June 28, 2016

Structuring Equity Interests for Independent Sponsors

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In a traditional private equity fund, the fund managers will raise money from investors to establish a pool of capital the fund can then use to invest in a number of portfolio companies. A big benefit of a fund is that the fund managers can invest immediately in a new portfolio company (as the fund can call committed capital from investors at any time). One potential downside of a fund is that, if promising potential portfolio companies are scarce, the investors' money is still tied up and subject to management fees.

An increasingly popular alternative is the "fundless" or "independent" sponsor (the "Sponsor"), particularly in the lower middle market. Rather than finding the cash up front and then searching for investments, the Sponsor finds a promising company and then matches that company with investors. It provides a bit more flexibility to investors who don't want or can't afford to have their cash tied up in a traditional fund for years, or who want to be more selective about where their money goes. The Sponsor will often set up a limited liability company or limited partnership (which will be taxed as a partnership in either case) to serve as an investment vehicle for the deal. In exchange for its efforts, the Sponsor will often receive some combination of closing fees, management fees (if the sponsor provides services after closing), and an interest in the profits of the investment vehicle, as well as the opportunity to invest in the deal. Closing fees and management fees are usually compensation for services rendered, and are therefore generally taxed as ordinary income to the sponsor when received.

Sponsors commonly attempt to structure their deals to defer the receipt of taxable income and to receive capital gains income by waiving their closing fees in exchange for an equity interest in the investment vehicle, which only allows the Sponsor to share in the future appreciation of the portfolio company. The equity interest the Sponsor receives will typically be junior preferred equity or other securities which are junior to the capital of any private equity fund or other investor and are out of the money at closing. If structured properly, most of the income allocated to or realized by the Sponsor upon a sale of the portfolio company should be capital gain income (other than perhaps their share of amortization or depreciation recapture). However, such arrangements have come under scrutiny from the Internal Revenue Service (IRS) in recent years. The most important factor in regulations recently proposed by the U.S. Department of the Treasury is whether the arrangement contains "significant entrepreneurial risk" for the Sponsor. Such regulations contain a rebuttable presumption that certain arrangements are automatically disguised payments for services, including arrangements which are fixed or determinable, or otherwise designed to ensure profits will be allocated to the service provider no matter how the business does. Carried interest arrangements are especially troubling to the IRS if the service provider controls the portfolio companies, because then the service provider may be able to control when and how distributions are made. To be respected, these arrangements must have real economic risk for the Sponsor, so that they do not receive cash on a down or sideways deal. Recent comments by officials at the IRS indicate that including a clawback provision for amounts distributed to the Sponsor is an easy way to show such risk. Additionally, the Sponsor rarely has control of the portfolio company, which is instead often controlled by a fund brought in as an investor; this lack of control gives more comfort to the IRS that the Sponsor faces actual economic risk on the deal.

A Sponsor who wants to avoid the fee waiver alternative (whether because of the enhanced IRS scrutiny or because the Sponsor's equity interest is subordinated to investors' capital and potentially preferred return thereon) may instead elect to structure the deal such that the Sponsor gets an equity interest that is on par with the investors' preferred equity. The Sponsor could successfully achieve this result if it has a valuable intangible asset, such as a business plan or signed letter of intent, which the Sponsor contributes to the investment vehicle, typically around the time of its formation. In exchange for this in-kind contribution, the Sponsor would receive an equity interest in the investment vehicle. The contribution of the letter of intent or other intangible property to the investment vehicle is intended to be treated as a tax-free contribution of appreciated property to a partnership for income tax purposes. The equity interest has to be received in exchange for the letter of intent, rather than in whole or in part as compensation for services rendered. If it is determined that a portion of the interest received by the sponsor is in exchange for services, the value of the portion of the interest so treated would be ordinary income to the sponsor.

Providing a Sponsor an interest in the investment vehicle, especially in lieu of fees or other compensation, requires careful planning and knowledgeable advisors to structure the deal properly. The determination of whether the interest received is a capital asset that does not immediately result in taxable ordinary income is dependent on the facts of circumstances of the particular deal in question.

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