KAYE SCHOLER LLP

INVESTMENT FUNDS NEWSLETTER

SEC Proposes New Rules for Fund Managers

By Timothy Spangler

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IN THIS ISSUE

The Securities and Exchange Commission (the "SEC") has proposed new rules for advisers to hedge funds and private equity funds. First, the SEC is proposing to adopt a new antifraud rule under the Investment Advisers Act of 1940 (the "Advisers Act") that would clarify, in light of the recent court decision in *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006), the ability of the SEC to bring enforcement actions under the Advisers Act against investment advisers who defraud investors or prospective investors in a hedge fund or other pooled investment vehicle. Second, the SEC is proposing a rule that would revise the requirements for determining whether an individual is eligible to invest in certain pooled investment vehicles. This would be accomplished by defining a new category of accredited investor called "accredited natural person," which is designed to help ensure that investors in these types of funds are capable of evaluating and bearing the risks of their investments.

Antifraud Provision

The *Goldstein* decision, in addition to overturning the SEC's rules adopted in 2004 mandating registration under the Advisers Act for several hundred hedge fund managers, created uncertainties regarding the obligations that investment advisers to funds have to the funds' investors.

In addressing the scope of the exemption from registration in section 203(b)(3) of the Advisers Act and the meaning of "client," the court expressed the view that, for purposes of sections 206(1) and (2), the "client" of an investment adviser managing a fund is the fund itself, not the investors in the fund. As a result, the opinion created some uncertainty regarding the application of sections 206(1) and 206(2) of the Advisers Act in certain cases where investors in a fund are defrauded by an investment adviser.

The *Goldstein* decision did not, however, call into question the SEC's authority to adopt rules under section 206(4) of the Advisers Act, which permits the SEC to adopt rules proscribing fraudulent conduct that is potentially harmful to investors who directly or indirectly invest in hedge funds and other types of pooled investment vehicles.

Proposed rule 206(4)-8, therefore, would prohibit advisers to investment companies and other pooled investment vehicles from (i) making false or misleading statements to investors in pooled investment vehicles, or (ii) otherwise defrauding them. The SEC would enforce the rule through administrative and civil actions against advisers under section 206(4) of the Advisers Act. There would be no private cause of action against an adviser under the proposed rule.

Any investment adviser to a pooled investment vehicle would be covered by the rule, including advisers who are not registered or required to be registered under the Advisers Act. The proposed rule would not distinguish among types of pooled investment vehicles and is designed to protect investors both in investment companies and in funds that are excluded from the definition of investment company under section 3(a) of the Investment Company Act of 1940 (the "Company Act") by reason of either section 3(c)(1) or 3(c)(7) of the Company Act.

The wording of the proposed rule, which is similar to that in many of the SEC's other antifraud rules, prohibits false or misleading statements of material facts by investment advisers. Unlike rule 10b-5 under the Exchange Act of 1934 and other rules that focus on securities transactions, however, rule 206(4)-8 would not be limited to fraud in connection with the purchase and sale of a security. Accordingly, proposed rule 206(4)-8(a)(1) would prohibit advisers from making any materially false or misleading statements to investors in the fund regardless of whether the fund is offering, selling or redeeming securities.

The term "accredited natural person" would mean any natural person who meets either the net worth or income test specified in rule 501(a) or rule 215, as applicable, and who owns at least $2.5 million in investments.

As a result, the proposed rule would cover a wide range of potential communications to both existing investors and prospective investors, including:

- statements regarding the investment strategy of the fund,
- the experience and credentials of the advisor and its principals,
- risks associated with the fund,
- the performance of the fund or other funds advised by the adviser, and
- the valuation of the fund and its investments.

Private placement memoranda, requests for proposals, account statements and any other form of communication would be covered by the proposed rules on an ongoing basis.

Importantly, however, proposed rule 206(4)-8 would not create a fiduciary duty to investors or prospective investors in the pooled investment vehicle not otherwise imposed by law.

Accredited Investor Definition

The SEC also proposed two new rules under the Securities Act of 1933 (the "Securities Act"). Rules 509 and 216 would define a new category of accredited investor ("accredited natural person") that would apply to offers and sales of securities issued by certain section 3(c)(1) exempt funds (defined in the proposed rules as "private investment vehicles") to accredited investors under Regulation D and section 4(6).

The term "accredited natural person" would mean any natural person who meets either the net worth or income test specified in rule 501(a) or rule 215, as applicable, and who owns at least $2.5 million in investments. The term would apply for purposes of ascertaining that a person is an accredited investor at the time of that person's purchase of securities of private investment vehicles.

Otherwise, all other provisions of Regulation D, and sections 4(6) and 2(a)(15) and rule 215, would continue to apply to the offer and sale of securities issued by private investment vehicles. Non-accredited natural persons could still purchase interests in such a fund under the provisions that permit up to 35 non-accredited investors to participate in such offerings. In practice, however, many funds refuse to accept non-accredited investors into their funds.

The proposed rules would apply solely to the offer and sale of securities issued by private investment vehicles, which are defined to mean issuers that would be an investment company (as defined in section 3(a) of the Company Act) but for the exclusion provided by section 3(c)(1) of that Act. The proposed rules would apply to private investment

> ***Any investment adviser to a pooled investment vehicle would be covered by the proposed rule 206(4)-8, including advisers who are not registered or required to be registered under the Advisers Act.***

vehicles that rely on the safe harbor provisions of Regulation D in connection with the offer and sale of their securities. The proposed rules would also apply to offerings of private investment vehicles made in reliance on section 4(6) of the Securities Act.

Importantly, existing fund investors who do not meet the new "accredited natural person" standard would not be eligible to make further investments in the fund. This could create significant problems for funds with undrawn capital commitments still outstanding.

Section 3(c)(7) exempt funds are not included within the definition of private investment vehicle because offers and sales of securities issued by 3(c)(7) funds must be made to qualified purchasers (as that term is defined by section 2(a)(51)(A) of the Company Act) who are also accredited investors under Regulation D.

According to statistics provided to the SEC in 1982, when Regulation D was adopted, approximately 1.87% of U.S. households qualified for accredited investor status. By 2003 that percentage increased by 350% to approximately 8.47% of households. By incorporating the proposed requirement for $2.5 million of investments owned by the natural person at the time of purchase, the percentage would decrease to 1.3% of households that would qualify for accredited natural person status, a percentage below 1982 levels.

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UPCOMING SPEAKING ENGAGEMENTS

April 24, 2007
Simon Firth
"Why List? Is It Always the Best Option?"
Listing Alternative Investment Funds
London

May 24, 2007
Timothy Spangler
"Hedge Funds – the New Entrants in M&A"
Mergers & Acquisitions: Evolving Law, Corporate Strategy and Business Strategy
London

April 25-26, 2007
Simon Firth, Workshop Leader
Owen Watkins, Panelist
"How Industry Players are Responding to the Risks and Opportunities Arising from CP06/20?"
Financial Promotion Under the FSA's New Principles-Based Regime
London

May 22, 2007
Thomas Jesch, Co-Host
Participation Agreements
Frankfurt

Financial Promotion in the UK: A Brave New World?

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Given that there are other products on the market with similar characteristics to which promotional restrictions do not currently apply, this levelling of the playing field is to be welcomed.

In October 2006, the Financial Services Authority issued consultation paper 06/20, "Financial Promotion and other Communications." CP06/20 appeared at the same time as CP06/19, "Reforming COB Regulation," of which the proposals in CP06/20 form part. Comments on CP06/20 were invited by February 23, 2007, except for those parts that relate to the transposition of the Markets in Financial Instruments Directive, where comments were requested by November 28, 2006.

The Financial Services Authority (the "FSA") has trailed the reform of conduct of business regulation as "a radical simplification of the rules" where "the move towards principles-based regulation means focusing on the outcomes that really matter rather than procedural box ticking." This suggests that the changes firms will see, and undergo, in the area of financial promotions will be extensive. But will that really be the case?

What are the main changes?

The changes that the FSA has proposed to the financial promotion regime are to be contained in NEWCOB 4 (communication to clients) and NEWCOB 5 (financial promotion). They fall broadly into two camps.

The first involves the inclusion of relevant MiFID provisions in what the FSA terms "intelligent copy-out" — verbatim directive text translated into FSA Handbook-speak with no additional guidance. The rationale for this is that such a process avoids placing any unintended additional obligations on firms. These MiFID provisions will replace any existing COB 3 rules that cover the same topics.

That said, the basic MiFID obligation, contained in Article 19(2) of Directive 2004/39/EC, is virtually identical to that currently contained in COB 3.8.4R(1) (for nonreal-time financial promotions) and COB 3.8.22R(1) (for real-time financial promotions): that promotional material addressed to clients or potential clients should be fair, clear and not misleading. The only significant difference between the two is that the MiFID obligation is an absolute one, whereas the current COB 3 provisions require only the taking of "reasonable steps."

The MiFID implementing directive contains, at Article 27, various conditions with which information must comply for it to be fair, clear and not misleading. Again, however, the requirements here are not dissimilar to existing rules. Thus, there are detailed provisions where the promotion contains a comparison, in respect of past performance and simulated past performance (compare Article 27(3), (4) and (5) with COB 3.8.4R(2) and COB 3.8.13-16). So, although the wording may differ from that currently in COB 3.8, the change to the rules should not cause firms any great difficulties.

As the FSA points out, where past performance is concerned, MiFID does not go as far as the current rules do. For example, it does not specify a standard presentation of past performance information. There would, of course, be nothing to prevent firms from continuing to provide information in the present format if they found that the most convenient way to operate.

The second type of change that the FSA has proposed consists of the removal of most of the detailed financial promotion rules and guidance currently found in COB 3. Specific rules on direct-offer financial promotions will therefore disappear, along with the rules for specific types of investment products.

In all cases, the FSA believes that the high-level rules will be sufficient to provide adequate consumer protection, quite apart from the fact that in some cases the existing rules would have been super-equivalent to MiFID. As part of this exercise, a number of current restrictions have disappeared.

Provided that they comply with the high-level requirements, firms will, for the first time under the FSA's rules, be able to make direct sales promotions of broker funds and include projections in financial promotions for enterprise investment scheme shares. Further, firms will no longer have to make specified disclosures relating to those shares. Where direct sales promotions for collective investment schemes are concerned, firms will not have to disclose whether charges are taken from capital or income, or the likely long-term effect of those charges.

Given that there are other products on the market with similar characteristics to which promotional restrictions do not currently apply, this levelling of the playing field is to be welcomed. The FSA has also proposed removing the restrictions on the promotion of qualified investor schemes, which are super-equivalent to MiFID requirements.

Other Related Changes

There are three other related changes of which firms should be aware. These developments may require firms to change their procedures for issuing financial promotions in the future.

First, following the terminology in MiFID, the FSA has proposed to divide investors into "retail clients," "professional clients" and "eligible counterparties." These categories, particularly the first, have a very wide measure of overlap with the corresponding existing categories of "private customer," "intermediate customer" and "market counterparty," but they are not identical. In particular, it is possible that some persons currently being treated as intermediate customers, including those capable of being classified as expert private customers under COB 4.1.9R, will need to be reclassified as retail clients. This will have consequences for the way in which promotions can be made to them under the FSA rules.

For example, unregulated collective investment schemes can be promoted, without restriction, to a person who is an intermediate customer, but they can be promoted to a private customer (the equivalent of a "retail client") only in certain prescribed circumstances.

At one level, the simplification of the rules is an improvement, but it is unlikely that the "box ticking" will go away.

Secondly, the FSA will consult later in the year on financial promotion rules for unregulated collective investment schemes. These provisions will replace the rules in COB 3.11. The FSA has indicated that it intends to retain the substance of the existing provisions. It will be interesting to see whether it takes the opportunity to review the categories of permitted promotion set out in COB 3 Annex 5.

Finally, under Section 145 of the Financial Services and Markets Act 2000, the FSA has no power to make financial promotion rules that apply to promotions for which an exemption exists in the order made by the Treasury under Section 21(5) of the Act (currently the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005). This is to ensure that authorized persons are not subject to a more stringent promotional regime than an unauthorized person would be. MiFID, however, does not have the same range of exceptions as is contained in the FPO. The Act will, therefore, need to be amended to enable the FSA to implement MiFID fully.

The FSA has noted that this will mean that certain promotions in respect of MiFID business by MiFID firms to which the FSA rules do not currently apply — such as those to high net worth individuals or sophisticated investors — will be subject to the relevant rules in NEWCOB. Affected firms are likely to have to amend their procedures.

What does this mean for firms?

At one level, the simplification of the rules is an improvement, but it is unlikely that the "box ticking" will go away. The FSA seems to regard box ticking as somehow giving rise to inadequate promotions, almost as if compliance with detailed promotional rules could leave firms in breach of the overriding clear, fair and not misleading requirement in COB 3.7.2R(1).

Unless a firm made only the most infrequent promotions, it seems inherently implausible that it would, on each occasion that it proposed to issue a promotion, seek to answer the question "Is this promotion fair, clear and not misleading?" with the FSA rulebook beside it, a blank piece of paper in front of it, and nothing else.

Given that firms need to have a process in place to ensure that they are run effectively and efficiently, it is much more realistic to suppose that, in the future, they will continue to behave much as now. That is, they will have a procedure to ensure that their promotions satisfy the relevant requirements. As part of that procedure there will be some form of checklist that reflects any applicable third-party material. Indeed, for all its public stigmatising of box ticking, the FSA itself acknowledges not just that this will happen, but that it is to be welcomed.

Nausicaa Delfas, the FSA's head of TCF strategy, financial promotions and unfair terms, gave a speech on December 12, 2006, on key themes and developments in financial advertising. She said: "From our side, it will continue to be important for us to help firms meet the principles. We will continue to use our web site and publications to communicate generally on the standards we expect and highlight good practice and concerns arising from our thematic work — we understand that these have been positively received so far. The outcomes of formal enforcement action will also help here."

This information could be useful to firms only if it were expected that it would somehow filter down into the promotional material that the firms issue. The most effective way to do that would be to make those who review promotions aware of that information by means of a checklist or other aid. This would ensure that the promotions are fair, clear, and not misleading. The checklist used would also reflect any relevant industry guidance that was confirmed by the FSA (see the FSA discussion paper 06/5 of November 2005).

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The German 2008 Private Equity Act — In Search of a Legal Savior?

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An expedited implementation of a favorable 2008 Private Equity Act along with proposed changes by the 2008 Corporate Tax Act should improve the investment environment in Germany.

The Current Framework

According to the recent EVCA analysis of the legal and tax environment for private equity investments, Germany is still one of the least attractive places for such investments in Europe. Apparently change is forthcoming. The current government is eager to pass the 2008 Private Equity Act, which would benefit investments in research-driven start-up companies.

The German government's rationale is based on a survey conducted by the Technical University of Munich, which concluded that private equity funds, like their domestic mutual fund peers, have to be treated as tax-transparent entities. This survey followed the Coalition Agreement of November 11, 2005, whereby the current government decided to reform the German Private Equity Company Act (*Gesetz über Unternehmensbeteiligungsgesellschaften*), which only applies to a limited number of domestic funds, into a full-blown Private Equity Act. Thereafter, the Private Equity Company might serve as the basic type of a German private equity fund.

The first draft of the 2008 Private Equity Act will be circulated in or after May 2007. The legislation should then be passed and become effective on January 1, 2008, along with the laws implementing the 2008 Corporate Tax Reform (*Unternehmenssteuerreform*). We have not been provided with a draft of the 2008 Private Equity Act yet; however, the publicized provisions under the draft 2008 Corporate Tax Reform Act make it worthwhile to ask if significant improvements will still be possible within a potentially challenging new tax environment.

The Future Tax Environment

The 2008 Corporate Tax Reform will include various provisions affecting private equity investments in Germany. The corporate tax burden should be reduced to a rate of 15% and the overall burden including trade tax will be at a rate under 30%. Germany should now be considered an attractive investment site with a competitive tax environment, at least for investors who are not subject to the German trade tax.

The thin-capitalization rules will be replaced by an interest barrier rule (*Zinsschranke*). Interest payments will not be deductible if the net interest payments exceed 30% of the financed company's EBIT ("Earnings before Interest and Taxes"). Companies with net interest expense below one million Euros will be excluded from this rule. The interest barrier particularly affects highly leveraged companies, as well as their shareholders. There will be no future recharacterization of interest payments as hidden distributions or income. Therefore, in the future, foreign private equity investors do not have to be concerned about withholding tax issues.

Commencing in 2009, capital gains realized by individuals without a trade or business will generally be subject to a 25% flat tax (*Abgeltungssteuer*). For corporate investors, capital gains shall remain subject to the German participation exemption (95% tax-free), so that treaty protection is only needed to avoid the charge on 5% of the capital gains.

German anti-treaty shopping provisions have already been extended by the 2007 Tax

Act. Accordingly, withholding tax exemptions or reductions can only be claimed if the claimant meets the stringent but yet unclarified substance requirements of the new Sec. 50d para 3 of the German Income Tax Act ("ITA"). The claimant, for example, must receive at least 10% of his gross income from an active business.

> ***The first draft of the 2008 Private Equity Act will be circulated in or after May 2007. The legislation should then be passed and become effective on January 1, 2008 along with the laws implementing the 2008 Corporate Tax Reform (Unternehmenssteuerreform).***

At least, the fiscal authorities seem to address taxpayer concerns that the requirements of Sec. 50d para 3 ITA will be applied as general principles for the anti-abuse rules. The overriding concern was that even the participation exemption would be subject to the substance requirements.

The carried interest taxation still provides the sponsor with a 50% tax exemption so that former uncertainties (carried interest as capital gain or service fee; no "infection" of the fund into a trade or business) are solved.

Value Added Tax ("VAT") may also be a minor issue where a separate management entity acts on behalf of the private equity fund. In this case, only the management fee received shall be subject to VAT. The fund shall not be able to claim input-VAT as a deduction so that the VAT burden becomes final.

What Would Additionally be Needed?

Where the restructured Private Equity Company becomes the basic type of German private equity fund, it has to be established that the change of form can be achieved on a neutral basis.

A general trade tax exemption for the Private Equity Company may address uncertainties regarding the criteria and whether or not one is dealing with a trade or business or with mere asset management.

An expedited implementation of a favorable 2008 Private Equity Act, along with proposed changes by the 2008 Corporate Tax Act, should improve the investment environment in Germany. A reliable investment environment can be attained if the tax authorities continue their prompt response to code amendments by virtue of clarifying letter rulings.

A favorable tax environment, especially for international private equity investors, seems to be on the horizon.

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NEWS ALERT – Germany's G-REIT is on the way

The German government finalized the G-REIT legislation process on March 19, 2007

- REITs will be exempt from corporate income tax and trade tax
- Foreign shareholders will only pay withholding tax on dividends
- Capital gains on shares are subject to the Double Tax treaty
- 60% REIT financing allowed
- Mezzanine structures possible
- 75% shareholder majority allowed
- Real estate capital gains (on sales to G-REITs) to be 50% tax-exempt temporarily

Profits Interests and Hedge Funds

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The last guidance, proposed regulations in 2005 (the "Proposed Regulations"), complicated the question by explicitly providing, for the first time, that Section 83 applies to a profits interest. This meant that the service provider could and should make an 83(b) Election if his or her profits interest is subject to an SRF.

Domestic and offshore hedge funds and their related management entities typically are created as partnerships. The principal reason for this is that this structure should allow the partners of the managing partnership to build additional wealth since the gains derived from the partnership's carried interest will be taxed at capital gains rates. The partnership also has the advantage of allowing the partners to defer a portion of the annual management fee paid by the hedge fund. While managers tend to accept these results as a given, the tax treatment of both is somewhat uncertain and subject to revision, particularly in the current climate in which both large amounts of individual compensation and/or deferrals have been harshly criticized by both the U.S. Congress and the media. This article will discuss the most recent guidance issued by the IRS and examine the potential problems of both.

Governing Tax Principles

As amended, Section 83 of the Internal Revenue Code of 1986 (the "Code") generally governs the taxation of property in any form that is transferred to an employee in connection with the provision of services. Under the section, the property transferred, less any amount paid for it (the "Spread"), is taxable at ordinary income rates. Taxation is deferred when the property is subject to a condition to perform future services, i.e. it is subject to forfeiture upon termination of employment for various reasons (a "substantial risk of forfeiture" or "SRF"). When the SRF lapses, the Spread will be taxable as ordinary income. Even if an SRF exists, the employee-recipient may elect to be taxed currently by making a so-called Section 83(b) Election (an "83(b) Election"). This will result in current taxation of the Spread but any additional gains generally will be taxed at capital gain rates. Making the 83(b) Election obviously makes the most sense when the property transferred has little or no value. Fund partners typically employ this method using a liquidation value approach to value their profits interests. This methodology ensures that the partners will have no taxable income in the year the interest is transferred and that any gains when the carried interest is monetized will be capital in nature.

The only issue raised by this structure is whether a profits interest constitutes "property" for purposes of Section 83. If it does not, no 83(b) Election could be made and all of the gain would be ordinary in character. In this regard, Section 83 provides that property includes real and personal property, but does not include an "unfunded promise to pay money in the future." Under this definition, the IRS has not treated stock appreciation rights ("SARs") and other incentive compensation devices as property, making Section 83 inapplicable to them. Profits interests unquestionably look much like SARs, making many practitioners uncertain as to the applicability of Section 83.

Between 1993 and 2005, the IRS issued three pronouncements which applied to this question. The first two of these – revenue procedures issued in 1993 and 2001 – do not address the issue directly. These procedures provided that, if a number of specific conditions are met, neither the grant nor vesting of a profits interest is a taxable event. This meant that an 83(b) Election would not be necessary since, on disposition, the profits interest would take on the character of the partnership's income, which generally would be capital.

> ***One issue generated by Section 409A, that the IRS did specifically address in the guidance it has issued, is the common back-to-back arrangements that permit the partners of a managing partnership to elect to defer receipt (and taxation) of a portion of the partnership's annual management fee for a period of years.***

The revenue procedures, however, provided that they applied only to profits interests granted to an individual who provides services "to or for the benefit of" a partnership. There obviously are many situations where an individual provides services to a partnership other than the partnership that holds the right to the carried interest. This raised the question of whether these services are provided "for the benefit of" the partnership. The revenue procedures did not provide an answer so many practitioners felt the prudent course was to file an 83(b) Election, even if it technically turned out to be unnecessary.

The last guidance, proposed regulations in 2005 (the "Proposed Regulations"), complicated the question by explicitly providing for the first time that Section 83 applies to a profits interest. This meant that the service provider could and should make an 83(b) Election if his or her profits interest is subject to an SRF (which is directly contrary to the position in the revenue procedures). Nevertheless, if the Proposed Regulations are finalized, they would provide much-needed certainty on this key question. The Proposed Regulations remain proposed and the IRS has given no indication of when, or if, they will be finalized. Until they are, the revenue procedures remain in effect and are controlling. In any case, the prudent course to follow is to file an 83(b) Election within the required time period.

If finalized, the Proposed Regulations would help on one other key issue and hurt with respect to another. They explicitly do not apply to the provision of services to a related party. Accordingly, a "tiered" structure as described above apparently would not provide the desired tax treatment, although it is unclear how such interests will be treated. The Proposed Regulations do provide that a partnership may utilize a liquidation value approach in valuing a profits interest, ensuring that such interest will have no value on the date of award. Using this election does have some practical problems, however, in that all partners must agree to it and it must be used for all purposes. If a partnership does not follow this approach, it will have to value the interest using another method without definitive guidance from the IRS. In the absence of such guidance, a traditional willing buyer/willing seller method seems most reasonable. The parties, however, would have to decide whether to take into account factors such as lack of marketability and minority discounts. The danger is that, if the IRS does not accept the valuation method, additional amounts will be taxed at ordinary income (rather than capital gain) rates.

Deferral of Management Fees: Section 409A

Section 409A of the Code was enacted in late 2004 and governs any deferred compensation arrangement, which is defined to include any interest in which an employee has a "legally binding right" in one taxable year to compensation that has not been actually or constructively received and is payable in a later year. Failure to comply with the section results in immediate recognition of income and the imposition of a 20% excise tax on an employee-recipient. The IRS generally has reserved the issuance of guidance with respect to the impact of Section 409A on partnerships, except to state that until it issues guidance, "taxpayers may treat the issuance of a partnership interest (including a profits interest) ... under the same principles that govern the issuance of stock." This provides a measure of comfort but does not fully recognize the pass-through character of a partnership.

One issue generated by Section 409A, that the IRS did specifically address in the guidance it has issued, is the common back-to-back arrangements that permit the partners of a managing partnership to elect to defer receipt (and taxation) of a portion of the partnership's annual management fee for a period of years. Such arrangements typically require that the hedge fund will distribute assets to the managing partnership whenever the partnership has an obligation to pay an employee who deferred compensation. Section 409A effectively precludes distributions at any time other than upon specified events such as separation from service, death, disability, and a Change in Control. The managing partnership clearly could make a distribution if an individual terminated without violating Section 409A. The question was whether the hedge fund could make a distribution to the managing partnership when none of these qualifying events applied to the partnership.

The Proposed Regulations provided that distributions from the hedge fund to the managing partnership and the partnership's payment of these funds to an individual was permissible under Section 409A, given that the agreements otherwise complied with the section. The Proposed Regulations did not, however, exempt accelerated payments from the fund to the manager (because, for example, the fund liquidates or there is a change in law) when a sanctioned distribution event has not occurred with respect to the employees. Thus, there could be situations where assets in effect would be "trapped" in the managing partnership until one of the 409A distribution events occurs.

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NEWS ALERT

Northwest Airlines and *Pacific Lumber* — Recent Ruling May Impact the Willingness of Hedge Funds and Distressed Investors to Serve on Ad Hoc Debt or Equity Committees

A recent decision from a leading US bankruptcy court has the potential to alter the manner in which hedge funds and other distressed investors seek to influence the direction of Chapter 11 cases. In *Northwest Airlines*, Judge Gropper of the United States Bankruptcy Court for the Southern District of New York ordered an unofficial or "*ad hoc*" committee of equity holders, comprised of hedge funds, to disclose in a public filing each member's debt and equity holdings, the dates of each acquisition and the price paid. Separately, he also denied a request that the members be allowed to file their information under seal.

Investors serving on *ad hoc* committees fight vigorously to avoid making these disclosures. Hedge funds argue that they trade based on proprietary systems that could be reconstructed from such data by competitors. Distressed investors argue that if they disclose the price at which they acquired their positions they will be seriously disadvantaged in plan negotiations. Both say that requiring the disclosure of trading data will have a "chilling effect" on sophisticated debt and equity investors who participate actively in, and bring value and liquidity to, Chapter 11 cases.

The decision in *Northwest Airlines* dealt with an unofficial committee of equity holders, but the Court's reasoning may apply equally to unofficial committees of bondholders or lenders. By its terms, Bankruptcy Rule 2019 requires every entity representing more than one creditor or equity holder (other than official committees) to file a statement disclosing the identities of each party represented, each party's holdings, the dates of each acquisition and the price paid. In practice, however, unofficial committees have generally avoided the requirement. The statement typically filed by an unofficial committee identifies the group's counsel, counsel's interest in the case, the group's members, and the aggregate amount of the group's debt and equity holdings, without any disclosure of the dates of acquisition, the price paid, or any individual member's stake.

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Forming or participating on an unofficial committee is one important way that hedge funds and other stakeholders seek to assert leverage in a Chapter 11 case. By consolidating, members may attain greater influence than they have standing alone, and will in many cases "secure a seat at the table" with the company, its lenders and other major players. Consolidating also allows members of the group to pool expenses and resources. The end result may be a greater recovery for those investors than if left to their own devices. Often, at the end of the case, unofficial committees also ask the court to compel the company to pay their attorneys' fees for making a "substantial contribution" to the reorganization. Such requests for reimbursement are often met with mixed results.

From a strategic standpoint, these disclosure challenges may be a new arrow in the quiver of debtors, lenders, official committees and other parties in interest seeking to restrict the influence of assertive or difficult *ad hoc* committees. The dispute in *Northwest Airlines* arose in the context of the *ad hoc* committee's request for an official equity committee. In response, the debtors challenged the adequacy of the group's disclosures. Some say the debtors applied the rule selectively to rein in a particularly aggressive group of stakeholders; the *ad hoc* committee is contending that the airline is undervaluing its stock and hiding or delaying a planned merger with Delta until the two carriers emerge from bankruptcy in the next year or so. Whether the ploy will be successful remains an open question. The group withdrew its request for an official equity committee but is now seeking the appointment of an examiner to investigate its charges.

As further proof that these challenges are susceptible to strategic use, there is a similar fight brewing in Pacific Lumber's Chapter 11 case. The highly contentious case was filed in Corpus Christi, Texas in January 2007, but the company's fighting with bondholders, environmentalists and the State of California dates back several years. Last week, on the heels of the ruling in *Northwest Airlines*, the company asked the court to order a group of hedge funds organized as an *ad hoc* committee of noteholders to disclose their individual holdings and the prices paid for their bonds. The company asserts that the hedge funds have engaged in "overly aggressive behavior" that threatens its reorganization prospects while "hiding behind a veil of secrecy."

The debate over what disclosures are required, and how public they should be, is still very much alive. In *Pacific Lumber*, the fight over what disclosures will be required is scheduled for hearing on April 10, 2007. In *Northwest Airlines*, the *ad hoc* committee filed an appeal from the denial of its request to file the disclosures under seal. Several committee members also filed a motion for reconsideration and, in an unusual move, the Loan Syndications and Trading Association and the Securities Industry and Financial Markets Association asked to be heard in support of the motion because of its potential impact on the debt and equity markets. The motion was denied, but the efforts of the two trading associations to weigh in illustrates its potential magnitude.

For the time being, then, the disputes in *Northwest Airlines* and *Pacific Lumber* between the companies and hedge funds should make investors think carefully about forming or participating on an *ad hoc* committee of debt or equity holders if they are concerned at all about the risk of being required to disclose their individual holdings, the dates they bought in or the price they paid.

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