

# Credit Crunch: Where is the Money Coming From? Debt Fund Structuring Issues

## Tax and Structuring Issues For Debt Fund Sponsors

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# Topics Covered

- Key Structuring Considerations for Debt Funds
- Tax Structuring
- Conflicts of Interest
- Equitable Subordination under the Bankruptcy Code
- Inter-Lender Issues
- Dealing with Material Non-Public Information
- Regulatory Considerations

# Key Considerations in Selecting Debt Fund Structure

- Business Focus of Fund
  - Secondary purchases of debt
  - Origination of debt
- Target Assets
  - Illiquid, difficult to value assets
  - Liquid assets
- Target Investors
  - U.S. taxable investors
  - U.S. tax-exempt entities (including ERISA investors)
  - Non-U.S. investors
- Proposed Economics
  - Closed-end vs. open end fund
  - Redemption features
  - Recycling features
  - Carry/fee Structures
- Debt funds may follow a typical PE fund or a hedge fund structure or have hybrid features

# Factors to Consider in Setting Up a Debt Fund

- **Legal Considerations**

- Type of legal entity (e.g., U.S., non-U.S., stand alone fund, master-feeder structure)
- GP and Management Company structure
- Regulatory Considerations
  - Investment Company Act
  - Investment Advisers Act
  - '33 Act
- Rule 10-b(5) issues
- Conflicts of Interest
- Tax considerations for targeted investors (and built-in flexibility to modify structure)
- Bankruptcy Code impact on operations of the fund

- **Business Considerations**

- Expected IRR
- Investment parameters and flexibility to modify
- Size of capital raise (and process for additional capital raises, if any)
- Timing of fundraise
- Use of leverage
- Ease of execution
- Costs and fees
- Liquidity desire of investors (ability of fund to manage investor liquidity)
- Expected manager and employee “investment” in fund
- Experience and size of management team and impact on capital raise

# Debt Fund Considerations

Key Structural Considerations	PE Model	Hedge Fund Model
<b>Redemption Options</b>	No redemption	Lock-up period of 1 year with quarterly withdrawals thereafter. Manager may have the ability to suspend redemptions in time of crisis.
<b>Management Fees</b>	1% to 2% on Committed Capital, step down to a lower percentage determined based on invested capital after commitment period.	1.5% to 2% of NAV
<b>Fees (i.e. arrangement) from Borrowers shared with LPs</b>	50% to 100% of fees shared with LPs	Typically not addressed in documentation
<b>Carried Interest</b>	5% to 20%, with preferred return of 6% to 10%; sometimes graduated carry percentages after achievement of IRR thresholds.	Typically 20%
<b>Clawback/High watermark</b>	Clawback; periodic and/or after the end of the fund's term	High watermark and loss carryforward
<b>Commitment Period</b>	Typically 5 or 6 years	N/A
<b>Fund Term</b>	10 year term, potentially with a 1 – 3 year extension option	35 years

# Debt Fund Considerations (con't)

Key Structural Considerations	PE Model	Hedge Fund Model
<b>Open End/Closed End</b>	Closed end	Open end
<b>Termination Events</b>	Key person triggers; no-fault termination; removal of GP provisions	No-fault termination or no ability to terminate before the end of the term
<b>Recycling</b>	Limited recycling may be permitted, subject to a cap based upon committed capital (i.e., 120%) and/or subject to the types of proceeds that can be recycled	All capital constantly invested
<b>GP Commitment</b>	1% to 5% of committed capital	Below 1% of NAV
<b>Distributions</b>	Interest payable quarterly Net proceeds payable quarterly tied to available cash	Only upon request, periodically after lock-up period
<b>Formation of Successor Funds</b>	Typically restricted until 75% of capital is invested, reserved, or used for investments or expenses	No limitation
<b>Closings</b>	Open for a period of 6 to 18 months	Continuous offering
<b>Fund Expenses</b>	Charged to fund (except placement fees)	Charged to fund (except placement fees)

# Overview of Tax Considerations

- When organizing a debt fund, the primary issues are the identity of investors and the type of debt
- Types of Investors
  - Taxable U.S. Investors
  - Tax Exempt U.S. Investors
  - Foreign Investors (including sovereign wealth funds)
- Type of Debt
  - U.S. or Foreign
  - Loan Origination
  - Distressed
  - Real Estate Backed

# Taxable U.S. Investors

- Taxable U.S. Investors (i.e., U.S. persons who are taxed on all of their investment income) generally prefer to invest in an investment vehicle that is treated as a pass-through entity (e.g, a partnership) for U.S. income tax purposes
- Benefits of Pass-Through Treatment for Taxable U.S. Investors
  - Avoid tax at Fund level
  - Pass-Through of Tax Attributes
    - Long Term Capital Gains (Not as beneficial in debt funds due to interest treated as ordinary income and market discount rules)
    - Tax Credits (e.g., foreign tax credits)
- Detriment of Pass-Through Treatment for Taxable U.S. Investors: Taxed on income whether or not distributed (“dry income”), including original issue discount (“OID”)



# Tax Exempt Entities

- U.S. Tax Exempt Investors are only subject to tax on income that is classified as “unrelated business taxable income” (“UBTI”)
- Most investment income earned by a tax exempt entity will not be treated as UBTI
- The major type of investment income taxed under the UBTI rules is “debt financed income” (i.e., debt purchased with borrowed funds)
- If a particular investment strategy involves the use of leverage, U.S. Tax exempt investors can avoid UBTI by investing in an offshore fund because that entity will usually be organized as a corporation for U.S. tax purposes rather than as a pass-through

# Foreign Investors

- Foreign investors in funds have several U.S. tax goals:
  - Avoid having to file a U.S. income tax return (often the most critical issue)
  - Limit U.S. tax on the structure. The United States taxes foreign persons only on:
    - “Effectively Connected Income”
    - U.S. Source “Fixed or Determinable Annual or Periodical Income” (“FDAP”)
  - Avoid placing the fund or its owners under potential IRS scrutiny
  - In the case of sovereign wealth funds, avoid income from commercial activities
- To achieve the foreign persons’ U.S. tax goals, the following steps are taken:
  - Organize the fund as an entity that will be treated as a corporation for U.S. tax purposes
  - Limit U.S. investors to tax exempt entities (*i.e.*, taxable U.S. investors generally not permitted)
  - Limit types of investment (e.g., being careful regarding U.S. debt and real estate investments)

# Taxation of Trade or Business Income

- If a foreign person is engaged in a U.S. trade or business, income that is “effectively connected” (so called “ECI”) with the conduct of that U.S. trade or business will be taxed at rates applicable to U.S. taxpayers
- Foreign corporations will also be subject to 30% branch profits tax on after-tax income (unless reduced by treaties)
- Foreign persons with U.S. trade or business income must file U.S. tax return
- “Securities trading safe harbor” protects most offshore funds from U.S. income tax

# Securities Trading Safe Harbor

- U.S. Trade or business rules. Facts and Circumstances except for securities trading safe harbor
- “Securities trading safe harbor” protects most offshore funds from U.S. income tax
  - Publicly traded debt compared to loans by banks/finance companies
    - Seasoning of loans
    - CLO/CDO model
    - Limited Activity
    - Private Equity Model
  - Distressed Debt
    - Activities to create value
    - Effect of small amount of activity

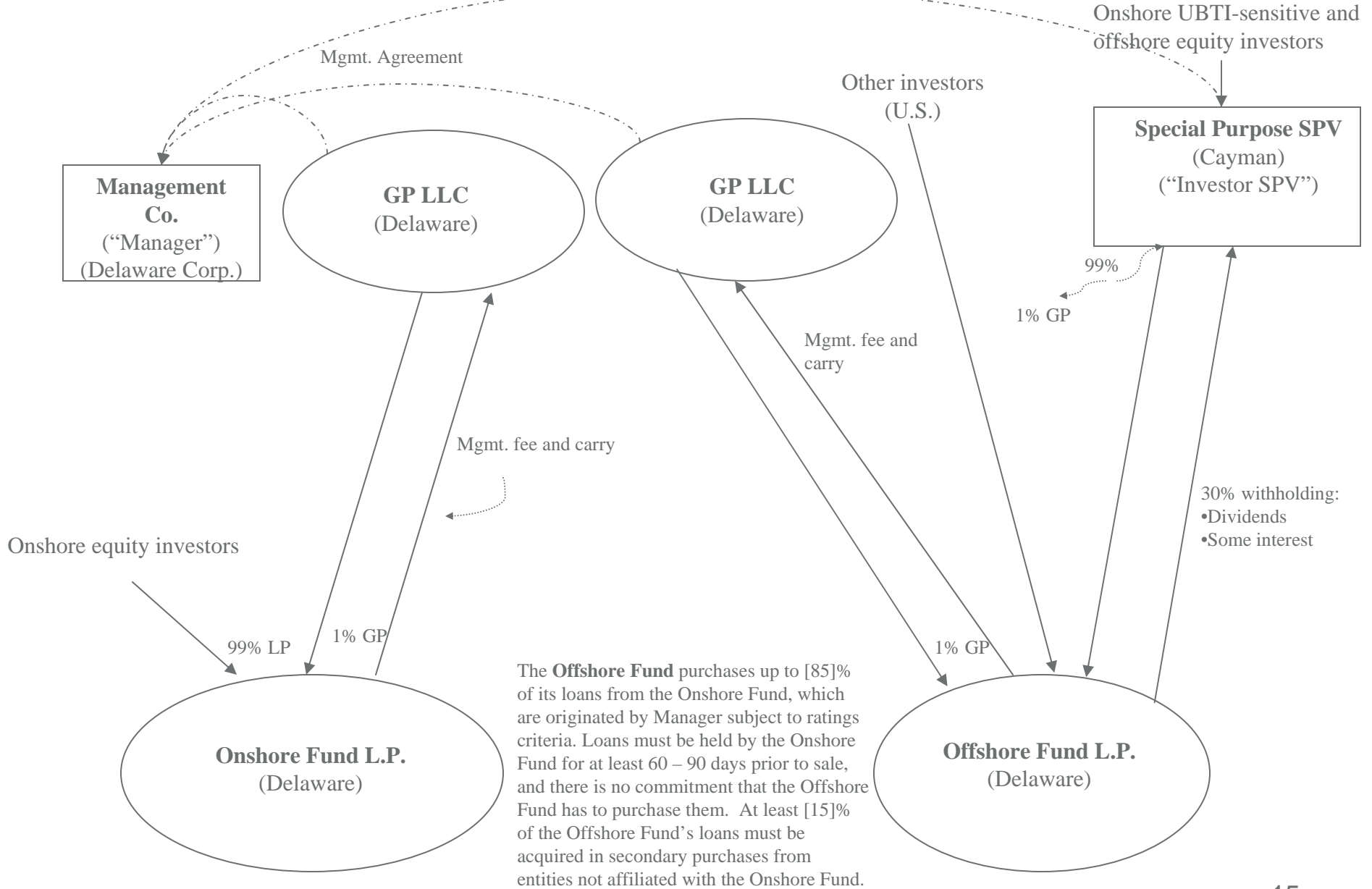
# Withholding Tax Rules

- U.S. source FDAP income is subject to 30% withholding tax unless reduced by treaty
- U.S. source FDAP includes interest and dividends paid by U.S. companies
- Most interest paid by U.S. companies to foreign persons is protected from withholding under “portfolio interest” exception

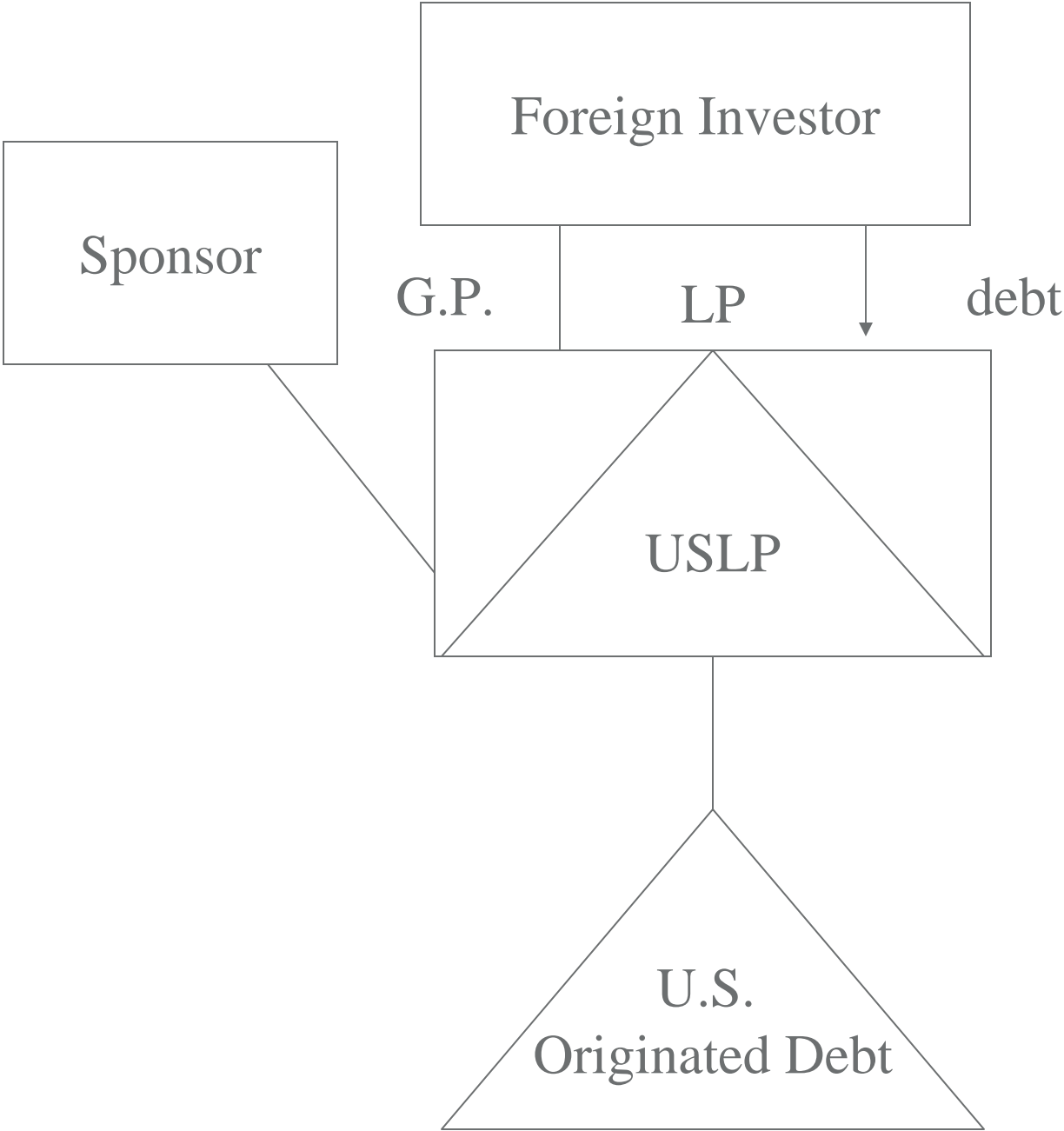
# Structuring Alternatives

- Seasoned Loans
- Blocker Structures
- REITs
- Foreign Debt Funds

# Seasoning Debt Fund Structure

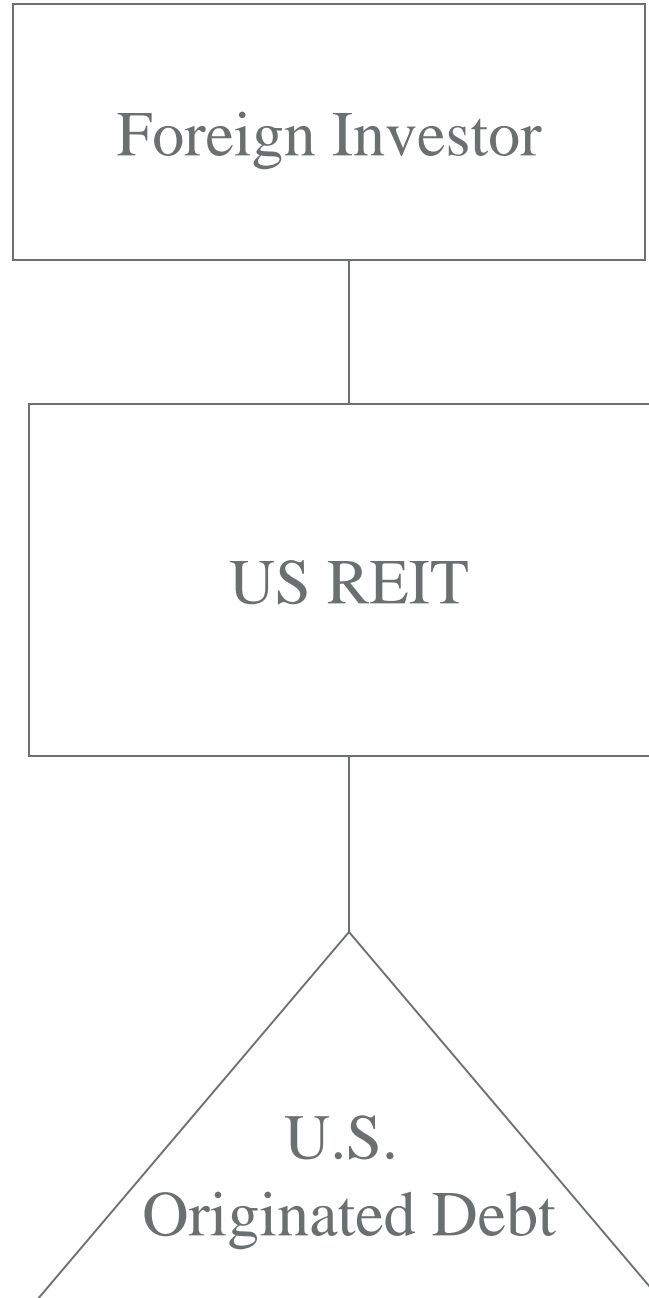


# Blocker Structure

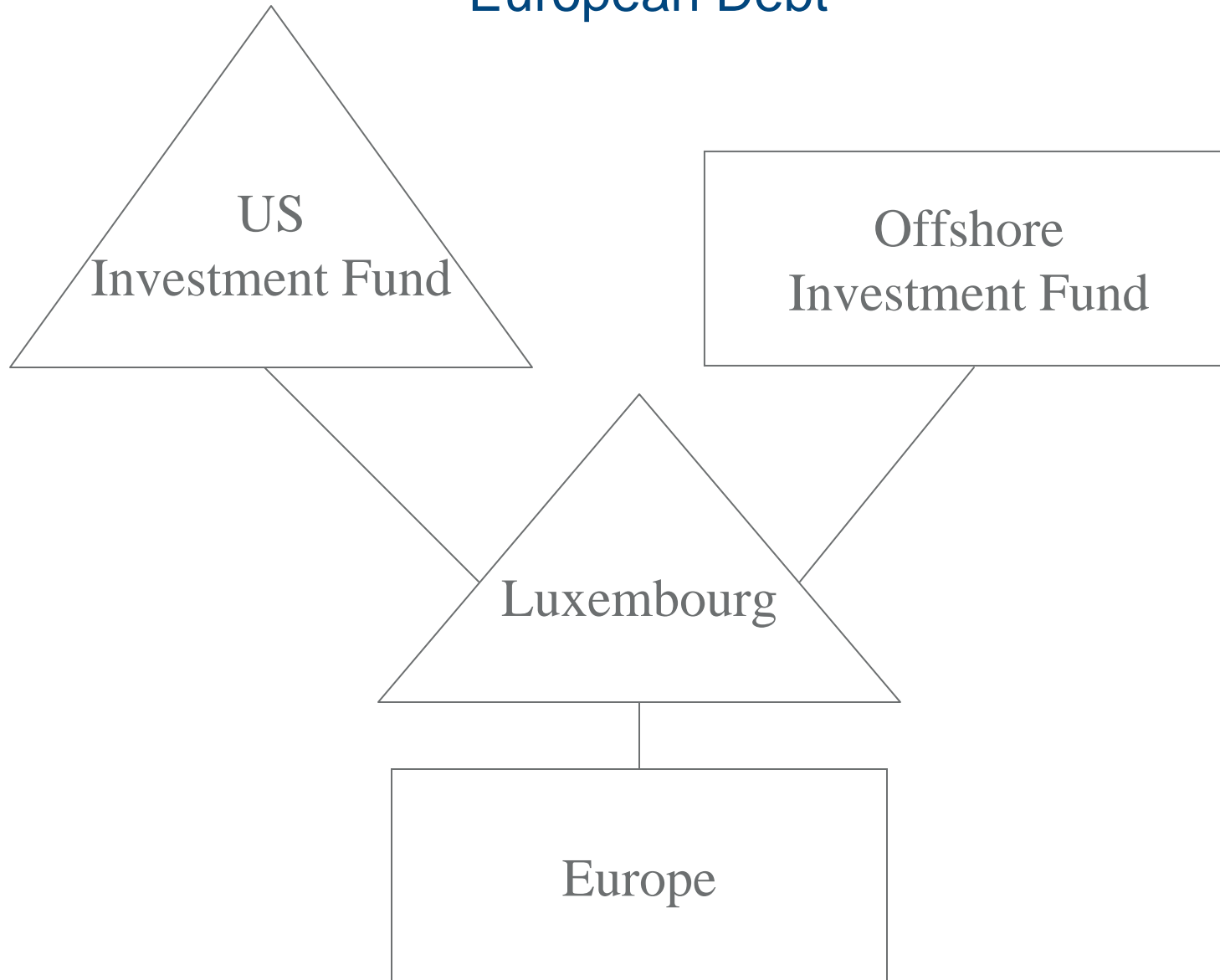




# REIT Structure



## European Debt



# Conflicts of Interest

- Fund wears more than one hat: if related funds (with different investors) hold both equity and debt claims, actions taken to benefit debt may be viewed as harming the equity, and vice versa
  - KKR/Masonite: KKR representative resigned from Masonite board following expressions of concern by other creditors after a KKR affiliate purchased Masonite debt. KKR was already the principal equity owner of Masonite
- Other, more traditional lender potential conflicts
  - Having representative serve on creditors' committee in a bankruptcy proceeding.
    - owe fiduciary duty to the class of creditors that the committee was appointed to represent.
    - members of committees may be subject to enhanced trading restrictions and confidentiality restrictions
  - Similar conflicts can exist in the workout context pre-bankruptcy
  - if a lender takes a board seat where it owes a fiduciary duty to the stockholders
  - Conflicts may force resignation from boards or committees or weigh as a distorting influence on decision making
- SEC concerns

# Equitable Subordination/Recharacterization as Equity

- Under Section 510(c) of the Bankruptcy Code, claims of a creditor can be subordinated if the creditor engages in inequitable conduct and injures other creditors or gains an unfair advantage
  - doctrine can be applied in circumstances where a creditor controls the debtor and uses this control to disadvantage other creditors
  - taking board seats in certain circumstances may be problematic, as may exercising too much control over the operations of the debtor
  - doctrine could be extended to the equity affiliate of the creditor taking the actions
  - a similar (but distinct) remedy in bankruptcy is that of recharacterizing a debt claim as equity

# Inter-lender Issues

- Other lenders frequently do not like equity holders of the borrower from taking debt claims in the borrower, due to the fact that the interests of an equity holder are not aligned with those of a pure creditor
- Notes issued in most insurance company private placements require that notes acquired by the borrower or its affiliates be cancelled. Most bank credit agreements prohibit assignment to the borrower or its affiliates, particularly those done on the LSTA form
  - almost certainly a distraction in lender group discussions/dynamics
  - issue of preserving lender confidences, especially in workout situations

# Dealing with Material Non-Public Information

- All loan market participants must comply with rules dealing with material non-public information to avoid insider trading under rule 10b-5
- Rule 10b-5 prohibits certain persons who are aware of material nonpublic information relating to a company or its securities from trading in the securities without appropriate disclosures. If such persons are not able to make the required disclosures, they must abstain from trading
  - normal business activities of lenders may trigger the insider trading restrictions in certain circumstances
  - lenders need to set up internal controls to protect against inappropriate dissemination and use of material nonpublic information: these can include walls, and need to know lists
  - lenders wishing to retain flexibility to trade may wish not to obtain material nonpublic information

# Dealing with Material Non-Public Information (con't)

- Many credit agreements are now set up to require the borrower to maintain two sets of information, one to provide to private lenders (those wishing to receive material nonpublic information), and one to provide to public lenders (those not wishing to receive such information)
- Joint Market Practices Forum (includes LSTA) principles for dealing with material non-public information allows implementation of informational walls, although these must be policed and are more difficult to do for smaller GPs

# Regulatory Considerations

- Exceptions under the Inv Co Act of 1940 that funds typically rely upon (3(c)(1) and 3(c)(7)) and how those exceptions differ when the issuer is offshore or in a master-feeder structure
- Exemptions under the Inv Advisers Act of 1940 that advisers typically rely upon (and the fact that, notwithstanding those exemptions, 90+ percent of the Act still applies)
- 33 Act/ 40 Act general solicitation issues and the dangers inherent in the use of websites
- Insider trading issues, including SEC focus areas (e.g., CCO) needs to understand all sources of data into and out of the adviser and have controls and monitoring in place relating to the use of material non public information
- Best execution and soft dollars in the context of debt hedge funds
- SEC exam focus areas
- Typical fee and organizational structures where the fund is a hedge fund



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