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An obvious alternative to looking for debt financing by banks to leverage acquisitions is to find investors who are willing to pick up the debt stake and organize them in an Originator Debt Fund.

Originator Debt Fund

Private Investment Funds Practice – Discussion Papers

The current crisis has seen debt funds become popular vehicles for making investments in undervalued debt securities or loans (often referred to as secondary debt funds).

While secondary debt will probably remain a very interesting market segment within alternative investments, this paper focuses on handing out loans to borrowers or directly purchasing debt instruments from the issuer upon their initial offering (these funds hereinafter referred to as “originator debt funds”). More particularly, this paper aims to elaborate on how the liquidity gap, which is currently felt by many market participants, can be bridged until the banks become less reluctant to provide leverage for acquisitions.

From the point of view of an equity fund sponsor, the obvious alternative to looking to banks for debt financing to leverage acquisitions is to find investors who are willing to pick up the debt stake in an investment and to organize these investors in a (parallel) fund. While this seems at first to be a simple idea, the actual implementation requires some complex considerations.

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Prerequisites

While the need for debt financing is obvious, any consideration of raising an originator debt fund must start with a critical evaluation of whether the respective fund sponsor has access to sufficiently attractive investment opportunities that are suitable for the targeted investor base. Essentially this means the consideration of the following:

- A sponsor who traditionally manages equity funds should investigate whether the investors would consider a debt investment with a risk and reward profile that deviates significantly from an equity investment. It is not unlikely that the fund sponsor will want to widen its investor base and approach new investor classes and not merely such investors that have invested in its equity funds of earlier vintage.

- The considerations relating to the investor side must be mirrored on the deal side. Whereas the structuring of the debt side of a transaction with bank financing was more or less a matter of negotiation with a bank on the basis of the prevailing market standards, the structuring of a debt piece to be acquired by an originator debt fund will generally have to be more tailor-made, both in respect of the risk and reward profile and in respect of taking account of specific issues which need to be addressed for making an investment eligible for a fund.

General Structuring Considerations

The following provides an outline of some very general structuring issues that need to be considered, both from a legal and from a commercial point of view, prior to commencing with detailed drafting of term sheets or the like.

TAX STRUCTURING

Any fund structure, and any underlying acquisition structure, will seek to meet the demands of various investor classes. The fact that debt funds will be generating predominantly interest income from the target investment calls for optimizing the structure, particularly with a view to investors who would be accustomed to receiving equity income (dividends and capital gains) could be a strong selling point.

(a) Specific investor classes
Other investor classes with specific requirements in terms of the tax treatment of the income from any debt fund are:

- tax exempt investors;

- tax exempt investors investing in the United States would be seeking to avoid the allocation of any unrelated business taxable income from a US tax point of view. German tax exempt investors are very sensitive to any income that would be considered trade income (*Gewerbliche Einkünfte)* from the German tax perspective;

- due to the implementation of the so-called "lump sum taxation" (*Abgeltungssteuer*), German individuals are, in principle, not sensitive to whether they receive interest income or equity income. However, since the benchmark for any investment is the 25 percent tax burden under the lump sum taxation regime, it would be significantly disadvantageous if any fund structure would turn this type of income into fully taxable trade income.

(b) Specific target countries
Specific target countries will require specific acquisition structures for the repatriation of profits to the investors, e.g.:

- In Germany, originator debt funds could provide the opportunity to optimize the position in respect of the interest stripping rules (*Zinsschrank*e).

- In France, the 3 percent tax must be dealt with, and this could impact on choosing an optimized fund structure for investments into French real estate.

As in any fund structuring process, the key to managing the structuring objectives will be the reasonable identification of the "must have" and "nice to have" features of the fund. Further, it is key that the tax considerations are seamlessly integrated into the regulatory requirements.

REGULATORY REQUIREMENTS

In most jurisdictions, the handing out of loans is subject to regulation. Thus, regulations potentially could apply at the level of the fund and in the jurisdiction of incorporation of the fund as well as at the level of the target investments and in their respective jurisdiction. In Germany, conducting the business of granting loans requires a banking licence. A prudent holding structure underneath the fund level may mitigate the number of jurisdictions potentially involved.

Depending on what jurisdictions are affected, it will need to be established to what extent the originator debt fund may avail itself of group exemptions from any licensing requirements. Certain fund vehicles, in certain jurisdictions, may enjoy some privileges by virtue of their legal structure. Further, the use of investment instruments other than straight forward loans may be advisable to achieve a reasonable level of comfort in respect of the regulatory assessment of the structure.

Although regulatory compliance is of course of paramount importance, it cannot be a stand-alone consideration. Instead, it must be investigated under due considerations of the tax structuring and, in particular, the effective repatriation of profits from the target jurisdictions.

REGULATORY ISSUES PARTICULAR TO CERTAIN INVESTOR CLASSES

Some investor classes will have particular regulatory concerns that need to be addressed. For example German insurance companies will typically wish to make an investment for account of their committed assets (*gebundenes Vermögen*). Depending on the details of the structure, an originating debt fund could qualify either as an investment in companies (*Beteiligungen*), within the meaning of Sec. 2 sub-section 1 No. 13 of the German Investment Ordinance (*Anlageverordnung*, "***IO***"), or as an investment in a foreign fund (*ausländischer Investmentanteil*) within the meaning of Sec. 2 sub-section 1 No. 17 IO. It is crucial to come to a commercially prudent decision on what structuring efforts should be made, e.g. implementing redemption features, to attract certain investor classes in the light of the concessions that would need to be made for regulatory purposes.

Conflicts of Interest

In structures where the debt fund is sponsored, managed or advised by an entity that belongs to the same group as the sponsor, manager or advisor (collectively "Sponsor") of the fund making the equity investments, there is a significant potential for conflicts of interest. These involve both legal liability risks as well as general reputational risks for the Sponsor.

A prudent management of potential conflicts of interest starts at the level of the fund terms for the fund providing the equity financing. It would need to be established that the particular conflicts involved in utilizing debt financing provided by a fund of the same Sponsor are effectively disclosed and resolved by investors. The terms of the originator debt fund and the equity fund will need to implement a procedure that ensures that the originator debt fund terms are fair to both the equity and the debt side. In this particular scenario, it will be difficult to establish what would generally be considered arm's length. Therefore, the potential conflicts must be managed by a procedure ensuring compliance in each individual case, possibly by bodies such as an investors' committee which serves both the equity and the debt fund.

Insolvency

The originator debt fund must be provided with the usual securities and warranties that would customarily be provided to a bank. The provisions governing the debt financing must be workable even in the event of insolvency of the borrower in order to ensure that the risk associated with the investment does not effectively equal the equity risk.

Consolidation

An effective management of potential conflicts of interest, as discussed above, will require a system of checks and balances to manage the relationship between the parties involved, i.e. the debt fund and the equity fund, their respective investors and the fund Sponsor. This system may very well involve independent third parties as intermediaries. In structuring these checks and balances, the risk that the originator debt fund might fall within the scope of a compulsory group consolidation for any investor or the Sponsor will need to be avoided.

Terms and Fees

A different commercial deal requires marketable and risk adjusted terms and fee structures that significantly deviate from the market standards for equity fund investments. For example in the absence of disposition proceeds a classical carried interest or promote will most likely not be suitable. New market standards are rapidly evolving, but there is much room for introducing innovative concepts to accommodate the targeted investor class.

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