the heart of the UK system for the taxation of individuals are the concepts of "residence," "ordinary residence" and "domicile," which reflect the level of connection an individual has with the UK.[1] Thus the "residence" test is applied on a tax year by tax year[2] basis and will be satisfied if an individual spends at least 183 days in the UK in a tax year (residence may also be established by shorter, but regular visits, over a 4 year period). "Ordinary residence," on the other hand, has a somewhat broader horizon and is generally established by an individual being, or intending to be, resident in the UK over a continuous period of at least 3 years or buying a property in the UK in which to live. The distinction between "residence" and "ordinary residence" is of most relevance to the tax treatment of employment income. In particular, if an employee is resident, but not ordinarily resident in the UK, remuneration relating to duties performed outside the UK is not subject to UK tax and the "Schedule 22" rules applicable to equity-based remuneration do not apply. Finally, "domicile" is akin to nationality — it is generally very difficult to change domicile because it involves a decision to reside permanently in a chosen jurisdiction different from that in which the individual is domiciled. In consequence, UK-based executives who come to work in the UK for a limited period will almost certainly not acquire a UK domicile, although they may become resident, and perhaps ordinarily resident, depending on the length of their stay.

Individuals who are resident, ordinarily resident and domiciled in the UK are taxable on their worldwide income and capital gains in the UK as it arises and regardless of whether it is received in the UK.

Benefits in Avoiding UK Residence

If an individual can avoid satisfying the UK residence test, he or she will only be taxed in the UK tax on (1) compensation relating to duties performed in the UK and (2) very limited types of UK investment income (*i.e.*, income on which tax is withheld at source and as to which treaty relief is not available). Moreover, compensation for services performed in the UK will generally not be subject to tax in the UK if they are merely incidental to the individual's regular employment outside of the UK.

However, individuals who are resident for tax purposes in another country are likely to be subject to tax in their home jurisdiction on these types of income. This double taxation may be alleviated if there is an appropriate double tax treaty between the UK and the relevant country of residence. Whether it is advantageous for the individual to avoid becoming UK tax resident will depend upon the facts and circumstances pertaining to that individual and should be considered carefully before coming to the UK. In particular, the rate of tax payable in his home jurisdiction and whether the UK or the home jurisdiction is able to tax this income under the terms of a relevant treaty will need to be considered. For example, if the UK has a lower tax rate than the individual's home country it may be preferable for the individual to avoid becoming UK resident particularly if he can take advantage of the treatment described in the paragraph below.

Benefits in Avoiding UK Domicile

If an individual cannot avoid treatment as a UK resident, there are material benefits in avoiding treatment as a UK domiciliary. Specifically, such individuals can order their affairs so that they are only taxed in the UK on (1) services performed in the UK and (2) UK invest-

1 The accompanying table highlights the differences in treatment of compensation in the hands of individuals of different status.

2 The UK tax year runs from April 6 until April 5 in the following calendar year.

The distinction between "residence" and "ordinary residence" is of most relevance to the tax treatment of employment income. In particular, if an employee is resident, but not ordinarily resident in the UK, remuneration relating to duties performed outside the UK is not subject to UK tax and the "Schedule 22" rules applicable to equity-based remuneration do not apply.

ment income.

Compensation Income. In order to avoid UK tax on any income for services performed outside of the UK, the income must not be remitted to UK and, where the individual is ordinarily resident but not domiciled in the UK, there must be a separate employment contract with a non-UK employer relating to duties performed outside the UK. Such split contract arrangements, while conceptually straightforward, can give rise to practical difficulties when it comes to creating a clear distinction between the executive's role under the two separate employment relationships. Individuals who are resident (but not ordinary resident) do not need to establish a split contract arrangement. Also, compensation arrangements for UK-based executives who are nationals of a country other than the UK or who perform some of their duties outside of the UK must be closely scrutinized to ensure they are structured in a tax efficient manner from both a UK and non-UK tax perspective. For example, there are potential complications in certain situations for a UK-based individual who performs some duties in the U.S. in relation to the taxation of compensation attributable to those U.S. duties. UK resident, non-UK domiciliaries can also obtain favorable UK tax treatment in relation to non-UK investment income. This treatment is described later on in this article.

As a basic matter, compensation payments such as salary and bonus payments which are subject to UK tax (as described above) will generally be subject to both income and employment taxes. The highest marginal rate of income tax in the UK is 40%. Both employees and employers must pay employment taxes (or "national insurance contributions"). The employer's contribution is at a rate of 12.8% and is due on all compensation paid to the executive. The employee's contribution is approximately 11% on earnings up to £31,720 p.a. and 1% on all earnings thereafter. The employer will generally be required to withhold UK income and employment taxes from compensation paid to UK-based employees, and to remit the withholdings to the UK tax authorities.

Non-UK Investment Income. Similarly, in order to avoid UK tax on non-UK investment income, an individual who is a resident of the UK, but not a UK domicile, must not remit the income back to the UK. UK-based executives will therefore be generally well-advised to minimize the amount of offshore income they remit to the UK. Many executives establish offshore trusts through which to hold overseas assets in order to take advantage of these remittance rules and also some particularly favourable rules applicable to such trusts.

UK Investment Income. An individual who is treated as a UK resident will be subject to tax in the UK on his or her UK investment income regardless of whether the income is remitted to the UK. UK investment income includes income arising from shares in UK registered companies, loan stock and other registered debt instruments issued by such companies.

Carried Interest Arrangements

New rules introduced in Schedule 22 of the Finance Act 2003 changed significantly the UK tax treatment of equity-based compensation plans for employees who are both ordinarily resident and resident in the UK (but not those who are only resident). Although

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UK resident and domicile status	Duties of employment performed wholly or partly in the UK	
	Compensation from UK duties	Compensation from non-UK duties
Resident, ordinarily resident, and domiciled	Liable to UK tax	Liable to UK tax
Resident and ordinarily resident, not domiciled	Liable to UK tax	Liable to UK tax if paid under separate employment contract with non-UK employer and not remitted to the UK
Resident, not ordinarily resident, not domiciled	Liable to UK tax	Not liable to UK tax unless remitted to the UK
Not resident	Liable to UK tax (subject to terms of applicable double tax treaty)	Not liable to UK tax

alert

The Aftermath of *Connecticut v. Forstmann Little & Co.*— Lessons from Connecticut State Court

A Connecticut jury delivered a mixed verdict in early July in the state pension fund's suit against Forstmann Little by finding that the private equity firm breached its contract with the State of Connecticut, but rejecting the State's request for monetary damages.

After losing $122 million in Forstmann Little's $2.5 billion of invest-ments into XO Communications and McLeodUSA, Connecticut sued seeking recovery of it losses. None of the other investors, which included several state pension plans, joined the suit, and many of Connecticut's claims were dismissed from the suit by the judge. However, breach of contract (and duty) claims remained. For example, one of the primary breach of contract claims was that Forstmann had breached an investment limitation in the partnership agreement by putting more than 40% of the fund's committed capital in a single investment, XO. Fortsmann argued that the limitation on putting more than 40% into a single investment applied to each separate investment in XO, rather than the aggregate amount invested in the company. The jury, however, agreed with Connecticut that Forstmann's putting more than 40% of the fund's assets into XO was "grossly negligent."

[F]actors in the jury's decision include that Forstmann Little kept the State informed about the performance of the companies in regular reports, the State accepted dividends and objected only after the investments started losing money, and Forstmann Little's actions were consistently based upon the advice of its legal counsel.

Ultimately, while the jury agreed that both investments were improper, the jury refused to award the State damages because the State had "acquiesced" to the investments. It was important to the jury that the State was informed about the proposed investments, and was fully aware of both the percentage of its commitment to be invested in the companies and the percentage of the companies that Forstmann Little would control. In fact, the state funded its contribution to both companies without complaint. Other factors in the jury's decision include that Forstmann Little kept the State informed about the performance of the companies in regular reports, the State accepted dividends and objected only after the investments started losing money, and Forstmann Little's actions were consistently based upon the advice of its legal counsel.

Notwithstanding the jury's decision on damages, Forstmann Little did not emerge from the courthouse entirely unscathed. In particular, the opportunity cost alone associated with being distracted from its core business (Forstmann Little has not completed an acquisition since 2001) was a steep price to pay. Although most investors in private equity understand the high risk nature of these investments, firms should consider their own risk management procedures to avoid investor lawsuits.

Here are a few suggestions to follow to help minimize potential liability:

Draft partnership agreements clearly. Ambiguous partnership agreements increase the risk of litigation. Not only do vague agreements foster misunderstanding by the fund's limited partners of what is permitted, but they also provide fodder for creative lawyers to craft arguments interpreting the contractual language away from the parties' original intent. Thus, to avoid such confusion, work with your lawyer to ensure that your partnership agreements clearly define your rights and duties. For example, percentage limitations are often drafted to apply to aggregate amounts invested in a single company — if a limitation is meant to apply to separate tranches in a single company, that should be made clear.

Draft broad investment objectives. It is important to draft your organizational documents to provide flexibility to structure transactions that the firm may want to do, even if they are not expected to be the primary fund investment activities. Broad investment objectives and a flexible investment strategy should be described in both the private placement memorandum and the partnership agreement.

Provide full disclosure. Full and ongoing disclosure concerning the

firm's strategy and investments is essential. This includes information in drawdown notices and ongoing information provided in reports and at partner meetings. One of the main bases for denying damages to Connecticut was that Forstmann Little had kept the State informed of its investments in the underperforming companies in many (according to Forstmann Little, over 20) written disclosures.

Consult with your lawyer. Another factor contributing to the jury's decision not to award monetary damages was that Forstmann Little acted according to the advice of its legal counsel. When determining whether a proposed course of action is permitted in a particular context under the partnership agreement's provisions, a fund sponsor should consult with its counsel, giving its lawyer all of the relevant facts, and should proceed only if counsel comfortably agrees that the interpretation is correct and the action is permitted. By consulting a lawyer and acting within the parameters of his or her advice, fund managers have a strong claim that they are acting in good faith when pursuing a course of action.

Draft with an eye toward litigation. When drafting your private placement memorandum and partnership agreement, think about litigation scenarios, likely bases of claims, and substantive and procedural factors that might contribute to a poor outcome for the firm. Consult your counsel for advice about specific protective measures you can take in your agreement and, generally, to minimize risk of litigation and of ultimate liability.

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Tax Reporting For Private Funds Sold in Germany: Moving in the Right Direction

Important questions about tax reporting for funds sold in Germany have been resolved. Private equity and hedge fund sponsors have been particularly concerned about the potential applicability of the detailed public tax reporting provisions of the new German Investment Tax Act. The Ministry of Finance has issued an informal letter which provides clarification in two key areas.

As written, the Investment Tax Act appeared to require privately placed funds, as well as publicly sold funds, to publish a detailed annual report, including lists of assets and/or trading strategies, in the *Federal Gazette* (a public on-line legal reporting mechanism). The recent letter from the Ministry of Finance states that, even if a fund meets the definition of "investment fund" under the German Investment Act, if it is privately placed, the fund would not be required to prepare and publish the detailed annual reports in the *Federal Gazette*.

Furthermore, one of the biggest issues for sponsors of funds of hedge funds (to which the Investment Act does apply) is the apparent requirement for underlying target funds to publish tax information. This was widely acknowledged to undermine severely the possibility of selling foreign funds of hedge funds in Germany. The Ministry of Finance letter addresses this concern. Hedge funds of funds (as well as other fund of funds structures) are not required to publish in the *Federal Gazette* tax information from or annual reports of their target funds. It is sufficient if the fund of funds reports and publishes in the *Federal Gazette* its own annual report and tax information on a consolidated basis. In addition, a fund of funds is not required to disclose the trading strategies and assets of target funds.

The Ministry of Finance acknowledged that, in principle, foreign private equity funds should not fall under the definition of "investment funds" and, accordingly, should not be subject to the Investment Tax Act at all. However, while it is expected that private equity funds will be taxed in accordance with general German tax principles and they will not have to comply with the requirements of the Investment Tax Act, until there is a statutory amendment to clarify this issue, some uncertainty remains about the tax treatment of private equity funds in Germany.

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The Tax Alphabet Cheat Sheet

*You've heard it all before. Those pesky tax acronyms that a tax lawyer claims are the reasons that the initial structure you contemplated needs to be revised. In our never-ending effort to make your life simpler (and tax lawyers easier to follow), here's your own personal tax cheat sheet.**

	What is it?	Why avoid it?	How to avoid it?
CFC	A "controlled foreign corporation" is a foreign corporation that meets a stock ownership test. There is a two step analysis for performing the stock ownership test. First, determine each person that is considered a "10% U.S. shareholder" of the foreign corporation. Second, add up all of the stock owned by the "10% U.S. shareholders." If the "10% U.S. shareholders" own more than 50% of the vote or value of the foreign corporation, then the foreign corporation is a CFC. A "10% U.S. shareholder" is a U.S. person that owns (directly or by attribution) 10% or more of the voting power of the corporation.	The "10% U.S. shareholders" may (1) have phantom income while they hold the CFC and (2) have dividend income treatment (in part) rather than capital gain treatment on exit.	Use non-U.S. (*e.g.*, Cayman Islands) partnerships for the fund and the GP. This helps because in the case of a non-U.S. partnership the ownership test is applied at the "partner level."
PFIC	A "passive foreign investment company" is a foreign corporation that satisfies either an income test or an asset test in a taxable year. (The stockholder makeup is not relevant.) The income test is met if 75% or more of the corporation's gross income is passive income (*e.g.*, dividends, interest, royalties, rents and certain gains). The asset test is met if 50% or more of the average value of the corporation's assets (on a gross value basis) consist of passive assets (*i.e.*, assets that produce passive income).	The consequences depend on whether a QEF election is made. If no QEF, gain on exit is taxed as ordinary income and a penalty charge is imposed on such gain and on dividends. If a QEF election is made the U.S. shareholders may have phantom income.	There is no good structural fix. Beware of start-up companies that generate interest income on invested capital but have no active income.
FPHC	A "foreign personal holding company" is a foreign corporation that satisfies both a stock ownership test and an income test. The stock ownership test is satisfied if more than 50% of vote or value of the corporation is owned by 5 or fewer U.S. individuals. There are crazy attribution rules that make this possible in the fund context. Specifically: (1) stock owned by a partnership is treated as owned proportionately by its partners and (2) any individual partner is treated as owning all of the stock owned (or deemed to be owned) by his or her partners. Thus, if a partnership owns more than 50% of the stock of a foreign corporation and the partnership has one individual partner, the ownership test will be met. The income test is met if 60% (or 50% in certain cases) or more of the corporation's gross income for any taxable year is passive income (*e.g.*, dividends, interest, royalties, rents and certain gains).	U.S. investors are taxed annually as if they received a taxable dividend equal to their share of the FPHC's "undistributed foreign personal holding company income."	Don't let U.S. individuals invest in the fund directly. Rather, require them invest through a partnership or S corporation.
PHC	A "personal holding company" is a company (foreign or domestic) that meets a test essentially the same as the FPHC test except that (1) a domestic corporation or a foreign corporation can be a PHC and (2) the ownership test is met if more than 50% of the value (rather than vote or value) is owned by 5 or fewer individuals (U.S. or foreign).	A tax is imposed at the corporate level of the PHC.	Don't let U.S. or non-U.S. individuals invest in the fund directly.

* For questions, please call Debevoise & Plimpton LLP tax partners Gary M. Friedman (1 212 909 6261), Peter A. Furci (1 212 909 6114), David H. Schnabel (1 212 909 6336) or (in London) Peter F.G. Schuur at 44 207786 9064.

Buying a Private Equity Fund Company

Private equity professionals are expert in buying and selling businesses. But what happens when the "target" is the fund company itself? A crazy idea? Not really. Investment management companies have long been the target of M&A activity. Increasingly, full service financial institutions are looking to acquire private fund companies to add to their portfolio of investment products — in some cases after having found that buying it is a more promising path than building it.

To date, much of the developing private equity sponsor M&A activity has been in the area of funds of funds, such as the recent acquisition of Pantheon by the Frank Russell Company. However, there is no reason why more traditional buy-out shops could not become a target of acquisition activity.

An acquisition of a private equity fund business presents many of the same issues as parties have to face in any acquisition: Should the transaction be structured as a stock purchase, an asset acquisition or a merger? What type of indemnity protections should the sellers provide? How extensive should the representations and warranties be? How should disputes be resolved? You know these issues well.

However, like the acquisition of any investment management business, the purchase of a private equity fund company also involves a number of special considerations. This article touches on three of the most important sets of these issues — the regulatory regime, the fund contracts, and employee matters.

Regulatory issues

Any prospective purchaser of a private equity business will need to focus on the regulatory regime under which the company operates. In what jurisdictions, if any, is the firm registered to act as an investment adviser? What types of consents are required as a result of such registrations to effect the acquisition? Are there jurisdictions in which the firm is not registered but should be? What about any registrations required of the funds sponsored by the target company? To what extent does the proposed acquisition, and the identity of the aquirer, change the nature of the registration(s) that the private equity firm is required to obtain and maintain?

In the case of fund companies operating in the U.S., one needs to keep in mind both the Investment Company Act and the Investment Advisers Act. The first of these should in most cases not present an issue: private equity funds are, of course, private, which means that they are not subject to registration under the Investment Company Act. Nonetheless, any purchaser of a private funds company should take care to establish that each of the relevant funds has properly established its exemption from registration.

The question of whether the private equity fund company itself, or one of its affiliates, needs to be registered under the Investment Advisers Act can be a more difficult issue. In many cases, because of the nature and extent of the business of the fund company, registration is required.

If the fund company is registered under the Investment Advisers Act, any transfer of control will require the consent of the firm's advisory clients. Section 205(a) of the Advisers Act provides that no advisory contract of an adviser that is registered under the Act may be assigned without the consent of the other party to the contract. Importantly, "assignment" is defined in the Act to include a transfer of control.

This raises the further question of which entities are the clients of the fund company for purposes of obtaining such consents. In the first instance, of course, this will be the private equity funds, the consent of which should not be difficult to obtain. Does, however, the Advisers Act require that consents be obtained from each of the limited partners of the funds, rather than or in addition to the funds themselves? The SEC has not yet directly addressed this question. In some cases, consent of at least a majority of the limited partners will be contractually required under the terms of the fund's limited partnership agreement, and most practitioners will conclude that the obtaining of this type of majority consent will also be sufficient for purposes of the Advisers Act. However, many fund agreements are silent on the issue of the right of the limited partners to consent to such a change of control or assignment.

In some cases, the private equity fund company may have investment advisory clients separate from and in addition to their sponsored funds — for example, sponsors of funds of funds often run segregated accounts for individual clients. Each of these clients will also have to consent to the "assignment" of its advisory contract.

The SEC, in general, allows investment advisers to satisfy the requirements of Section 205(a) of the Advisers Act through a "negative consent" process, whereby the adviser provides its clients with written notice of the transaction, generally 45 days in advance of the closing. The notice provides the client with an opportunity to terminate the

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Buying a Private Equity Fund Company (cont. from page 15)

relationship and states that the adviser will assume from the client's continued receipt of advisory services after the consummation of the assignment that the client consents to the transaction. However, this approach is likely unavailable if the private equity fund agreement requires by its terms limited partner consent for an assignment or change of control. Where an advisory contract mandates the "written" consent to an assignment, the SEC's "negative consent" policy does not purport to override the parties' contractual obligations under state law.

Where the private equity fund company is registered under the Advisers Act, it will have to either amend its Form ADV (the registration form under the Advisers Act) or the successor firm that emerges from the transaction will have to become a registered investment adviser. While this is not an onerous process, it should be planned for and addressed in the acquisition agreement.

In addition to U.S. regulatory issues, a prospective purchaser must analyze the registration and consent requirements that may apply in any other countries in which the fund company does business. In many jurisdictions — for example, the UK — the consent of the applicable regulator will be required. Once again, the key is the basic due diligence exercise of determining the jurisdictions in which the target company is registered or required to be registered and then determining the implications of such registration

Management Fees, Carried Interests and Other Fund Terms

The most significant assets of any private equity fund company — other than its employees — are its fund agreements and related management contracts. Any prospective purchaser must fully understand the economic and non-economic terms of those agreements.

It is of course important to evaluate the run rate of the firm's on-going management fees. In most cases, though, the firm's carried interest in its fund portfolio will be of even greater importance, while at the same time being more difficult to evaluate. Any acquirer will want to gain a full understanding as to where each fund stands in its investment cycle and the realization prospects of existing portfolio investments. How deep into the funds' portfolio companies to extend the due diligence exercise will be a fundamental decision that the potential acquirer will have to make early in the acquisition process.

At the same time, already realized investments cannot be ignored either. In particular, an acquirer should evaluate the extent to which the fund management company is a risk of a claw-back of previous distributions. Likewise, the purchaser should ensure that there are no outstanding post-sale warranty or indemnity obligations at the fund level.

Equally critical is understanding the manner in which the management fees and carried interests are shared among the principals of the firm, and how the firm manages the risk of any clawbacks.

Non-economic contractual provisions need also to be reviewed with care. What key-man provisions apply? Does a change of control require the consent of some or all of the firm's clients? In what circumstances can the general partner of a fund be removed by the fund's investors? While the starting point for these issues is the partnership agreements themselves, care must be taken to ensure that all side letters that may modify or augment these terms are reviewed as well.

Employee Issues

Even more than the funds themselves, the most important asset of a private equity firm is its people. Hence, an acquisition transaction will be successful only if the purchaser is able to identify, retain and motivate the key managers and employees of the firm.

The issue of retaining the key employees of the private equity firm — who are likely also to be the sellers of the firm — needs to be approached in the context of the purchase price negotiations. Specifically, the structure of the payment of consideration for the purchase of the company should reinforce the objective of retaining and motivating the selling shareholders and other key employees.

Ideally, a significant part of the purchase price would be paid on a deferred basis, with the deferred portion contingent on the continued employment of the selling shareholder and the financial performance of the company following the closing. In addition, the purchaser may wish to provide the target employees with a continuing equity stake in the firm following closing, whether through a roll-over of a portion of their existing interest or through the grant of new equity interests, which could be in the form of options, restricted shares, or phantom equity.

In allocating earn-out and continuing equity interests among the employees of the private equity firm, the purchaser will want to take generational issues into account. Typically, equity interests in the target firm will be weighted heavily towards the most senior people, with the next generation

— who the purchaser will likely be primarily relying upon to grow the business after closing — having a relatively smaller interest. In most cases, the purchaser will wish to weigh the earn-out and the allocation of new equity interests towards this next generation. Obviously, the effect of any such reweighting on the tax treatment of these payments needs to be carefully considered.

In addition to the "carrots" of earn-outs, bonuses and equity stakes, the purchaser will also want to include some "sticks." Non-compete covenants are legally disfavored, but should be enforceable in the context of an acquisition, particularly in the case of the selling shareholders getting the most out of the deal. For other employees, a more effective tool may be to limit the ability of any departing employee to use the track record generated at the private equity firm.

In the end, an acquisition of a private equity firm is an acquisition of its people, the reputation they have built and the prospects that the next generation can continue the firm's success. The individual funds are important, but are a wasting asset. The acquisition will be profitable only if the firm is able to replicate its prior success with new funds. The ultimate objective of the acquisition process should be to establish a structure and system of incentives that will facilitate this effort and make its achievement more likely.

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Recent and Upcoming Speaking Engagements

June 22-23
Adele Karig
Effective Management Fee Tax Strategies
Institute for International Research: Private Equity Tax Practices
Boston, MA

June 24-25
Michael P. Harrell
Negotiating Win-Win Private Equity Fund Terms
Private Equity Analyst Limited Partner Summit East
New York, NY

July 20-21
Adele Karig
Efficient Structures for Receiving Management Fees
Strategic Financial Management for Private Equity Firms
New York, NY

July 27
Sherri Caplan
Terms and Conditions Trends in Private Equity Funds
Private Funds Terms & Conditions for LPs and GPs — Post Conference Workshop
Leveraged Buyouts 2004
New York, NY

September 9-10
Franci J. Blassberg, Program Chair
Special Problems When Acquiring Divisions and Subsidiaries
Negotiating the Acquisition of the Private Company
The 20th Annual Advanced ALI-ABA Course of Study on Corporate Mergers and Acquisitions
New York, NY

September 21
Franci J. Blassberg, Moderator
Cash-Out: Innovative Ways to Generate Distributions
2004 Private Equity Analyst Conference
New York, NY

September 22
Michael P. Harrell
Terms and Conditions In-Depth: Innovative Strategies for Private Equity and Venture Capital Raising
2004 Private Equity Analyst Conference
New York, NY

Avoiding the Whipsaw in Acquiring Foreign Companies (cont. from page 1)

its Cuba sanctions regulations and assesses civil penalties against dozens of companies each year.

At first blush, the solution may seem obvious in the case of a non-U.S. company that does a small amount of business in Cuban-origin goods: In those circumstances, why not simply discontinue trade in those goods as soon as the company comes under U.S. ownership? Unfortunately, the problem is not so easily solved. Many countries regard the U.S. embargo on Cuba as an affront to their sovereignty and a threat to their trading interests, and have enacted countermeasures against the embargo. In particular, the Council of the European Union has adopted a regulation forbidding companies incorporated in the EU from complying — either actively or by deliberate omission — with U.S. sanctions against Cuba. To implement the Council regulation, a number of EU member countries have enacted legislation providing for significant criminal penalties. For example, a United Kingdom citizen or company that complies, by acts in the UK, with the U.S. embargo on Cuba may be committing an indictable offence punishable by an unlimited fine under UK law. Anecdotal reports suggest that blocking legislation of this sort is seldom enforced, but prosecution nonetheless remains possible, and criminal prohibitions should never be regarded lightly.

Any U.S.-owned or U.S.-controlled company must consider the implications of these conflicting prohibitions before deciding to acquire a foreign company with any Cuba-related business. That does not necessarily mean that a U.S.-owned company may never acquire a foreign company that historically has done business with Cuba or has dealt in Cuban-origin merchandise. While European blocking legislation prohibits acts or omissions taken to comply with the embargo, it does not forbid a company from declining to do business with a Cuban entity or declining to purchase Cuban-origin goods for other reasons. In some instances, legitimate business considerations may lead an acquired company to discontinue Cuba-related transactions for reasons entirely independent of the U.S. embargo. In the absence of such *bona fide* independent business reasons, however, compliance with both U.S. and foreign law may be difficult or impossible to achieve.

Caviar, Carpets, and Compact Discs

Iran is another major target of U.S. sanctions regulations administered by OFAC. With certain exceptions, the U.S. prohibits any investment in Iran, any trade or financial dealings with Iran or entities controlled by the Government of Iran, and any trade in Iranian-origin goods and services. As an exception, the regulations permit most trade in Iranian-origin foodstuffs, carpets, and informational materials like books, tapes or compact discs. In addition, OFAC has discretion to issue specific licenses for certain other types of transactions involving Iran.

The good news for the potential U.S. acquirer of a third-country company is that the Iranian Transactions Regulations, for the most part, do not apply directly to foreign companies acting entirely outside the U.S. Rather, they apply to "United States persons." That term is defined to mean persons located in the U.S., U.S. citizens and permanent residents wherever located, and entities organized under the law of the U.S. — including their foreign branches, but not including foreign subsidiaries or affiliates operating outside the U.S.

That definition does not, however, end the problem for U.S. owners of foreign companies. The regulations not only forbid U.S. persons from engaging in prohibited transactions themselves, but also forbid them from even approving or facilitating transactions by third-country nationals that would be prohibited to U.S. persons. Management based in the U.S. or expatriate Americans residing in third countries may violate U.S. law if they become involved in approving a foreign affiliate's transactions with Iran. Even a routine decision not to breach a preexisting contract can be prohibited. Again, what may seem to be the most obvious solution does not work: U.S. persons cannot simply refer prohibited transactions to someone else within the company. Under the OFAC regulations, for example, a U.S. person who refers purchase orders for a prohibited transaction to a foreign person is engaging in unlawful "facilitation." Likewise, changing operating policies for the purpose of permitting a foreign affiliate to perform a specific contract without approval by a U.S. person is prohibited facilitation, if the change is directed or carried out by U.S. persons.

In addition, U.S. law restricts Iran-related transactions—even when undertaken by foreign persons located outside the U.S.—if they involve activity in the U.S., such as transshipment through the U.S. of goods destined for Iran or transfer of funds through U.S. banks. The Iranian Assets Control Regulations, which block certain assets belonging to Iran and Iranian nationals, prohibit foreign companies owned or controlled by

U.S. persons from dealing in the blocked assets even entirely outside the U.S. And by their terms, the Iranian Transactions Regulations prohibit foreign companies — even those with no U.S. ownership — from re-exporting U.S.-origin goods, technology or services to Iran.

For these reasons, a contemplated acquisition of a non-U.S. company that trades with Iran or deals in Iranian-origin goods or services requires careful consideration of how to comply with the demands imposed by U.S. law. Where Iranian transactions form a significant part of the target company's business, an acquisition by a U.S.-owned buyer may not be advisable, because U.S. involvement could prove unavoidable. But where, for example, the only Iran-related business consists of small transactions handled by low-level non-U.S. employees on the same basis as transactions from other countries, the subsidiary may be able to continue doing business as usual without any approval, facilitation or other involvement by U.S. persons.

In the event that a U.S.-owned company acquires a non-U.S. company that engages in Iran-related business, the acquirer's management should consider not only how it can assure compliance initially, but also what procedures it can put in place to take care that it does not inadvertently slide into noncompliance in future years. To avoid possible future compliance issues, the acquirer may wish to consider stopping its new foreign subsidiary from doing Iran-related business entirely. The Iranian Transactions Regulations have not in general provoked the same sort of blocking legislation from non-U.S. jurisdictions as have the Cuban Assets Control Regulations, but it is important to check the current state of the law in the jurisdictions where the foreign company is incorporated or operates.

The List Goes On

U.S. trade restrictions do not stop with Cuba and Iran. OFAC also administers restrictions on certain dealings related to the Balkans, Burma (Myanmar), Iraq, Libya, North Korea, Sudan, Syria and Zimbabwe. These regulations are anything but uniform. For some countries — such as Sudan — the restrictions amount to a broad embargo, generally comparable to the restrictions against trade with Iran. For others — such as the Balkans — the sanctions only target specific individuals or entities designated as threatening stability or democracy. In some instances, the regulations single out particular categories of transactions, such as imports but not exports, or new investments but not other transactions.

In addition to country-specific restrictions, OFAC administers restrictions on dealings with specific individuals or entities designated as being involved in terrorism, narcotics trafficking, or proliferation of weapons of mass destruction. The State Department's Directorate of Defense Trade Control (DDTC) administers the International Traffic in Arms Regulations (ITAR), which restrict the exportation of designated "defense articles and defense services." The Commerce Department's Bureau of Industry and Security (BIS) administers the Export Administration Regulations (EAR), which restrict the exportation and reexportation of "dual-use" items having possible military uses in addition to commercial uses. The possibility of compliance issues under these and other regulations should be considered in view of the nature, scope, ownership and location of a particular company's business.

Diligence and Compliance

A private equity company with U.S. ownership or management would be well-advised to look into U.S. economic-sanctions issues relatively early in the process of considering a potential acquisition. Where the target of the acquisition is a non-U.S. company, its management is unlikely to be attuned to the economic-sanctions issues that could arise on acquisition by a U.S.-owned company. The day before—or after—the closing is not the ideal time to learn of a potentially serious compliance problem. In some instances, U.S. sanctions laws may make an acquisition impracticable or impossible. But often, with advance planning and careful negotiation, a U.S.-controlled acquirer can assure that a foreign target company is in compliance with applicable U.S. and foreign law from the moment that control changes hands. ▢

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The U.S. owners of a foreign company also need to be wary of being whipsawed by the relationship between U.S. laws imposing economic sanctions and foreign laws prohibiting compliance with some U.S. economic sanctions.

Future Products Liability Claims Pose Fraudulent Conveyance Risk (cont. from page 3)

under applicable law. This question, in turn, was informed in part by the tort law of the relevant jurisdiction. Each of the courts focused its analysis on identifying actual, legally cognizable injuries at the time of the challenged transfer.

The *B&W* court, for example, relying on its interpretation of Louisiana case law, held that a cognizable claim arises the moment a single asbestos fiber begins to cause cellular damage and, in so doing, appeared to hold that all future claims by individuals merely exposed to B&W's asbestos-containing products could be considered in determining solvency. The *B&W* court also made clear that whether B&W was solvent at the time of the transfer was based on an *objective* estimation of its future liabilities at that time, not on the asserted subjective reasonableness of management's contemporaneous estimates. Notwithstanding the court's clearly expressed view that post-transfer claims were complete obligations for purposes of solvency analysis — and without meaningful elaboration — the court nevertheless concluded, under an objective standard, that the plaintiffs had not proven that B&W's 1998 estimate of its asbestos liabilities was unreasonable, and thus concluded that he could not find that B&W was insolvent at the time the transfer at issue was made.

Like the *B&W* court, the *Grace* court concluded that liability arises when a tortious injury occurs, regardless of when the plaintiff becomes aware of the injury or when the injury becomes diagnosable or is sued upon. However, rather than focusing principally on exposure as a liability trigger or on the objective reasonableness of Grace's estimate at the time of the transfer at issue, the *Grace* court assumed that most claimants exposed to asbestos years earlier had sustained at least some form of "subclinical injury," and that all claims filed after the transfer date should relate back to the transfer date to determine solvency without regard to the information then available to management or to the reasonableness of management's solvency analysis at that time.

Unlike the courts in *B&W* and *Grace*, the Second Circuit in its recent *Bairnco* decision did not apply a legal presumption that injury necessarily occurs as of, or at some predetermined time after, exposure. Under New York debtor and creditor law, solvency analyses must be limited to debts "existing" at the time of the challenged transfer. The *Bairnco* court placed the burden of proving the existence and value of unasserted asbestos liabilities squarely on the plaintiffs. Under this allocation of proofs, the *Bairnco* fraudulent transfer plaintiffs were unable to prove insolvency based on unasserted and unknown future asbestos claims — in much the same way the defendant-transferors in *B&W* and *Grace* were unable to *disprove* their insolvency given the presumptive validity afforded to unknown asbestos claim in those cases. The *Grace* court suggested that the "burden of guessing wrong [about the extent of future liabilities] should be placed upon the [transferor] and its transferee." In contrast, the *Bairnco* court removed most of the guesswork from assessing fraudulent transfer risks posed by long-tail products liabilities, by treating the future claims of yet-uninjured persons as presumptively invalid unless proven otherwise by the party seeking to prove a fraudulent transfer.[2]

Unlike the courts in B&W and Grace, the Second Circuit in its recent Bairnco decision did not apply a legal presumption that injury necessarily occurs as of, or at some predetermined time after, exposure. Under New York debtor and creditor law, solvency analyses must be limited to debts "existing" at the time of the challenged transfer.

2 The Bairnco court declined to rule on whether the pre- or post-1986 state tort accrual law applied to transactions that occurred between 1981 and 1988. This is relevant to the analysis because under pre-1986 law, toxic-tort causes of action accrued upon exposure, but cases had to be filed within three years of the last exposure date. Seeking to mitigate the harsh impact of the statute of limitations, the post-1986 law, which remains operative today, considers an action to have accrued on "the date of discovery of the injury by the plaintiff" or the date when such injury would have been discovered with the application of reasonable diligence. Thus, for transactions commenced prior to 1986, companies facing application of New York fraudulent conveyance law cannot be certain whether their asbestos-related debts at the time of a challenged transaction will be defined (as is apparently the case in Louisiana where B&W was decided) on the basis of exposure or on the basis of discovery of an injury.

Degree of Foresight Required: Reasonableness or 20/20 Hindsight?

Once a court has determined what types of asbestos injuries will be recognized as future liabilities, it must also decide under what circumstances a defendant company should have considered these liabilities at the moment in time under scrutiny. Must the company account for only those liabilities reasonably foreseeable at the time of the transaction, or must it accept an insolvency ruling if subsequent events, whether or not reasonably foreseeable, unfold such that the company was, as a matter of fact, insolvent at the time of the transaction? Because this latter position was adopted by *Grace*, and because it greatly increases the risk of an unforeseen insolvency determination and thus a potential fraudulent conveyance finding, this issue has become critically important to private equity firms seeking to estimate future asbestos-related liabilities.

Under *Grace*, the only relevant question in assessing whether the company was insolvent at the time of the transaction is whether its liabilities were in fact greater than its assets. *Bairnco* and *B&W*, on the other hand, appear to support the proposition that solvency is measured not on the basis of actual future liabilities calculated with the benefit of 20/20 hindsight, but rather on the basis of an objective valuation of existing claims and future claims that were reasonably foreseeable at the time the transfer occurred. As the trial court in *Bairnco* explained: "solvency must be gauged at the time of the transfer and not with the benefit of hindsight . . . it is what [the company] believed back in the 1980s, at the time of the transfers, that controls, not analyses performed now . . . ." Because Keene Corporation, the defendant in *Bairnco*, "reasonably believed" that its insurance would fully cover its future asbestos liability, its restructuring could not be considered a fraudulent conveyance. The Second Circuit approved this approach by affirming the trial court's decision "in all respects."

Since the issuance of *Bairnco* and the disqualification of the presiding judge in *Grace*, both of which occurred on May 17, 2004, the defendant corporation in *Grace* — Sealed Air Corporation — has filed a motion to vacate the *Grace* opinion. The motion alleges that the *Grace* court erred by refusing to adopt the reasonableness standard and, in so doing, caused undue hardship for Sealed Air specifically and the business community more generally. Until the new presiding judge rules on the motion, those engaging in products liability-related solvency analysis must assume that a court could find insolvency — and the potential for constructive fraudulent conveyance — if future liabilities turn out to be greater than assets at the time of the transaction in question, without regard to whether the liabilities were reasonably foreseeable.

Given the difficulty of protecting oneself from a fraudulent conveyance claim under the *Grace* standard, private equity firms may find some solace in the Second Circuit's affirmance of the reasonableness standard and in the chance that *Grace* may yet be set aside. There is, however, no judicial consensus on the issue, and those evaluating a transaction involving future product liabilities and potential insolvency will find themselves wading through what remain relatively murky waters. We'll keep you posted on whether those waters get any clearer. ▢

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Until the new presiding judge rules on the motion, those engaging in products liability-related solvency analysis must assume that a court could find insolvency — and the potential for constructive fraudulent conveyance — if future liabilities turn out to be greater than assets at the time of the transaction in question, without regard to whether the liabilities were reasonably foreseeable.

To BDC or Not to BDC — The Promise and Perils of "Public Private Equity" (cont. from page 5)

which might prevent them from reinvesting in a fund even if they would like to. Thus, a corporate pension fund might cease making new private equity investments if its corporate parent has a more popular than expected early retirement program, and needs cash for retirement payouts. Because outsiders may not be able to distinguish between limited partners who fail to reinvest because they don't like the fund and those who pass because they are experiencing a cash crunch, these decisions can cause headaches for private equity organizations as well.

As a result, it may make sense for private equity funds to discourage those investors who are especially likely to have cash crunches from investing in the fund. One way to do so is to make the funds very illiquid. Investors who are especially prone to cash shortfalls are likely to find such investments unappealing, and stay away from the fund as a result. As funds become more liquid, there is more danger that they will attract financially unstable investors, which may lead to greater difficulties in raising new funds.

Lessons for Private Equity

Thus, liquidity is a mixed blessing for private equity. It undoubtedly is something that investors appreciate. But it may attract investors with very short horizons, whose failure to reinvest may have negative repercussions for the private equity organization. The providers of this "hot money" may be here today and gone tomorrow, and it may be difficult to find new investors to replace them.

What, then, are our recommendations? We certainly do *not* believe that public funds are always wrong for private equity firms. But they must be approached with caution. In particular, we emphasize three key lessons:

- *Balance public and private funds.* Given these instability problems, it is unlikely that public capital markets will replace other alternative sources of funds anytime soon. Even if they raise money through BDCs or other mechanisms, private equity groups should maintain strong ties from traditional funding sources.
- *Raise public funds for the least risky segments.* The problems we discuss above stem from information gaps between investors and funds. As a result, public fundraising should be done in segments where information problems are least severe, such in funds that are making debt- and debt-like investments. (And indeed, many of the current crop of proposed BDCs are being organized to invest primarily in mezzanine securities.) Similarly, less established private equity groups without a proven track record should not consider this option.
- *Consider alternative ways to address liquidity issues.* It's not an all-or-nothing decision whether to organize a BDC or not. Private equity organizations can change their mix of investors in a variety of ways. On the private side, groups can, within limits (including the limits on transferability imposed by certain tax rules), increase or decrease the number of restrictions on transferring partnership interests. On the public side, organizations can influence the target share price at which their BDC trades. A high share price can scare away the smallest and least liquid investors, just as Warren Buffett seeks long-term investors by keeping the share price of Berkshire Hathaway high. ▢

— Josh Lerner
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— Antoinette Schoar
MIT Sloan School of Management

It's not an all-or-nothing decision whether to organize a BDC or not. Private equity organizations can change their mix of investors in a variety of ways.

Compensating UK-Based Executives of Private Equity Sponsors (cont. from page 11)

Schedule 22 applies to the grant of a carried interest in a private equity fund, in a significant concession to the private equity industry the UK Inland Revenue has published a safe harbor that limits substantially the application of Schedule 22 to carried interest holders.

If Schedule 22 applies to a grant of carried interest, the recipient will be subject to a tax regime that is similar to the rules applicable to U.S. "section 83(b) elections." If the recipient and his or her employer make a joint election within 14 days of the grant, the recipient will be taxed at the time of grant on the difference between the value of the interest at time of grant (computed without regard to any vesting or other restrictions) over the price paid by the recipient, but the recipient will not be taxed as the interest vests. This value must be determined by the recipient and his advisers and so it is essential to start thinking about valuation issues as soon as possible. The value of an interest is determined by reference to the price that would be exchanged between a willing buyer and a willing seller of the interest.

If the election is not made, the recipient is taxed at the time of grant on the difference (if any) between the value of the interest (taking into account any vesting and other restrictions) over the price paid by the recipient and then as the interest vests or other restrictions lapse or the fund makes carried interest distributions. The additional tax will be based on the value of the carried interest as of that time. Whenever an income tax charge arises under Schedule 22 the employee and employer will also be subject to employment taxes.

Under the safe harbor issued by the Inland Revenue, the grant to an executive of a carried interest in a private equity fund, and subsequent increases in the executive's share of the carried interest, will not be subject to tax under Schedule 22 provided the interest is acquired at market value. The Inland Revenue accept that market value is the small amount of capital contributed by the executive where a carried interest holder acquires an interest in a fund on formation, and it appears to also be the position in practice on a later acquisition of an interest provided the fund's portfolio investments to which the carried interest relates have not appreciated in value since they were acquired.

To qualify for the safe harbor, the fund and the executive must satisfy, a number of detailed requirements including paying the executive's proportionate capital contribution based on the his share of the carry. Although these requirements will need to be reviewed on a case-by-case basis, they are unlikely to create difficulty in the context of a private equity fund carried interest arrangements with conventional fund economics.

If the safe harbor applies or if the executive is not within the scope of Schedule 22, no election will need to be made, no tax will be imposed upon the grant of the interest and carried interest distributions will be taxable as income or capital gains, depending on the underlying source from which they arise. Although income is generally charged at a 40% rate, the effective rate of tax on capital gains will vary between 10% and 40%, depending on a number of factors. Additionally, non-UK domiciled executives can take advantage of the remittance rules to avoid UK tax altogether. In any event, employment taxes will not be chargeable.

Summary

When planning compensation packages for UK-based executives, it is important to think about the tax consequence of such arrangements as early in the process as possible. There can be significant differences in the tax efficiency of very similar arrangements. It is particularly important to consider tax issues on a timely basis if an equity-based grant is to be made because of the very short timeframe for making an election if one is required. In addition, if the executive is a non-UK domiciliary or will be spending time working outside of the UK, there are opportunities for reducing the impact of UK tax that will also need to be considered. ▢

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