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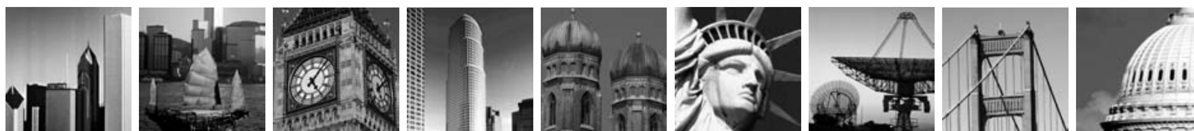
March 24, 2009



KIRKLAND & ELLIS LLP

Private Equity Newsletter

TARP/AIG Bonus Bill Could Affect Private Equity Firms and Their Portfolio Companies

PENpoints

The new House bill prompted by the recently paid AIG bonuses could affect virtually any bonus payments made by a company related to a recipient of more than $5 billion in TARP funds.

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On March 19, 2009, the U.S. House of Representatives passed H.R. 1586, the House's response to recently paid AIG bonuses. Although precipitated by the AIG bonus payments, the bill casts a far wider net and could apply to virtually any bonus payments made by an entity that is related to a company that received (or in the future receives) more than $5 billion in TARP funds.

The Senate is considering, but has not acted upon, a bill that differs considerably in detail but is also aimed at taxing bonuses paid by TARP recipients.

Description of the Bill

If enacted, the House bill would generally tax at a 90% federal rate a "disqualified bonus payment," received after December 31, 2008, from a "covered TARP recipient," by an individual with adjusted gross income of $250,000 ($125,000 in the case of a married individual filing a separate return)[1] for the taxable year of receipt.[2] For purposes of the bill:

- A "disqualified bonus payment" is broadly defined to include any incentive payment or other bonus that is in addition to any compensation amount payable at a regular hourly, daily, weekly, monthly or other similar period rate.
- A "covered TARP recipient" means:
  - (i) Fannie Mae and Freddie Mac,
  - (ii) any entity that received more than $5 billion in TARP assistance (see inset at right for a current list),
  - (iii) any entity included in the same Code §1504 "affiliated group" with any of the foregoing (a standard generally requiring ownership of 80% or more of a corporate entity's stock by vote and value) and
  - (iv) any partnership or LLC if more than 50% of its capital or profits interests are owned directly or indirectly by one or more of the foregoing.

As a result, a "disqualified bonus payment" from a TARP recipient's controlled entity (as defined in clauses (iii) or (iv) above) would be subject to the bill's 90% tax.

The 90% tax would not apply if the bonus recipient "voluntarily" elected to incur an effective 100% tax by returning the bonus (without receipt of any related consideration) within the taxable year of payment.

It is significant to note that the bill does not include any grandfathering provisions, so the important date for determining whether a "disqualified bonus payment" would be taxed at 90% is the date it is paid, not the date it is

+$5 Billion TARP Recipients

AIG
Bank of America
Citigroup
General Motors
GMAC
Goldman Sachs Group
JPMorgan Chase
Morgan Stanley
PNC Financial Services
U.S. Bancorp
Wells Fargo

earned. The bill does provide, however, that the tax ceases to apply if the "covered TARP recipient" reduces its outstanding TARP assistance to $5 billion or less, apparently before the end of the bonus payment year.

Implications for Private Equity Firms and Their Portfolio Companies

In its present incarnation, the bill could have significant consequences to a private equity professional who either currently or previously rendered services to a "covered TARP recipient" (including an 80% corporate subsidiary or a more than 50% partnership or LLC subsidiary). It is not uncommon for an institutional private equity firm to be controlled, directly or indirectly, by a bank holding company or investment bank, and for its professionals to be entitled to an incentive payment from the firm years after the payment was earned either by investing in, or exiting, a portfolio investment.

If the private equity professional's payment is structured as a payment of compensation (as opposed to a distribution in respect of an equity interest), it would very likely be considered to be an "incentive" or "bonus" payment for purposes of the bill. If it were structured as an equity interest, it might nonetheless be covered, since the bill covers a "payment … for services."

Moreover, if a covered TARP recipient has a direct or indirect (e.g., through its merchant banking operation) interest in a controlled portfolio company (80% if a corporation or more than 50% if a partnership or LLC), a bonus paid by the controlled portfolio company to its executives would also be covered.

The Future

Opponents of the bill are already questioning its constitutionality,[3] its unfairness based upon the individual status of each bonus recipient and the serious damage it could wreak upon the American banking industry's ability to hire and retain executives.

While it is certainly possible that the bill (or some cousin of the bill) could be enacted, it is hoped that any such law would reduce or eliminate much of its blatant unfairness.

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1 The bill's 90% tax applies to the lesser of the "disqualified bonus payment" and the individual's adjusted gross income in excess of $250,000 ($125,000 for married taxpayers filing separate returns), meaning that the entire amount of a disqualified bonus payment would be subject to the tax for individuals with other adjusted gross income in excess of the applicable amount.

2 Indeed the aggregate taxes (federal and state) on such a payment might very well exceed 100% after taking into account the bill's 90% tax, state income tax and the uncapped federal Medicare tax (1.45% on each of employer and employee).

3 E.g., the bill is retroactive to payments made before enactment or even proposal; is applicable to payments pursuant to existing—and even longstanding—contractual arrangements; imposes an aggregate federal, state and Medicare combined tax rate possibly exceeding 100% and imposes a radically varying tax rate on compensation based upon employer's status *vel non* as a TARP recipient.

If you have any questions about the matters addressed in this Kirkland PEN article, please contact the following Kirkland author or your regular Kirkland contact.

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Private Equity Firm Files Lawsuit Against Two of Its Allegedly Defaulting LPs

PENpoints

Lawsuits like *CapGen* are rare, as capital contribution defaults by LPs have been few and far between, even amid the current global financial crisis.

In an unusual case likely to attract attention from both private equity fund sponsors and investors, CapGen Capital Advisors LLC ("CapGen"), a New York-based private equity firm focused on the financial services industry, filed a lawsuit on March 4 against two of its LPs for allegedly defaulting on required capital contributions. The lawsuit is notable because there are so few published cases of private equity fund sponsors suing their LPs for alleged defaults.

The lawsuit, filed in Delaware Chancery Court (*CapGen Capital Advisors LLC v. Chalice Fund LP*), asserts that the LPs, by failing to make required capital contributions to three CapGen funds, violated Delaware law and breached the funds' operative agreements. The funds, which were raised in 2007-08, have $500 million of aggregate capital commitments. The defendants are two of their smaller LPs: Chalice Fund, L.P. allegedly committed $3.5 million, and WK CG Investment, LLC allegedly committed $1 million.[1] CapGen is seeking payment of the outstanding capital contributions with interest and a court order compelling the LPs to make all future capital contributions (plus payment of the funds' litigation expenses).

According to the lawsuit, the funds' operative agreements allow CapGen, as GP, to exercise the contractual self-help remedy of forfeiture of all or a portion of a defaulting LP's interest in the funds, but CapGen appears not to have exercised that right, choosing instead the relatively unorthodox approach of suing its LPs.

The brief time from capital call to courthouse is noteworthy. According to the complaint, CapGen issued a capital call in late December, with payment due in early January, and sent the defendants a delinquency and cure notice in late January and a final notice—including a statement of intention to sue—in late February. CapGen filed the lawsuit March 4, 2009, less than three months after issuing the capital call.

Lawsuits like *CapGen* have historically been rare for several reasons. As a general matter, capital contribution defaults by LPs have been relatively few and far between. Even amid the current global financial crisis and the tremendous liquidity pressure it has exerted on certain LPs, current anecdotal evidence indicates that the number of actual defaults is still small on a percentage basis. However, the specter of potential LP defaults is certainly a much more real concern today than ever before for the private equity industry.

Another reason for the relative rarity of default-related litigation is the panoply of other remedies that can be applied against defaulting LPs in the typical private equity fund partnership agreement, often (as is alleged in the *CapGen* case) including the GP's right to forfeit all or a portion of the defaulting LP's interest in the fund. Where an LP's interest has accumulated significant value, the prospect of forfeiture for default can be a compelling deterrent. In addition, most fund sponsors historically worked to facilitate an alternative solution for a cash-strapped LP in order to avoid default—for example, by assisting the LP in obtaining a credit line to fund its capital calls or a third-party buyer that is able to fulfill the LP's obligations.

But, as the *CapGen* litigation may indicate, the current economic environment, particularly the continued stress in the financial markets and the liquidity pressures that such stress has inflicted on private equity investors, may yield more lawsuits against defaulting LPs.

1 According to the complaint, at the time of the capital call at issue in the dispute, CapGen had called down slightly less than one-third of LPs' total capital commitments.

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PENnotes

3rd Annual Duke Private Equity Conference
Raleigh, North Carolina
April 15, 2009

The Duke Private Equity Club is hosting its Third Annual Duke Private Equity Conference on Wednesday, April 15, in Durham, North Carolina. This conference brings together alumni, professors and students interested in the field of private equity to discuss current developments in the industry. Kirkland partners Kirk A. Radke, Andrew Wright and Jonathan S. Henes will lead the Buyout, LP and Restructuring panels at the conference, respectively.

The Private Equity Secondaries Conference
New York, New York
April 24, 2009

The Private Equity Secondaries Conference will cover the growth, development, legal issues and investment trends in the emerging secondary market. Discussions will focus on secondary market expansion, liquidity needs of direct investors and an overview of the global investment market for secondaries. Kirkland partner Michael D. Belsley will participate in a panel titled "Legal Considerations in the Secondary Market."

Infrastructure Investment World Americas 2009
Bridgewaters, New York
April 27 - 30, 2009

Infrastructure Investment World Americas 2009 has been designed by the infrastructure community to uncover the possibilities and address the challenges that this crucial asset class poses in this time of uncertainty. The conference will bring together the key players in the infrastructure community, including government, infrastructure funds, financiers and end investors. Kirkland partner Bruce L. Gelman, P.C., will speak at this event.

Hedge Funds: Issues and Opportunities in Today's Market
New York, New York
April 29, 2009

This conference, co-chaired by Kirkland partner Stephen Fraidin, will explore the latest hedge fund strategies and survival tactics, including activist strategies and case studies of proxy contests, legal issues affecting hedge fund activism, how to prepare and respond to a hedge fund attack and a new look at redemption issues.

The 29th Annual Ray Garrett Jr. Corporate and Securities Law Institute
Chicago, Illinois
April 30 - May 1, 2009

The 29th Annual Ray Garrett Jr. Corporate and Securities Law Institute will take place from April 30 - May 1, 2009, in Chicago. More than 450 attorneys will come together for a discussion of current issues affecting today's corporate and securities lawyer, including: developments in the capital markets following the financial crisis, changes in the structure of market regulation and changing accounting standards, among others. Kirkland partner Keith S. Crow, P.C., will lead a panel discussion on "Developments in M&A."

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Kirkland & Ellis LLP's Private Equity Practice

Kirkland & Ellis LLP's private equity attorneys handle leveraged buyouts, growth equity transactions, recapitalizations, going-private transactions and the formation of private equity, venture capital and hedge funds on behalf of more than 200 private equity firms in every major market around the world.

Kirkland has been widely recognized for its preeminent private equity practice. In 2009, Kirkland received the awards for Best Law Firm (Private Equity Deals) and Best Law Firm (Fund Formation in North America) from Private Equity International. In 2008, Mergermarket ranked Kirkland first by volume for Global and North American Buyouts in its "League Tables of Legal Advisers to Global M&A for Full Year 2007." Also in 2008, Kirkland received prestigious first-tier rankings in both private equity and fund formation from Chambers & Partners.

The Lawyer magazine recently recognized Kirkland as one of the firms in "The Transatlantic Elite," noting that the firm is "leading the transatlantic market for the provision of top-end transactional services ... on the basis of a stellar client base, regular roles on top deals, market-leading finances and the cream of the legal market talent." In addition, Kirkland's London office was recently named the 2008 "Banking Team of the Year" at the Dow Jones *Private Equity News* Awards for Excellence in Advisory Services.

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