

**New Developments in  
Private Equity, Venture Capital,  
and Fund Formation**

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# Table of Contents

<b>I.</b>	<b>Federal IT rates thru 2010</b>	<b>4</b>
<b>II.</b>	<b>Congressional FIT study re funds &amp; wealthy indiv'ls</b>	<b>5</b>
<b>III.</b>	<b>LBO structuring</b>	<b>18</b>
	<b>A. Tribune Deal</b>	<b>18</b>
	<b>B. Other developments for LBO of big public co</b>	<b>39</b>
<b>IV.</b>	<b>Fund Formation</b>	<b>40</b>
	<b>A. Reg D private placement of LP interests</b>	<b>40</b>

<b>B.</b>	<b>DOL plan asset regs</b>	<b>48</b>
<b>C.</b>	<b>IAA '40 GP registration</b>	<b>51</b>
<b>D.</b>	<b>3 techniques for PE/VC fund or mgmt co to go public w/o violating ICA '40</b>	<b>56</b>
<b>V.</b>	<b>IL governor's gross receipts tax proposal</b>	<b>69</b>

# I.

## Federal IT rates thru 2010

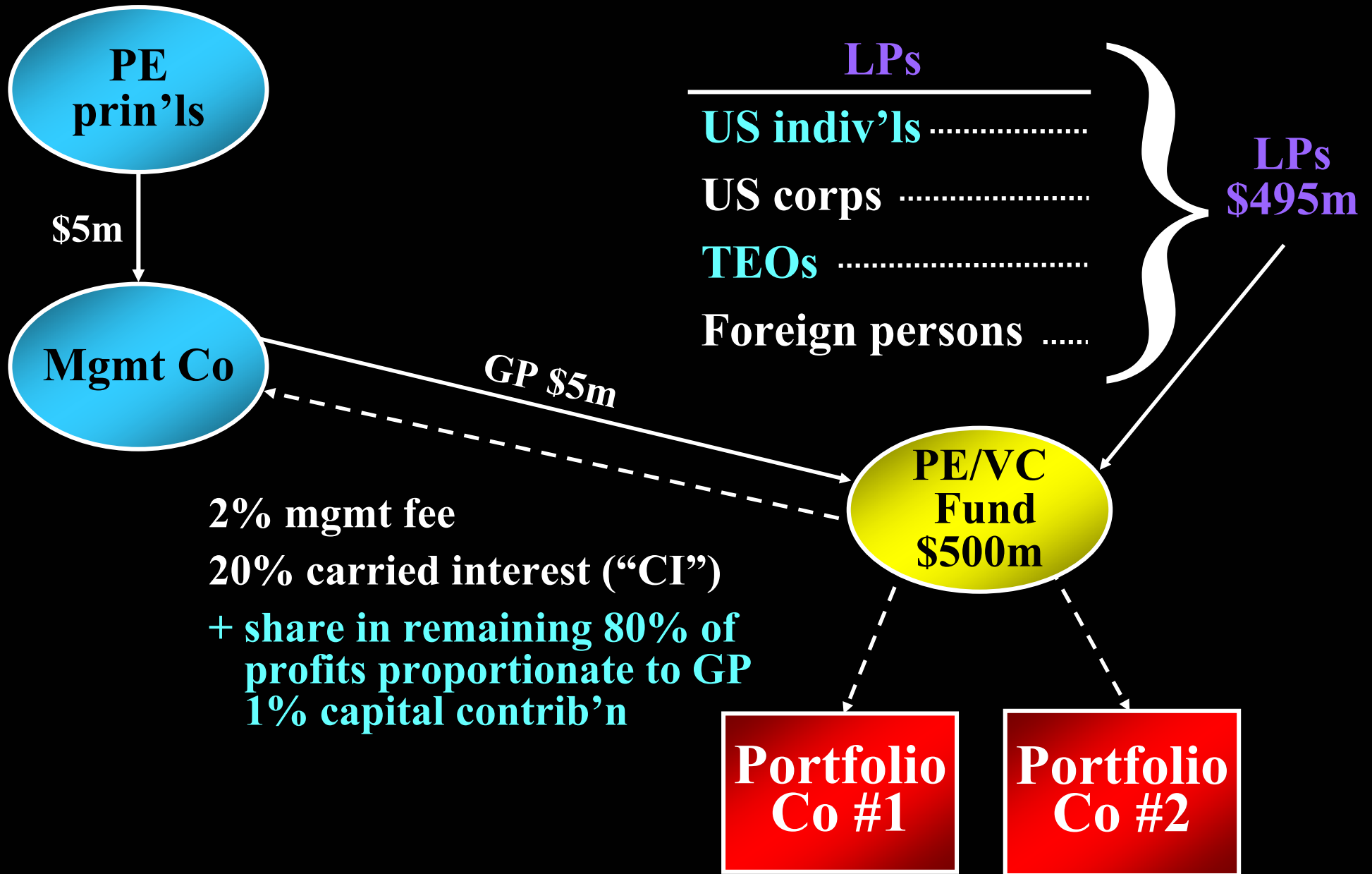
- **C corp—OI and CG** **35%**

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- **Indiv'l regular OI** **35%**

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- **Indiv'l qualified div income** **15%**
- **Indiv'l LTCG (sale or exchange of capital asset w/ >12 mo hldg period)** **15%**
- **Indiv'l reduced §1202 LTCG rate on “small business stock” held > 5 yrs** **14%**
- **Indiv'l tax-free rollover on “small business stock”** **0%**

## II.

# Congressional FIT study re funds & wealthy indiv'ls



**(a) No legis'n introduced, so how do we know Cong is studying?**

- **Yesterday closed-door hearing held by Senate Finance Com'ee staff**
  - **along w/IRS, Treas'y, and joint Cong'l Com'ee on Taxation**
- **55 page paper presented by Prof Victor Fleisher arguing for changes in PE taxation**
  - **Jack presented the contrary view**

## **(b) Fund carried interest**

- **Current law**: When fund recognizes LTCG, indiv'l GPs or LPs portion taxed at LTCG rate (incl'g GP's CI share)
- **Cong'l study**:
  - Is CI really comp for services?
    - so OI, not LTCG
  - If so, not clear if impose FIT when CI issued (at est'd FV, i.e., the WCG system)
    - or only as cash received

- **Not clear if would cover:**
  - **all CI**
  - **or only PE funds**
  - **or also VC, mezz, RE and O&G funds,**
  - **or only “large” funds**

- **Argument for OI: corporate employee recognizes comp as OI when receives NQO or stock,**
  - **so should recipient of p'ship  
CI**

- **Jack's argument for CG:**
  - **2 tax systems: complex double-tax system for corps and much simpler p'ship/JV system**
  - **W/ p'ship system: pool capital and talent, recognize income at p'ship entity level, tax each partner on share of income (w/ character determined at p'ship level)**

- **Joe and Sally example**
- **PE/VC example**
- **This system has made America the most vibrant entrepreneurial economy in the world in terms of:**
  - **employment**
  - **stock mkt bouyancy**
  - **prosperity**
- **Has also made America most emulated system, the envy of the entire world**

- **Harsher taxation will clearly result in PE/VC turmoil**
  - **At least prompt upward renegotiat' n of the 20% CI**
  - **Reduce amt of available PE/VC money**
  - **Don't go down a path when you don't know where it leads**
  - **Esp'ly when vibrancy of American economy at stake**

- **Intermediate position**
  - **Impute OI to CI holders  
each yr = int rate (“AFR”)  
x capital subj to CI**

## **(c) Mgmt fee conversion to CG**

- **Current law: Mgmt fee (net of exps) = OI, but can convert part of mgmt fee to LTCG where:**
  - **fund documents reduce mgmt fee by specified amt (e.g., \$4m per year)**
  - **in exch for special GP allocation of CG or qualified div income for future yr = to amt of forgone mgmt fee**
  - **To qualify as CG, GP must take economic risk if future net profits in all profitable yrs < forgone mgmt fee**

- Cong'l study:
- Def'd mgmt fee = OI when deferred
- Esp'ly w/offshore fund

**(d) Fortress/Blackstone publicly traded mgmt cos**

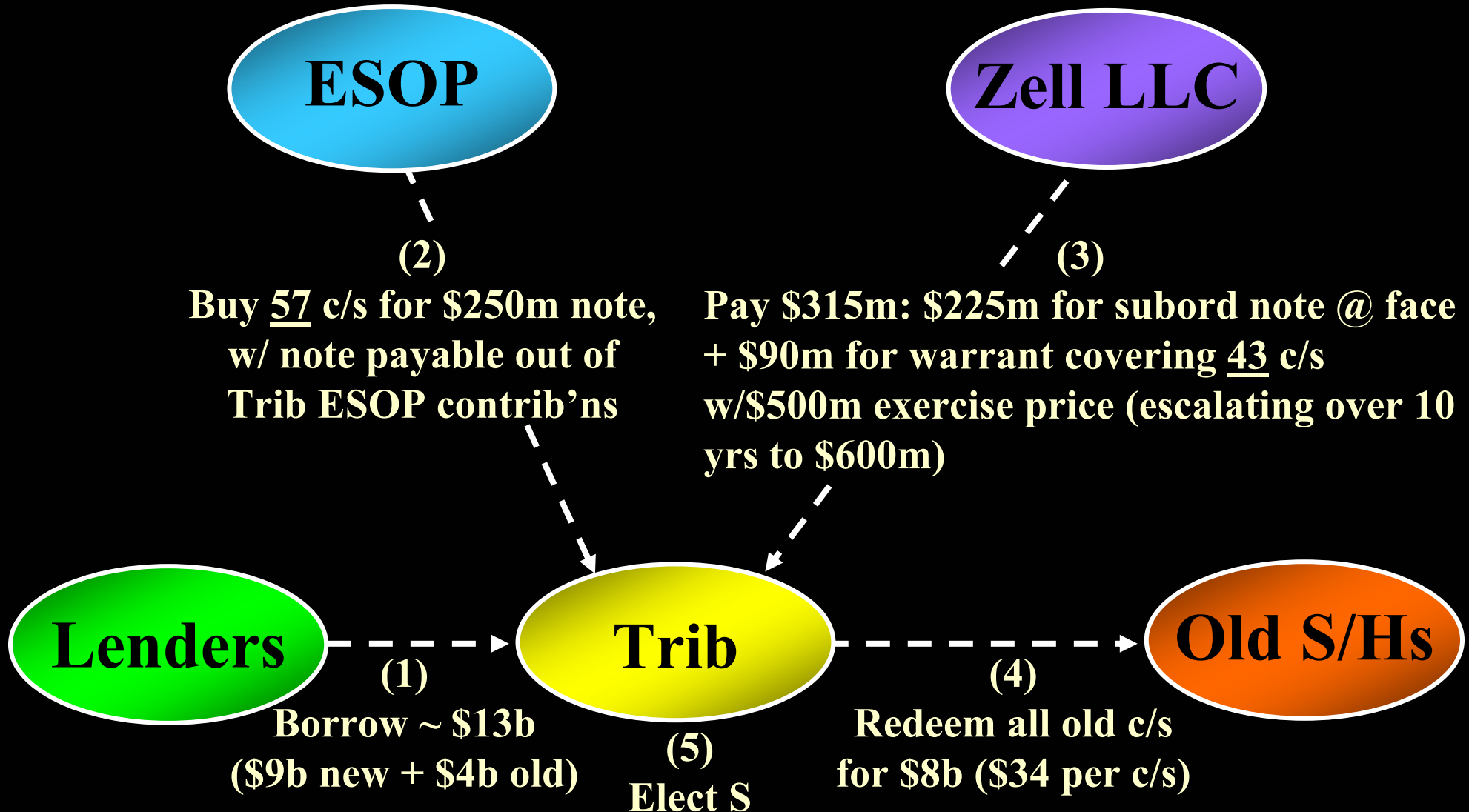
- **Perhaps they should be taxed as corps if publicly traded**
- **Perhaps all PE/VC (or at least all large) funds should be taxed as corps**

**(e) Any indiv'l w/ > \$1m taxable income**

- **OI: 39.6% rather than 35%**
- **LTCG: 20% rather than 15%**
- **Divs: 39.6% rather than 15%**
  - **Not clear if retroactive to 1st dollar or only on excess**
- **Not focus of hearing**

# III. LBO structuring

## A. Trib deal



# Recap format

- **No Newco formed to buy target**
- **Rather new debt and equity money run thru old target entity**

# Some basic SCo tax rules

**(1) SCo not subj to entity level IT, as is C corp**

- **Rather SCo's taxable income taxed to S/Hs pro rata**
- **i.e., SCo = flow-thru for IT purposes, not subj to Amer double tax system for C corps**

- (2) SCo must have only 1 class of stock (w/ voting power variations permitted)**
- i.e., all SCo shares must be economically identical**
- (3) SCo must have  $\leq$  100 S/Hs**

**(4) Each SCo S/H must be either (a) U.S. individ'l (or estate or trust for U.S. individ'l) or (b) TEO**

- **No S/H can be: corp, p'ship, or LLC (except tax-disregarded single member LLC)**

**(5) SCo taxable income allocable to TEO = UBTI, taxable to TEO S/H**

- **but ESOP exempt from UBTI rule**

**(6) For any asset sale w/in 10 yrs after C corp elects S:**

- **§1374 imposes corp-level IT on SCo**
- **to extent of asset BIG when elected S**

# Trib deal's adv'ges for Zell

- (1) Bec Zell holds Trib deb + warrant (not Trib stock), 100% of Trib's taxable income allocable to ESOP prior to Zell's warrant exercise**
  - ESOP pays no IT bec ESOP exempt from SCo UBTI tax**

- **However, annual entity-level IT savings from SCo-ESOP structure look small or nonexistent here:**

- **Trib pre-LBO EBIT =  
~ \$1.3b**

- **Trib post-LBO int exp =  
~ \$1.3b, i.e., \$13b debt x  
~ 10% int rate**

# **Even after Zell exercises warrant, Trib remains SCo**

- **bec Zell LLC = disregarded entity owned by individ'l**
- **and hence Sam taxable on 43% of Trib's post-exercise income w/o corp-level IT**

**(2) If Trib remains SCo for > 10 yrs during which Zell refrains from exercising warrant, Trib can sell assets after 10 yrs (a) w/o §1374 corp-level IT and (b) w/o S/H level IT**

- **Zell warrant life = 15 yrs**
- **But near-term Cubs sale subj to entity-level IT (e.g., §1374)**

**(3) When Trib contri**  
**\$250m + int to ESOP (to**  
**pay off ESOP's note) over**  
**30 yrs, Trib IT ded'n for**  
**ESOP contrib'ns**

- **Max IT ded'n (for all**  
**qualified plans in aggreg)**  
**= 25% of employee comp**

# Trib deal's disadv'ges for Zell

- (1) If Zell simply bought 100% of Trib stock, Zell would receive 100% of ultimate sale proceeds**
  - In any deal (w/ or w/o ESOP), Zell diluted for top execs' equity incentives**
  - But w/o ESOP, Zell dilution begins at 100%, while w/ ESOP Zell dilution begins at 43%**

**(2) ESOP's 57% of c/s belongs principally to Trib rank and file employees**

- ESOP stock allocated among Trib employees proportionately to comp (w/ ~ \$225,000 comp ceiling per employee)**
- So top execs allocated very little**

**Perhaps ESOP enables Trib to negotiate some comp reductions, but doubtful (see United's post-ESOP summer from hell)**

**(3) If Zell simply bought 100% of Trib stock, Zell would have absolute board and S/H control**

**But under ESOP contracts, Zell has only limited control rights:**

**(a) Zell chairman at least 3 yrs**

**(b) Zell appoints 1 add'l director until Zell fully-diluted o/ship < 10%**

**(c) ESOP gets maj of directors**

- Trib appoints ESOP trustees, subj to ESOP participants/ DOL challenging whether trustees carrying out fiduciary duties

**(d) Zell contractual veto rights (e.g.):**

- Div
- Redemp'n
- Incur > \$250m debt
- Acq'n/ disposition

**(e) So why didn't Zell take contractual board maj (e.g., 3 out 5 directors)**

- **See (4) and (5) below**

**(4) ESOP/DOL fairness/fiduciary duty rules require ESOP be treated fairly, w/ damages as remedy**

- **So Zell, ESOP trustees, and/or Trib might become defendant if deal too sweet for Zell, considering:**
  - **economics, incl'g Zell right to delay payment for his c/s and 57-43 allocation of ultimate sale proceeds and**
  - **voting power/control rights**

**(5) Horrendously complex Code §409(p) and §4979A would impose harsh penalty taxes if Zell + other 10% fully-diluted S/Hs owned 50% or more of Trib SCo's fully-diluted c/s**

- 10% and 50% calculations treat ESOP c/s as owned by ESOP beneficiaries**
- Prevents allocating 100% of Trib taxable income to ESOP where ESOP's fully-diluted o/ship small**

**And if Zell right to elect (e.g.)  
3 out 5 directors,**

- **§409(p) regs apparently  
treat Zell as holding 60%  
of Trib stock, thus invoking  
§409(p) and §4979A harsh  
tax penalties**

## **(6) C/S purchase price differential:**

- **ESOP pays \$4.42 per c/s, while Zell (if exercises warrant after 10 yrs) pays \$15.87 per c/s (i.e., \$11.45 differential)**
- **Zell c/s payments: \$90m to buy warrant + \$500m warrant original exercise price + \$10m per yr exercise price step up for 1st 10 yrs**

- **Why would Zell pay 3.6x ESOP price per share?**
- **Bec Zell's excess purchase price (\$11.45 per share) = ~ 14% annual compound int on Zell's right to defer for ~ 10 yrs 87% (i.e., \$600m) of c/s purchase price**
- **Assuming Trib makes no distrib'ns to S/Hs before Zell warrant exercise**

## **B. Other developments for LBO of big public co**

### **Public S/H revolt**

- **No matter how hi the prem offered by LBO fund, price must be too low or greedy LBO fund wouldn't do deal**

### **Result:**

- **KKR and Goldman's current Harmon LBO offers old public S/Hs right to forgo part of cash and instead take up to 27% stub c/s in post-LBO target**
- **and 50 day go shop period to seek higher buyer w/ reduced break-up fee**

# IV.

## Fund Formation

### A. Reg D private placement of LP interests

'33 Act prohibits public offering of LP interests w/o SEC regis'n

- which is costly, time consuming, and publicly discloses business plans

Also ICA '40's §3(c)(1) 100-or-fewer-LPs and §3(c)(7) QP-only exemptions lost if PE/VC fund engages in public offering

## **Solution: Sell LP interests in private placement under SEC reg D**

- **Unlimited AIs**
  - **AI = indiv'l w/ \$1m NW or \$200k annual income or \$300k annual income w/ spouse, or**
  - **entity w/ \$5m assets**
- **Up to 35 non-AIs (each sophisticated along w/ purchaser representative and receives more extensive than normal POM)**

# 12/06 proposed Reg D amendment

## In summary:

- Natural person investing as AI in most §3(c)(1) funds must also have \$2.5m of investments
- Comment period ended 3/07 and not final until adopted by SEC

## More detail:

### 1. Covers investment in “private investment vehicle”:

**(a) PIV = entity using §3(c)(1)’s 100-or-fewer-investor exemption from ICA registration**

**(b) Thus PIV does not cover:**

- §3(c)(7) QP fund
- Employee Securities Co (“ESC”) for employees of single co (or affiliated group of cos)

- **Commodities or RE fund covered by another ICA exemption**
  - **Operating co not primarily engaged in business of investing in securities**
- (c) PIV explicitly excludes “venture capital fund,” defined as business development co under IAA §202(a)(22)’s overly complex asset composition test**
- **which doesn’t really describe VC fund**

**(d) Principal entities covered by PIV definition are thus hedge and PE/VC funds**

- **Altho PIV apparently also covers:**
  - **family investment entity,**
  - **neighborhood investment club,**
  - **entity formed by several PE/VC funds and mgmt indiv'ls to do consortium acq'n,**
- **bec all use §3(c)(1) to avoid ICA**

## **2. Covers investment by “natural person” in PIV**

- **Implicitly includes indiv'l's investment thru intermediate entity (e.g., p'ship or LLC) FFPO investing in PIV**
  - **incl'g GP entity FFPO investing in fund**
- **Does not cover investment by stable entity (not FFPO) even though includes indiv'ls**

### 3. So “natural person” investing in PIV = AI only if:

(a) meets old \$1m NW test or old  
\$200k/\$300k income test and

(b) also owns \$2.5m of investments

- New \$2.5m test does not cover:

- 35 non-AIs

- so require more extensive  
than normal POM and  
sophistication requirement

- issuer’s exec officer/director/  
GP

## **B. DOL plan asset regs**

**(1) Where  $\geq 25\%$  of fund's LP money from employee benefit plan investors ("BPIs"), onerous ERISA fiduciary rules apply to fund GP and its principals**

- **Until 8/06 BPIs broadly defined for 25% test**
- **8/06 legislation signif'ly narrowed BPI definition:**
  - **Continues to include private ERISA plans**

- **But BPI no longer includes:**
  - **state/local pension plans**
  - **foreign pension plans**
  - **church pension plans**
- **BPI does include fund of funds if  $\geq 25\%$  BPI money (using new narrower BPI definition), in which case part of FOF investment counts (corresponding to portion of FOF money from BPIs)**

**(2) If  $\geq 25\%$  BPI money, fund can still avoid ERISA fiduciary rules by using “VCOC exception”**

- Fund’s 1st investment in active business entity w/ fund hldg contractual mgmt rights**
- Thereafter  $> 50\%$  by cost of fund’s investments in such businesses**
- Until 1st investment, LPs pay mgmt fee directly to GP (not thru fund)**

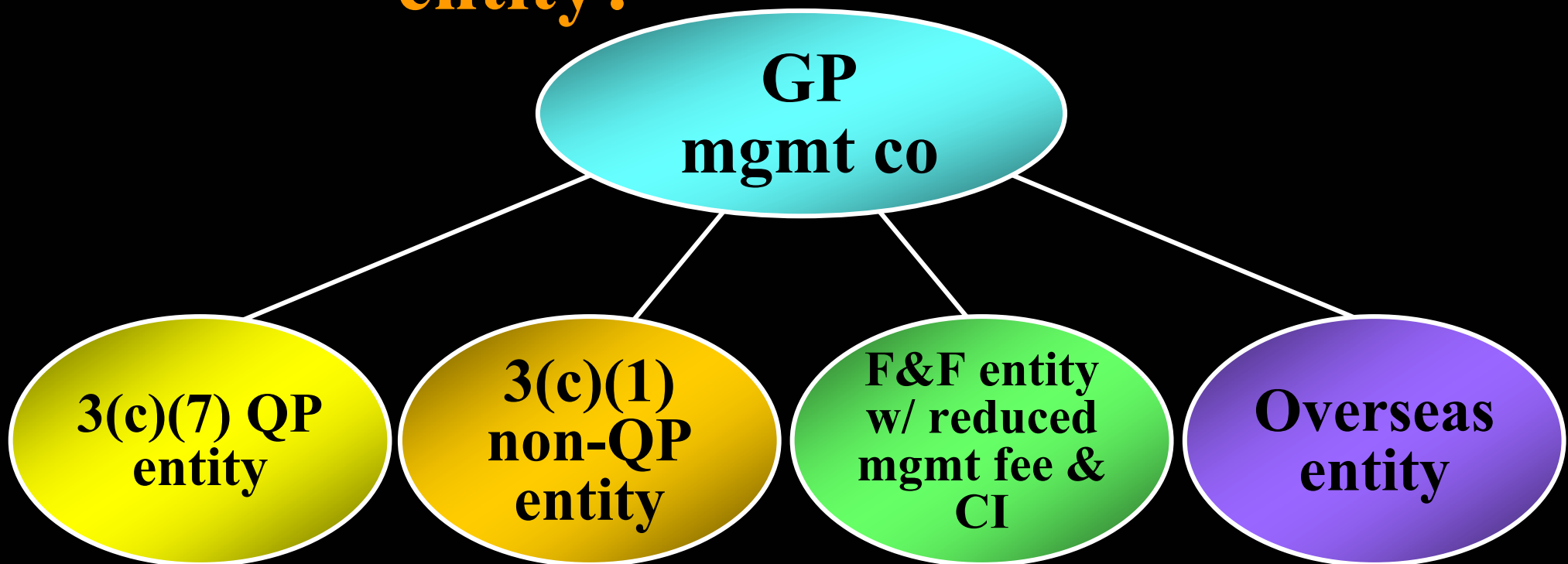
## **C. IAA '40 GP registration**

- a. IAA '40 requires investment advisor (incl'g PE fund's GP mgmt co) ("IA") receiving comp to register**
  - so no CI permitted, unless exemption**
- b. GP mgmt co not required to register as fed'l IA if < 15 clients**

**c. In counting to 14, gen'ly count fund as 1 client, except fund where LPs can opt into or out of each deal or adjust proportion of investment up or down**

**d. Does multi-entity fund (w/ each entity investing in tandem in each PC) count as**

- **a single client or 1 client for each entity?**



- **SEC refuses to answer**

**e. If GP required to register as IA, no CI, except from:**

- **3(c)(7) QP-only fund, or**
- **w/ 3(c)(1) fund, each LP who is “heavy hitter” w/ \$1.5 NW or \$750k under IA’s mgmt, or**
- **w/ look-thru for these 2 tests where LP is itself 3(c)(1) entity, or**
- **BDC fund, where  $\geq 60\%$  invested in private + troubled + certain controlled PCs w/ managerial rights (and  $CI \leq 20\%$ ), or**
- **non-U.S.-resident LP**

- f. SEC 12/04 so-called hedge fund rule: count each fund LP if fund documents allow anyone to w/draw money w/in 2 yrs, other than for “extraordinary” event**
- Rule declared invalid as “arbitrary” by DC Circuit 6/06 and SEC not appealing**

**D. 3 techniques for PE/VC fund or mgmt co to go public w/o violating ICA '40**

**Co primarily investing in securities (like PE/VC fund) must register under ICA '40**

- but ICA '40 mutual-fund-like regulation too cumbersome for PE/VC fund**

# So PE/VC fund typically structured to fit exemption

- **3(c)(1): 100 max investors, or**
- **3(c)(7): 100% QP investors**
- **but fund disqualified from exemption if public offering**

**For many yrs PE/VC funds have sought escape from cycle of raising new fund every 3-5 yrs**

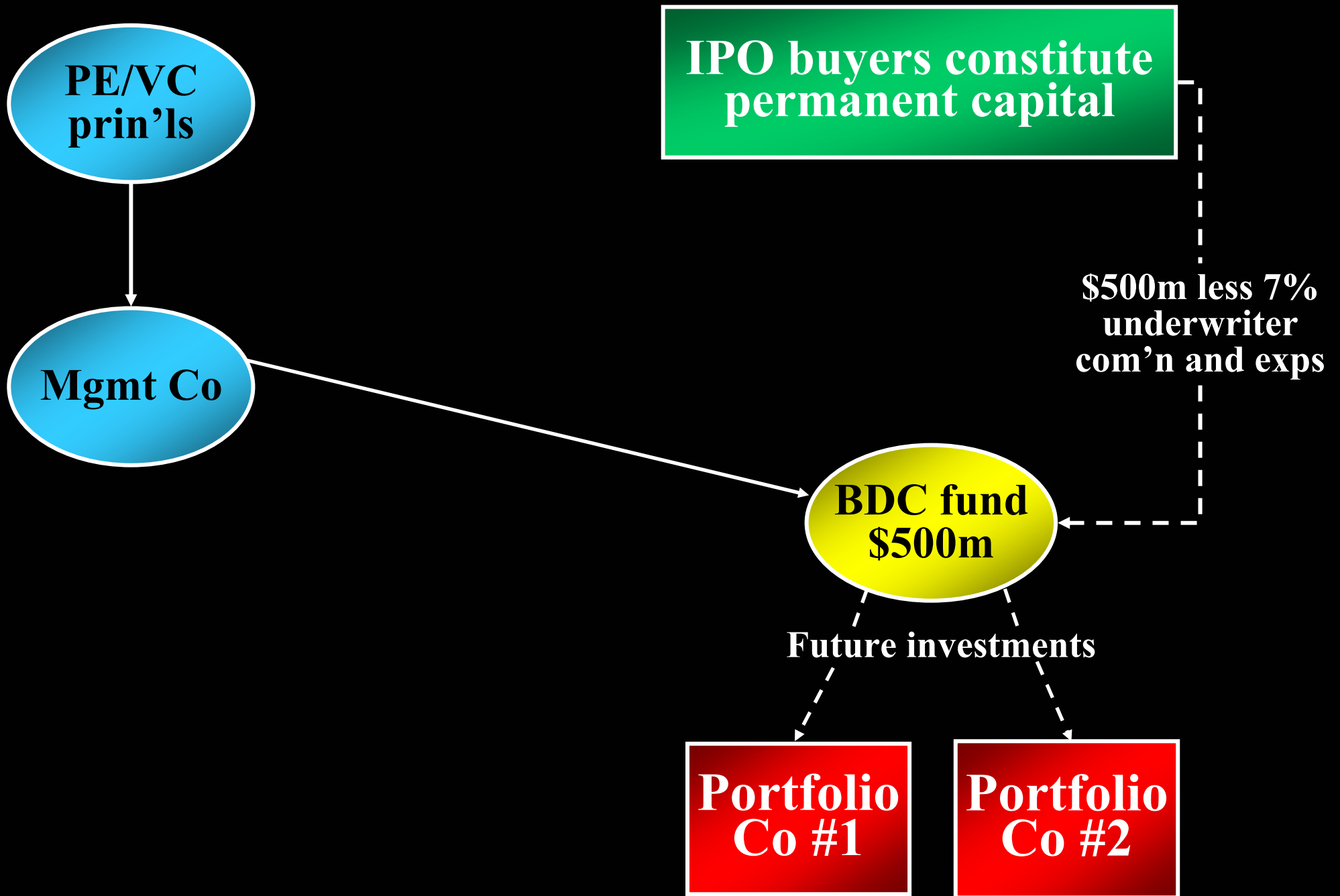
- **i.e., have sought structure (e.g., public LPs) where fund can forever roll over proceeds to new investments**
- **if fund publicly traded, LPs can sell in mkt whenever want liquidity**

**In recent yrs some PE/VC funds or mgmt cos have utilized 3 IPO techniques, while avoiding ICA '40 mutual-fund-like regulation**

**(1) BDC approach**

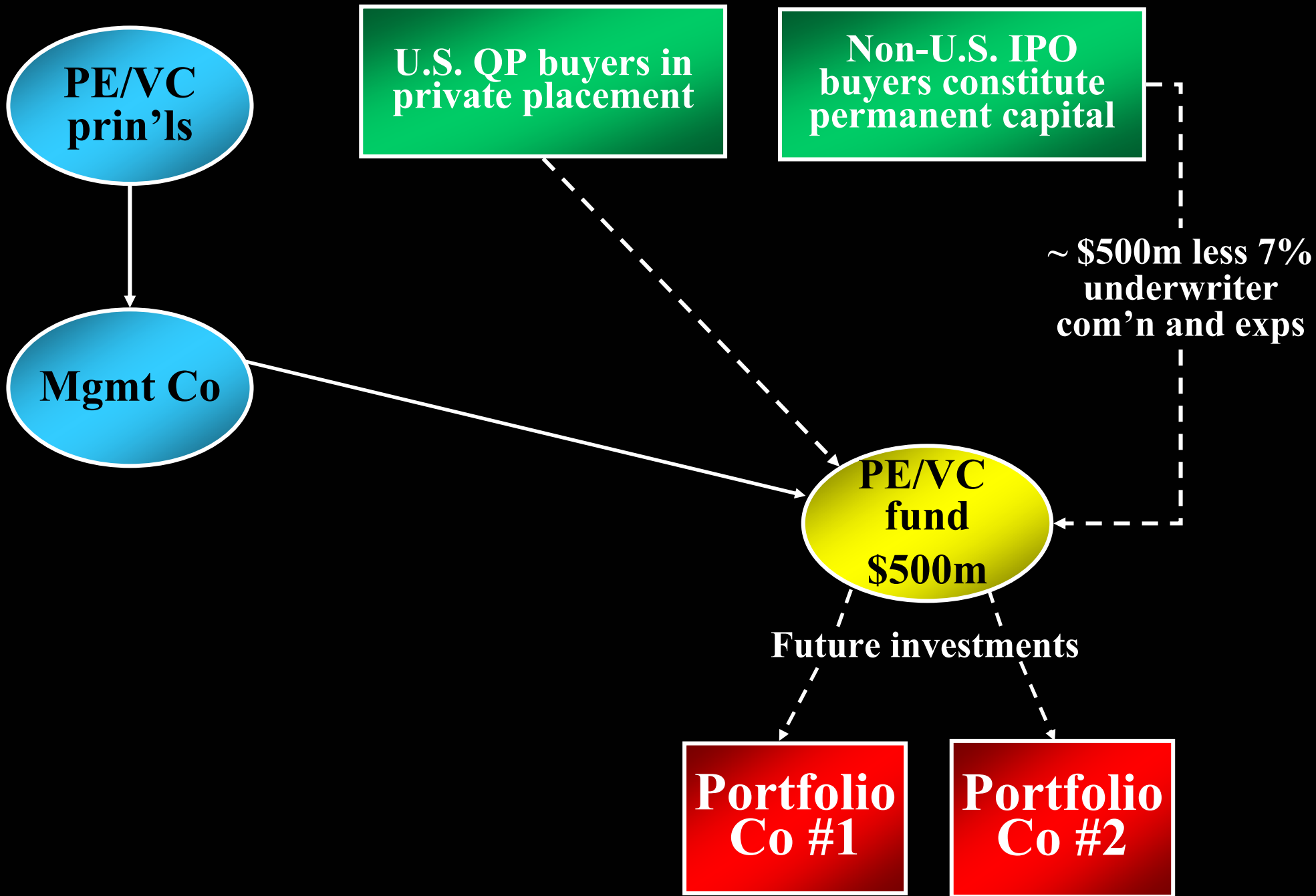
- **IPO of fund units**
- **Fund must do ICA '40 regis'n, but ICA '40-light reg'n**
  - **if qualifies as statutorily-defined BDC under overly complex 70% asset-composition and mgmt-assistance tests**

- **Permanent investor capital for fund**
- **Allied Capital, Amer Capital Strategies, Apollo**
  - **Most recent wave in 2004 created funds doing mezz debt w/some equity**
- **Start-up BDC has signif't trade-at-discount problem**
  - **Immed after formation, when 7% of cash raised has been spent for underwriting com'ns and exps, fund trades at ~ 93% of IPO price**



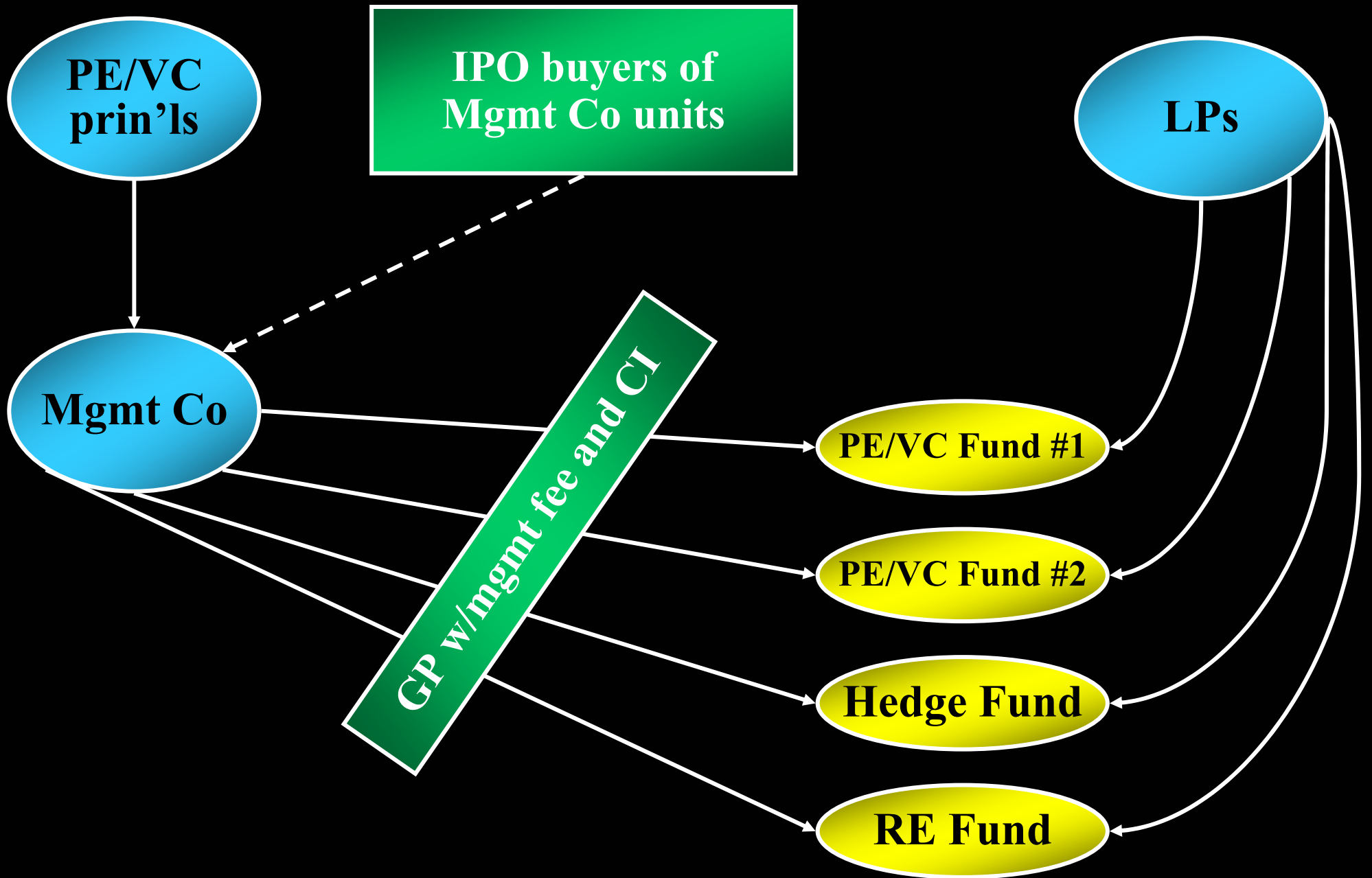
## **(2) European public offering**

- **Public sales to non-U.S. persons**
  - **w/ U.S. QPs in private placement**
- **KKR (2006)**
- **No ICA '40 regulation at all**
- **Permanent capital for fund**
- **Avoid BDC definitional complexities, but no U.S. public trading allowed**
- **Same trade-at-discount problem as BDC at front end**



### **(3) U.S. public offering of *mgmt co* units**

- **Fortress 2/07, and Blackstone pending**
- **Selling portion of mgmt co, not fund units**
- **Avoid ICA '40 regis'n, because SEC views mgmt co assets (mgmt fee and CI) as comp, not as PC securities**
- **Fortress sold ~ 22% of mgmt co for ~ \$1.5b (part to public and part to Nomura), valuing mgmt co at ~ \$7b**
- **No front-end trade-at-discount problem, not confined to European trading, and no BDC definitional issues**



# Problems w/public fund or public mgmt co:

- **10Qs and 10Ks, so need to constantly revalue investments and CI**
- **Potential lawsuit where write down after plaintiff buys or where write up after plaintiff sells**
- **Trading price based on qtr'ly earnings**
- **Likely avoid long-term deal w/little earnings in early yrs**

- **Probably seek to create diversified brand, incl'g (e.g.) hedge fund, RE fund, investment adviser**
- **All info public**
- **Must register as fed'l IA**

**Perhaps end of private  
VC/PE industry as we  
know it, or  
perhaps private fund  
advantage over public  
fund**

**V.**  
**IL governor's**  
**gross receipts tax (“GRT”) proposal**

**(a) Gov proposing GRT to replace IL corp IT**

- ~ 300 page draft statute recently released
- If passed, huge tax increase on (1) IL business and (2) likely on non-IL business dealing w/ IL buyers
- Very controversial w/ IL business groups fighting (incl'g IVCA)

**(b) GRT imposed on gross receipts, not on profits**

- **GRT even if lose money**

**(c) Covers corp, p'ship, LLC, and proprietorship**

- **Including PE/VC fund and mgmt co**

**(d) GRT rate:**

- **0.85% on sale, lease, or rental of tangible personal property, including tangible personal property incorp'd into RE**
- **1.95% for other businesses, including services and financial**

**(e) Corp IT**

- **GRT credited against corp IT**
- **No credit against PPRT**

## **(f) Geographical coverage**

- **Covers sale of goods or services into IL, not sales of goods or services by IL business out of IL**
- **However, where non-IL mfr/service provider sells to IL buyer in pure interstate commerce, IL gen'ly lacks constitutional nexus to impose GRT (just as no IL sales tax allowed)**
- **But pure interstate commerce = murky concept**

**(g) Exemptions:**

- **Transactions betw entities filing combined/unitary IL IT return**
- **Taxpayer w/ < \$2m gross receipts**
- **Employee comp (but not indept contractor comp)**
- **TEOs (except UBTI)**
- **Retail food for offsite consumption and drugs**
- **Gaming**

**(h) Proposed effective date 1/1/08**

**(i) Pyramiding, w/ GRT imposed on each transaction**

- **E.g., GRT imposed 4 times if sale from:**
  - (1) parts mfr to assembler**
  - (2) to wholesaler**
  - (3) to retailer**
  - (4) to consumer**
- **No credit for GRT paid on prior inputs (in contrast to European VAT which credits VAT on prior inputs)**
- **Gov says lower 0.85% rate for goods alleviates pyramiding**
- **Creates incentive to integrate operations**

## **(j) Services**

- **GRT clearly covers services as well as goods**
- **Incl'g financial services, law, acctg, consulting**
- **Doesn't cover IL-based service provider ("SP") rendering service to non-IL person**
- **Does cover NY-based SP rendering service to IL-based person, subj to constit'l nexus**

**(k) How would GRT apply to PE/VC fund? or to PE/VC fund's mgmt company?**

**Fee income**

**(1) Covers mgmt co's gross fee income (at 1.95%) if mgmt services rendered in IL**

- **No 2d tax when fee income distributed/allocated to indiv'l mgmt co partner**
- **But may be 2d tax if fee income distributed/allocated to entity partner**

## PC sales proceeds

- (2) Apparently does not cover fund's gross receipts from sales of stock or p'ship interests in PC, bec exemptions for:**
- **qualifying investment securities and**
  - **property other than stock in trade and inventory**
- (3) May also exempt PC sales proceeds as distributed/allocated to mgmt co**
- **so long as treated as retaining exempt character from (2) above (which is not clear)**

- (4) Exempts PC sales proceeds as distributed/allocated to indiv'l mgmt co partner**
- but not clear for entity partner (e.g., family EPV)**

## Flow-thru portfolio co earnings

**(5) Apparently covers flow-thru PC earnings distributed/allocated to fund to extent PC sells goods/services to IL**

- **and again as distributed/allocated to mgmt co**
- **not as distributed/allocated to indiv'l partner**
  - **but not clear for entity partner (e.g., family EPV)**

# Corporate portfolio co dividend

- (6) Apparently covers corp PC dividend when received by fund if payor domiciled in IL
- and then again as distributed/allocated to mgmt co
  - not when distributed/allocated to indiv'l partner
    - but not clear for entity partner (e.g., family EPV)

# **(1) GRT more expensive than PPRT for p'ships/LLCs**

- **GRT imposed on gross receipts (whereas PPRT imposed on net income), so no deduction for partner comp or any other exps**
- **PE/VC fund's GP entity now deducts (e.g.) partner comp (incl'g NFI and CI) under PPRT rules**
- **1.95% GRT rate > current 1.5% PPRT rate**

## **(m)** Rent

- **Landlord's RE rental income @ 1.95%**
  - e.g., on apartment, home, office, factory
- **PP rental income @ 0.85%**
  - e.g., auto rental