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KIRKLANDPEN
Private Equity Newsletter

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Expected IRS Guidance Unlikely to Prohibit PE Fund Management Fee Waivers

PENpoints

IRS fee waiver guidance will likely specify examples of both acceptable and unacceptable fee waivers.

Recent statements by IRS and Treasury representatives signal that, contrary to indications last year, IRS intends to issue formal guidance on management fee waiver arrangements sometime during 2014. The guidance will likely be in the form of proposed regulations and will likely specify examples of both acceptable and unacceptable fee waivers.[1]

Although there are many possible variations, in a typical management fee waiver arrangement the general partner of a private fund agrees (either at fund formation or periodically during the fund's life) to forego a portion of the management fees otherwise payable by the fund in exchange for an increased (special) allocation of the fund's future profits (generally consisting of long-term capital gain). Certain IRS and Treasury representatives have suggested that some of these variations properly convert management fee ordinary income into long-term capital gain, while others do not.

IRS guidance will likely require that the general partner's special profit allocation be subject to genuine economic risk in order for the fee waiver arrangement to be acceptable. For example, the IRS is more likely to challenge a waiver (1) where the facts suggest that the gain out of which the waived amount is to be paid was already "built-in" at the time the fee waiver was executed (i.e., where the fund assets had already appreciated sufficiently to ensure that the waived amount would be paid) or (2) if the general partner executes the waiver after it has earned the management fee that is being waived.

It is uncertain whether the expected guidance will apply to existing fee waiver arrangements or only to those entered into after guidance is published. We think that the guidance will most likely apply to existing arrangements, as IRS officials have expressed the view that the general legal principles underlying the guidance are already inherent in existing law.

In light of these developments, as well as the complexity of fee waiver strategies generally, fund managers should consult experienced counsel (1) before implementing a new fee waiver strategy and (2) to determine whether existing fee waiver strategies are likely to comply with the expected guidance.

1 See *KirklandPEN* dated May 29, 2013 for coverage of previous IRS statements concerning fee waiver arrangements, which have consistently suggested that well-designed fee waiver arrangements are viable.

If you have any questions about the matters addressed in this *KirklandPEN,* please contact the following Kirkland authors or your regular Kirkland contact.

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The Evolving Face of Deal Litigation

As dealmakers put the finishing touches on public M&A transactions, the question is no longer if there will be a lawsuit, but rather when, how many and in what jurisdiction(s). While many of the cases remain of the nuisance strike-suit variety, recently it seems every few weeks there is an important Delaware decision or other litigation development that potentially changes the face of deal litigation and introduces new risks for boards and their advisers. Now more than ever, dealmakers need to be aware of, and plan to mitigate, the resulting risks from the earliest stages of any transaction. These recent developments include:

- Increasing Skepticism of Disclosure-Only Settlements. Historically, a majority of strike-suits have been settled pre-closing with the target agreeing to make additional disclosures in exchange for full releases. When the settlement came up for court approval, plaintiffs' attorneys would seek and usually obtain a fee-award in an amount that was an acceptable "tax" on the deal. Delaware courts have become increasingly likely to criticize the true materiality of the additional disclosures and award substantially reduced attorneys fees, and even reject the settlement.
- Risk of Significant Post-Closing Damages Awards. The growing suspicion of disclosure-only settlements has been accompanied by explicit and implicit encouragement by the Delaware judiciary of pursuit by plaintiffs of the admittedly limited number of cases where real, rather than imagined, issues exist, most often in circumstances involving an actual or perceived conflict. In recent high-profile cases involving findings of material breaches of fiduciary duties by the target board or advisers, the court has awarded or signaled that it will award significant damages and attorneys' fees.
- Appraisal Rights as an Asset Class. Appraisal claims have become an increasingly prevalent alternative, and often more lucrative, avenue of attack for plaintiffs seeking economic opportunities in deal litigation. While not yet a feature of every deal like strike-suits, appraisal claims by significant financial investors have become a regular occurrence in the deal landscape over the past year, with continuing growth in the range of long- and short-term investors willing to explore this remedy, as well as an increase in funds dedicated specifically to appraisal as an independent investment opportunity.
- Other Key Issues Gaining Traction. A number of other issues affecting public-target M&A of interest to private equity sponsors include Delaware courts' (1) sensitivity to a financial adviser's real and perceived conflicts of interest (e.g., an investment bank providing staple financing); (2) expectation that a board critically assess the independence of its members, set ground rules for their conduct and then supervise its members to ensure they are acting within the scope of their authority; and (3) willingness to entertain claims that a large stockholder influenced the timing and terms of a transaction because of its own concerns, which may not be in the best interests of the other stockholders. To learn more, see our recent *M&A Update.*

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Inversions — Upside for Acquisitions

A recent trend driving deal activity is the prevalence of acquisition-related inversions whereby the acquiring company redomiciles to a lower-tax jurisdiction concurrently with completing the transaction. While not the exclusive driver, a significant benefit of these inversions is reducing the future tax exposure of the combined company. The tax rules applicable to these inversion transactions are inherently complex and situation-specific. To learn more, see our recent *M&A Update*. In addition, note that since our *M&A Update*, legislation has been introduced in Congress to limit inversions completed after May 8, 2014.

U.S. Sanctions Update: New Sanctions Program Creates Risks for Companies Doing Business with Russia or Ukraine

In response to Russia's recent annexation of Crimea, President Obama authorized sweeping new sanctions against certain Russian individuals and entities. Companies operating in or otherwise engaging in business or other dealings with, in, involving or relating to Russia or Ukraine should ensure that such activities do not involve or otherwise relate to parties designated under new U.S. sanctions. To learn more, see our recent *Alert*.

PENnotes

Private Equity Forum (Fifteenth Annual)
New York, New York
June 30 - July 1, 2014

The Practising Law Institute will host its "Private Equity Forum (Fifteenth Annual)" on June 30-July 1 in New York. A distinguished panel of experts will discuss recent regulatory developments affecting the marketing of private equity funds in the United States and Europe; negotiating with investors; current issues in private equity M&A; ethical issues; compliance programs for private equity firms that are registered investment advisers; and recent enforcement and other regulatory issues. Kirkland partner Mark Mifsud will lead a panel called "Recent Regulatory Developments Affecting the Marketing of Private Equity Funds" covering the recent Reg D developments and AIFMD. For more information, click here.

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Kirkland & Ellis' nearly 400 private equity attorneys have handled 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 400 private equity firms around the world.

Kirkland has been widely recognized for its preeminent private equity practice. The Firm was named "Private Equity Group of the Year" in 2012 and 2013 by *Law360* and was commended as being the most active private equity law firm of the last decade in *The PitchBook Decade Report*. In addition, Kirkland was awarded "Best M&A Firm" and "Best Private Equity Firm" in the United States at *World Finance*'s 2012 Legal Awards and was honored as the "Private Equity Team of the Year" at the 2011 *IFLR* Americas Awards.

Chambers and Partners ranked Kirkland as a Tier 1 law firm in 2012, 2013 and 2014 for Investment Funds in the United States, U.K., Asia-Pacific and globally. The Firm was ranked as the #1 law firm for both Global and U.S. Buyouts by deal volume in Mergermarket's *League Tables of Legal Advisors to Global M&A for Full Year 2011, 2012 and 2013*, and has consistently received top rankings among law firms in Private Equity by The Legal 500, the Practical Law Company and IFLR, among others.

The Lawyer magazine has recognized Kirkland as one of its "Transatlantic Elite" every year since 2008, having noted 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."

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