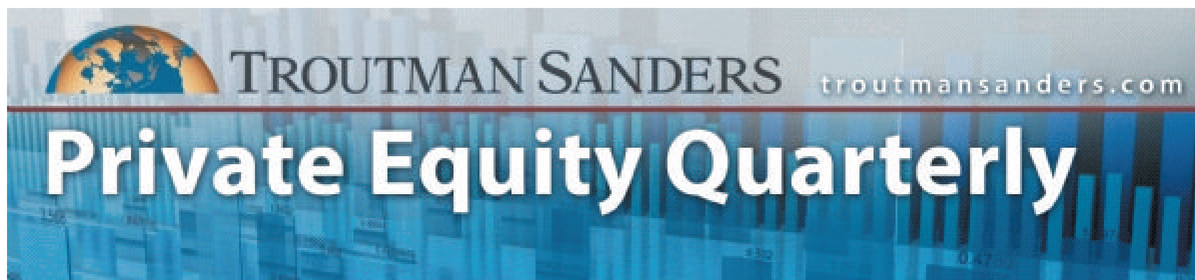

SPRING - 2016

IN THIS EDITION

- **Bankruptcy and Litigation** - **Buyer Beware: District Court Imposes Pension Liability on Private Equity Funds**
- **Bankruptcy and Litigation** - **The Cost of Conflict**
- **Real Estate Private Equity** - **Creatively Completing Your Capital Stack: The Emergence of Real Estate Sponsor Equity "GP" Funds**
- **Government Regulatory** - **Regulatory and Enforcement Round Up: A Record CFTC Whistleblower Award and Some Key DOJ/SEC FCPA Instructions For Companies**
- **Real Estate** - **Mr. Irresistible Force, meet Ms. Immovable Object**

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By Harris Winsberg and Brett Goodman

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REAL ESTATE PRIVATE EQUITY

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By John McDonald and Paul Steffens

As the real estate boom continues to reach new heights, capital constrained real estate private equity sponsors are increasingly raising "GP" funds to provide some or all of the sponsor equity contributions for their real estate investment vehicles, instead of making such sponsor equity contributions themselves. While GP funds can provide sponsors with a new and creative way to complete their capital stacks, they can also raise fundamental issues concerning the allocation of risk and reward between the sponsor and the outside investors. This article discusses some of the issues implicated by GP funds and summarizes certain key deal terms of GP funds.

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Regulatory and Enforcement Round Up: A Record CFTC Whistleblower Award and Some Key DOJ/SEC FCPA Instructions For Companies

By Sharie Brown

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REAL ESTATE

Mr. Irresistible Force, meet Ms. Immovable Object

By David Jones

In the acquisition and financing of income-producing property, there are usually three parties at the table: the sponsor (often a local entrepreneur who has located and will manage and lease the building), the equity investor (often an institution, such as a life company, real estate fund or REIT) and the lender.

In closing the equity and debt, the sponsor functions as a tiny fulcrum balancing a teeter totter board with an elephant on one end and a hippo on the other, neither of whom wants to stay balanced with the other. As if the fulcrum's job wasn't already hard, a recent Memorandum from the Office of Chief Counsel of the IRS potentially up-ends one of the traditional risk allocation and tax benefit analyses that makes real estate investments appealing to equity investors in

the first place.

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BANKRUPTCY AND LITIGATION

Buyer Beware: District Court Imposes Pension Liability on Private Equity Funds

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On March 28, 2016, in the latest of a series of decisions, in *Sun Capital Partners III, LP, et al. v. New England Teamsters & Trucking Indus. Pension Fund,*[1] the United States District Court for the District of Massachusetts issued a decision adverse to private equity funds that invest in companies with commitments to multiemployer pension funds. The decision imposed withdrawal liability on two Sun Capital funds that the District Court found to be trades or businesses under common control with their bankrupt portfolio company. With respect to characterizing a private equity fund as a trade or business, the District Court followed an earlier ruling by the United States Court of Appeals for the First Circuit[2] that a private equity fund will be a trade or business if it sufficiently operates and manages the portfolio company or is otherwise advantaged by it.

With respect to common control, the two funds together owned indirectly all of the stock of the portfolio company. Although the two funds were formally separate, with neither fund owning enough of the portfolio company to be considered in control of it, the District Court held that the two funds were a "partnership-in-fact." Thus, the two funds were jointly liable for $4.5 million of withdrawal liability owed to a Teamsters pension fund.

Background

The Sun Capital case derives from the bankruptcy of Scott Brass, Inc. ("SBI"), which is a portfolio company of the two private equity funds ("Fund III" and "Fund IV"). SBI defaulted on its withdrawal obligations to the New England Teamsters & Trucking Industry Pension Fund, a multiemployer pension plan. The funds sought declaratory judgment that they were not liable for the payment of withdrawal liability. The defendant counter-claimed that the funds were jointly and severally liable under the Multiemployer Pension Plan Amendments Act ("MPPAA")[3]
because they were engaged in a trade or business under common control with SBI. In its original decision, the District Court granted summary judgment to the funds on the ground that they were passive investors, rather than trades or businesses.[4]

The First Circuit reversed the District Court's original ruling in favor of the funds. The First Circuit held that an otherwise passive investment by a fund would be a trade or business if the fund sufficiently operates, manages and is otherwise advantaged by the portfolio company. According to the First Circuit, some form of "investment plus" approach is appropriate when evaluating the trade or business prong. The court declined to set general guidelines for what satisfies the "investment plus" standard and instead adopted a fact-specific approach, taking into account a number of factors with no one factor being dispositive.

Applying this approach, the First Circuit concluded that Fund IV met the trade or business requirement but that the record was insufficiently developed to decide the status of Fund III. The court's conclusion as to Fund IV was based on the court's determination that management fees that SBI paid to a Sun Capital management company would offset fees that Fund IV otherwise would have owed to its general partner. The court was uncertain whether Fund III received such an offset. On remand, the District Court was charged with answering two questions: (1) whether Fund III was engaged in a "trade or business" and (2) whether the two funds were under common control with SBI.

Engaged in "Trade or Business"

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With respect to the question of trade or business, the District Court found that Fund III was entitled to the same type of offset to which Fund IV was entitled. In addition, the District Court reevaluated this factor of offset in light of the fact that the general partner of Fund IV had waived its right to fees currently due from Fund IV, and thus Fund IV had no present benefit from its right to offset the general partner's fee by the management fees paid by SBI. Although Fund IV could carry forward the right of offset, that right of carry-forward would be of no future benefit if the general partner continued to waive its right to fees from Fund IV.

The court concluded that the funds' right to generate offset carry-forwards created an economic benefit to the funds even though it was of uncertain value. The possibility of future value from the right of offset was considered sufficient to satisfy the "investment plus" test articulated by the First Circuit, and thus the funds met the trade or business test.

Under "Common Control"

With respect to the question of common control, the District Court concluded that the funds were under common control with SBI. Under the Pension Benefit Guaranty Corporation's regulations, two or more trades or businesses are under common control if they are members of a "parent-subsidiary" group.[5] To constitute a parent-subsidiary group, the parent in the chain must control 80% of the subsidiary. Each fund's interest in the indirect owner of SBI (Sun Scott Brass, LLC) fell below the 80% threshold, with one fund owning 70% and the other owning 30%.

The District Court found that prior to forming Sun Scott Brass, LLC, the two funds decided to co-invest and made a conscious decision to split their ownership stake 70/30 in the LLC. The District Court focused on the funds' "top-down decisions to allocate responsibility jointly." This unity in decision-making between the funds indicated that they had formed a "partnership-in-fact" even though the two funds had no formal partnership arrangement. The District Court concluded that the statute contemplated disregarding business entity formalities meant to prevent responsible parties from having withdrawal liability.

Private Equity Considerations

This most recent *Sun Capital* decision strikes a blow to the structuring of investments to avoid the 80% rule. Private equity funds must be extremely careful when investing in companies with multiemployer pension liabilities and take a hard look at these potential liabilities before making an investment.

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[1] *Sun Capital Partners III, LP v. New Eng. Teamsters & Trucking Indus. Pension Fund*, NO. 10-10921-DPW, 2016 U.S. Dist. LEXIS 40254 (D. Mass. Mar. 28, 2016).

[2] *Sun Capital Partners III, LP v. New Eng. Teamsters & Trucking Indus. Pension Fund*, 724 F.3d 129 (1st Cir. 2013).

[3] 29 U.S.C. § 1301(b)(1).

[4] *Sun Capital Partners III, LP v. New Eng. Teamsters & Trucking Indus. Pension Fund*, 903 F. Supp. 2d 107 (D. Mass. 2012).

[5] 26 C.F.R. § 1.414(c)-2.

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Among the claims Davis analyzed were certain claims against the law firm that represented CEOC, its parent, Caesar's Entertainment Corporation ("CEC") and the sponsors in connection with transactions between CEOC and CEC. While Davis determined that such claims are likely not cognizable, the absence of separate legal counsel for CEOC weighed significantly on Davis' determinations of CEC's and the sponsors' liability. According to the report, had CEOC been permitted to retain its own counsel, it is possible that some or all of the transactions discussed in the Examiner's report would have been structured differently and in a manner that provided fair consideration or reasonably equivalent value to CEOC's creditors while still achieving CEOC's and the sponsors' goals. Plainly, such a revised transaction would have gone a long way to reducing or eliminating CEOC's and the sponsors' liability to CEOC's creditors.

I. Background

A. The LBO and Great Recession Impact Caesars' Business

In 2008, Harrah's Entertainment, Inc. was acquired in a $30.7 billion leveraged buyout (the "LBO") by the private equity firms Apollo and TPG (together, the "Sponsors"). The enterprise was later rebranded under the Caesars name and the company's name changed to CEOC. The LBO was funded with $24 billion in debt, more than $17 billion of which was secured by liens on substantially all of the debtors' assets, and a large percentage of which was guaranteed by CEOC's parent company, CEC.

Given the large debt incurred in connection with the LBO as well as the capital expenditures necessary for Caesars' business to continue to grow and thrive as it had pre-LBO, it was essential that Caesars continue its pre-LBO revenue growth. Unfortunately, the Great Recession took hold shortly after the LBO closed and its effects on the gaming industry were particularly devastating. Indeed, the Examiner's report states that the recession's impact on Caesars was so severe that even today the company's financial performance remains below its pre-LBO level.

B. Caesars' Debt Is Restructured to Create Runway for the Business to Recover

In response to the Great Recession, CEC and the Sponsors took a number of steps to restructure Caesars' debt to buy the business time to recover. As with any business, Caesars during this period required additional capital to fund its desired growth. To attract this capital, CEC and the Sponsors caused CEOC to enter into a number of transactions that reduced CEOC's asset base so that such assets could be financed without the overhang of the LBO debt CEOC had incurred.

1. The CERP Transaction

For example, in 2013, CEOC and CEC entered into a series of

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transactions pursuant to which two projects CEOC was developing were sold to a newly formed CEC subsidiary, Caesars Entertainment Resort Properties ("CERP"). According to the Examiner's report, there were no negotiations between CEOC and CEC over the consideration CEOC would receive from the sale, and CEOC and CEC were represented in the transaction by the same counsel. Notably, 70% of the consideration CEOC received comprised non-cash indirect benefits, such as the avoidance of future expenses and the release of a guarantee of lease payments given by CEC. The Examiner determined that CEOC was insolvent at the time of the CERP transaction.

2. The CES Transaction

A second transaction reviewed by the Examiner involved the creation of another new CEC subsidiary, Caesars Enterprise Service, LLC ("CES") to which CEOC granted a broad license to Caesars' customer loyalty program, and to which CEOC also transferred its enterprise-wide management responsibilities. According to the Examiner's report, the CES transaction was engineered by Apollo to protect Caesars' intellectual property and management services in the event of a CEOC bankruptcy, which was then a known risk. CEOC was not involved with the negotiation of the transaction and did not have access to its own counsel. The Examiner determined that CEOC was insolvent at the time of the CES transaction.

C. Fraudulent Transfers and Breaches of Fiduciary Duty

Given the descriptions of the CERP and CES transactions – and CEOC's insolvency at the time it entered into those transactions – it is perhaps not surprising that the Examiner finds that creditors have strong claims relating to such transactions. Indeed, with respect to each transaction, the Examiner found that creditors have strong fraudulent conveyance claims as well as strong breach of fiduciary duty claims against CEOC's directors and CEC as CEOC's controlling shareholder.

D. The Need for Independent Counsel

As the Examiner noted, law firms often represent multiple clients in transactional matters and it is common for law firms to represent the portfolio companies of their private equity clients, as well as for the same firm to represent both a parent company and its 100% owned subsidiary. When a parent and its subsidiary are both solvent, one law firm can represent both parties in a transaction between them as their interest in the outcome of the transaction is the same.

A solvent company can transfer assets for little or no consideration and is generally free to make such transfers to related parties. Indeed, if CEOC were solvent at the time of the CERP and CES transactions, its creditors would likely have no claim with respect to such transactions as a solvent company is to be managed for the benefit of its shareholders and no fiduciary duties are owed to the creditors of a solvent company.

When the portfolio company or subsidiary is insolvent, however, a different calculus is involved. In those situations, the company is to be managed for the benefit of its creditors, and it will often be the case – as with the CERP and CES transactions – that transactions that benefit the parent may not be in the interest of the subsidiary. Indeed, in such situations, there is a conflict of interest between the parties such that the same law firm cannot represent both clients unless each client gives informed consent in writing. According to the Examiner, neither CEOC nor CEC issued conflict waivers or otherwise expressed their written consent to their dual representation by the same law firm.

While we will never know what would have happened had CEOC retained its own counsel, the presence of independent counsel for CEOC may have resulted in a different outcome. As the Examiner's report illustrates, when a parent company and its subsidiary enter into transactions at a time when the subsidiary is insolvent, their respective boards of directors should take all steps to ensure the negotiations are done at arm's length, including the retention of separate counsel. While it may often be difficult for the parties and their law firm to know when a subsidiary crosses the line from solvent to insolvent, independent counsel may be better positioned to insulate a

transaction between related parties from later attack.

Instead, the Examiner's Report found that the approach to the CERP and CES transactions taken by CEC and the Sponsors evidenced a desire to protect their own interests at the expense of CEOC's external creditors and led to what the Examiner deems to be strong claims against them ranging from $461 million to $1 billion. A cautionary tale, indeed.

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REAL ESTATE PRIVATE EQUITY

Creatively Completing Your Capital Stack: The Emergence of Real Estate Sponsor Equity "GP" Funds

By John McDonald and Paul Steffens

As the real estate boom continues to reach new heights, capital constrained real estate private equity sponsors are increasingly raising "GP" funds to provide some or all of the sponsor equity contributions for their real estate investment vehicles, instead of making such sponsor equity contributions themselves.[1] While GP funds can provide sponsors with a new and creative way to complete their capital stacks, they can also raise fundamental issues concerning the allocation of risk and reward between the sponsor and the outside investors. This article discusses some of the issues implicated by GP funds and summarizes certain key deal terms of GP funds.

Sponsor Equity

Real estate investment vehicles, whether they are structured as single-property joint ventures or "blind pool" funds investing in several properties, typically require the sponsor to provide a substantial portion of the equity capital – up to 20% – that is used to acquire and develop or otherwise improve the properties, with the remainder of the equity capital coming from outside investors.

Skin in the Game

Outside investors in real estate investment vehicles typically require sponsors to make equity contributions in their investment vehicles to enhance the alignment of interests between the sponsor and the outside investors. Outside investors typically argue that sponsors having "skin in the game," consisting of their own capital at risk in investments made by the investment vehicle, helps to mitigate the risk of the sponsor making unwise investment decisions that lead to losses and incentivizes the sponsor to make successful investments.

Other Incentives

While sponsors do not dispute these possible benefits, they typically respond that reputational damage and inability to raise subsequent real estate investment vehicles are sufficient incentive for them to not make unwise investment decisions. Also, the sponsor typically provides between 5-10% of the equity capital for the GP fund that provides the sponsor equity component of the underlying real estate investment vehicle's capital, which often is fairly significant relative to the sponsor's net worth. Further, since the vast majority of sponsors' compensation is tied directly to the performance of their investments through their promoted interest, they are sufficiently incentivized to make successful investments without being required to make substantial sponsor equity contributions. Finally, there is the practical reality for successful sponsors that, due to their success in sourcing multiple attractive real estate opportunities and the "back-end" nature of their promote compensation from other investment vehicles, they are often capital constrained and so have more opportunities available to them than can be pursued if they are required to make substantial sponsor equity contributions to all of their real estate investment vehicles.

An Attractive Investment

Investing in a GP fund, rather than in the underlying real estate investment vehicle, can be attractive to investors because GP funds typically offer investors greater financial return potential. That is the case because the sponsor typically receives a larger percentage of the investment vehicle's profits relative to the

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amount invested as compared to the outside investors, due to the sponsor also providing the "sweat equity" of sourcing and managing the investment vehicle's investments. Sponsors raising GP funds are essentially monetizing that sweat equity by substituting outside investors' capital for their own capital in satisfaction of their sponsor equity contribution obligations to their real estate investment vehicles.

A threshold issue for sponsors considering raising a GP fund is ensuring that the outside investors in the underlying real estate investment vehicle are comfortable with the sponsor equity coming from other investors, rather than from the sponsor's own funds. For the reasons discussed above, some outside investors may be opposed to the sponsor utilizing a GP fund, while others may be amenable to the sponsor doing so. Once any such concerns have been addressed, the next step for the parties is structuring and negotiating the GP fund.

Key Deal Terms

Since GP funds are relatively new, they do not yet have an established body of "market" deal terms. The terms of GP funds can vary significantly depending on the relative negotiating strength of the sponsor and the GP fund investors, as well as other factors. However, some common GP fund deal terms have emerged over time, which are as follows:

> **Distribution Structure.** GP funds typically employ the customary private equity fund distribution structure in which the investors receive back their invested capital, plus a preferred return on that invested capital, and any remaining profits are divided between the outside investors and the sponsor according to an agreed-upon split ratio. The outside investor/sponsor profit split ratio sometimes changes in favor of the sponsor as successively higher internal rate of return (IRR) hurdles are reached. Sometimes, once the outside investors receive their preferred return, there is a "catch up" so that the sponsor ultimately receives the agreed-upon percentage of the GP fund's total profits. The profit split among the sponsor and the GP fund investors may be determined on an investment-by-investment basis or on an aggregate basis. Since GP fund investors typically participate in all or a portion of the promote paid by the underlying real estate investment vehicle (as described below), the GP fund's profit split often exceeds the standard 20% for the sponsor.
>
> **Variations on Sharing of the Promote.** In some GP funds, the investors are entitled to the proceeds received from the underlying real estate investment vehicle attributable to their invested capital, but do not share in promote payments from the underlying real estate investment vehicle. However, GP fund investors more commonly receive all or a portion of the underlying real estate vehicle's promote payments based on the premise that they would otherwise not have any incremental benefit, as compared to investing directly in the underlying real estate investment vehicle, and would bear greater risk.
>
> **Sharing of Fee Income.** GP funds typically do not share in fee income received by affiliates of the sponsor for ancillary services to the underlying real estate investment vehicle, such as development, property management, leasing, construction management and financing fees. That is the case because such fee income is often attributable to discrete services being provided by the sponsor affiliates that would otherwise be provided by third parties to the underlying real estate investment vehicle, typically at market rates.
>
> **Management Fees.** Sponsors of GP funds that invest in more than one underlying real estate investment vehicle typically receive management fees (either directly or through an affiliated management company) similar to other types of private equity funds. As is the case for other types of private equity funds, the management fees of GP funds are typically calculated as a percentage of the fund's total capital commitments until the end of its investment period and a percentage of the fund's total invested capital for the remainder of its term (the percentage typically ranges from 1.5-2.0%). Sponsors of GP funds that invest in a single underlying real estate investment vehicle may also receive management fees from the GP funds, which may be based on the amount invested and may be paid periodically or as a one-time fee upon closing the investment.
>
> **No Investment Decision-Making Rights.** Although the GP fund investors

are investing in the entity that makes the investment decisions for the underlying real estate investment vehicle, they are typically passive investors that do not participate in that decision-making process. That is the case because any such involvement would likely raise issues with the underlying real estate investment vehicle's investors, which premised their decisions to invest in the underlying real estate investment vehicle based on the track record, judgment and investing acumen of the sponsor and would not welcome what they would likely view as interference from the GP fund's investors in the decision-making process.

Timing of Capital Contributions and Distributions. GP funds typically provide for capital contributions and distributions that correspond to those of the underlying real estate investment vehicle. As a result, the term of the GP fund matches the term of the underlying real estate investment vehicle, so that the GP fund can call capital from its investors whenever the underlying real estate investment vehicle calls capital from the sponsor. GP fund investors are typically required to fund their capital contributions to the GP fund within the time period in which the sponsor is required to make the sponsor equity contributions to the underlying real estate investment vehicle. GP funds typically also make capital calls to cover any GP fund-level expenses that are not satisfied out of distributions received by the GP fund from the underlying real estate investment vehicle. Subject to holdbacks to cover GP fund-level expenses, whether directly or to replenish reserves, distributions are typically made by the GP fund to its investors within a short time after the GP fund receives distributions from the underlying real estate investment vehicle.

Sponsor Debt Guarantee Obligations. Investors in GP funds are usually not responsible for any of the "non-recourse carve-out" and/or "completion" guarantees typically provided by sponsors to lenders in connection with debt financings obtained by the underlying real estate investment vehicle. Sometimes, sponsors are able to persuade their lenders to accept the GP fund as the guarantor of those obligations rather than the sponsor entity or its principals providing the guarantees based on the rationale that the GP fund, through its capital commitments, has more substantial financial resources than the sponsor and its principals. The GP fund investors not being responsible for those guarantee obligations in situations in which the lender requires the sponsor to be responsible is sometimes cited by sponsors as being part of the rationale for the GP fund not sharing the promote payments received from the underlying real estate investment vehicle with the GP fund investors.

Information Rights. Since the GP fund's economics are based principally on the financial results of the underlying real estate investment vehicle, GP fund investors typically receive copies of the quarterly and annual financial statements of the underlying real estate investment vehicle, along with GP fund-level financial information. The sponsor sometimes needs to obtain the approval of the outside investors in the underlying real estate investment vehicle to provide such information to the GP fund investors.

Conclusion

In summary, GP funds can be a useful tool for real estate sponsors to overcome their capital constraints and free themselves to make additional investments and can also be an attractive investment opportunity for GP fund investors. Please don't hesitate to contact the authors with any questions that you may have concerning GP funds.

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1 Real estate GP funds are part of a growing trend among private equity funds of all types, including leveraged buyout funds and hedge funds, in which investors are increasingly making investments in the general partner entities of the funds, rather than or in addition to becoming limited partners of the funds.

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By Sharie Brown

Confidential CFTC Whistleblower Receives Record $10 Million Award

In a press release issued on April 4, 2016, the Commodity Futures Trading Commission (CFTC) announced that it paid a $10 million award to a whistleblower for original information that led to a major enforcement action by the CFTC. Without providing any details of the nature and extent of the original information provided to the CFTC to warrant such a record breaking bounty, the CFTC's Director of Enforcement, Aitan Goelman, and Christopher Ehrman, Director of the CFTC's Whistleblower Office, both signaled their hope that the large amount of this bounty will encourage other whistleblowers to come forward with information regarding suspected violations of the Commodity Exchange Act (CEA) that the CFTC might not otherwise be in a position to address. The CFTC did not divulge the title or position of the whistleblower receiving the award, as whistleblowers are legally entitled to confidentiality regarding their identity, as well as to information that could be used to identify them.

The record bounty was paid pursuant to the expansion of whistleblower awards under section 748 of the Dodd-Frank Act, which makes individuals eligible for a 10% to 30% whistleblower award if the whistleblower provides original information that results in at least $1 million in fines and penalties by the covered enforcing agencies that bring enforcement actions and impose fines and penalties based on the original information provided by the whistleblower. According to its mission statement, the CFTC was created to "foster open, transparent, competitive, and financially sound markets, to avoid systemic risk, and to protect the market users and their funds, consumers, and the public from fraud, manipulation, and abusive practices related to derivatives and other products that are subject to the Commodity Exchange Act." In this current matter, the record bounty was paid from the CFTC's Consumer Protection Fund (CPF). The CPF is funded by sanctions and penalties paid for violating the CEA. The CFTC's last whistleblower award of $290,000 was announced in September 2015.

In light of the above record breaking award from the CFTC, and the recent whistleblower awards made by the U.S. Securities and Exchange Commission (SEC) under a similar program for violations of various securities laws, including the U.S. Foreign Corrupt Practices Act, companies and firms should enhance their compliance monitoring, supervision, and detection procedures and controls. Proactive monitoring, detection, and remediation will help ensure that the organization detects and remediates misconduct before it rises to a level that drives a whistleblower to make a voluntary report to the CFTC or the SEC in order to obtain a whistleblower bounty.

The SEC Targets Inadequate Procedures and Improper Hiring Practices for Internships Provided to Relatives of Foreign Government Officials in Violation of the FCPA

On March 1, 2016, the U.S. Securities and Exchange Commission announced that Qualcomm Incorporated would pay $7.5 million in order to settle charges that it violated the FCPA by hiring relatives of government officials in China in order to win business for its mobile technology products. According to the SEC, Qualcomm offered paid internships and full-time employment opportunities,

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among other gifts and entertainment, to relatives of Chinese officials from state owned and controlled telecommunications companies in China. Emails and other correspondence made clear that the relatives of the Chinese officials were hired in order to help Qualcomm try to obtain business from government officials in exchange for the hiring of their relatives in permanent jobs and in paid internships, without regard to Qaulcomm's hiring policies or whether the hired person had the skills that matched the requirements for the job or internship. In one instance, a relative of a Chinese official not only received preferential job treatment, but also obtained a personal loan of $70,000 from a Qaulcomm executive in order to buy a home. Moreover, the relative of a Chinese official was hired even when an interview resulted in a "no hire" recommendation.

Under the above circumstances, the SEC determined that Qaulcomm lacked effective internal controls and procedures to prevent violations of the FCPA, including hiring procedures, and also violated the books and records requirements of the FCPA.

It is likely that companies and firms may continue to attempt to hire relatives of foreign government officials in international countries. Companies should proceed with caution and ensure that they have robust procedures and internal compliance controls to make certain that all interns and prospective employees in foreign regions are hired pursuant to clear, written standards, in consultation with the Law Department and the Human Resources Department, to ensure that the candidate meets the basic standards for the job or the internship. Enhanced scrutiny and extra caution should be applied when the candidate is a foreign official's relative, as such candidates will raise a "red flag" under the FCPA, particularly if the foreign official related to the candidate is responsible for influencing decisions related to the company's business operations in the foreign country.

While such hiring of relatives of foreign officials will likely continue and is not *per se* unlawful, the risk created by hiring the relative of a foreign government official in a country in which the company operates requires careful adherence to all written compliance and hiring procedures. It also requires extra reviews and monitoring to ensure that business managers are not promoting such hiring in order to maintain or retain business for the company from the government official of the hired relative. The hiring company should be prepared to demonstrate, as effectively as possible, that the foreign official's relative did not receive preferential treatment under the hiring procedures during the hiring process or during the course of the internship or employment tenure because the employee or intern performed his or her duties satisfactorily, as required, and met basic standards. The hiring company should also be able to show that the internship or hiring was not intended to influence the official's decision to award business to the hiring company, among other considerations.

DOJ FCPA Pilot Program Outlines Criteria For Receiving Full Corporate Cooperation Credit In FCPA Cases

The U.S. Department of Justice (DOJ), Fraud Section's Foreign Corrupt Practices Act (FCPA) Enforcement Plan and Guidance, issued by Andrew Weissman, Chief, Fraud Section, DOJ Criminal Division, on April 5, 2016 ("*Weissman* Memo") gave practical, written guidance for companies that hope to receive full credit for cooperation and compliance-related actions undertaken when the companies suspect and uncover FCPA misconduct. The Fraud Section has commenced a one-year pilot program (effective April 5, 2016) that is designed to motivate companies to voluntarily self-disclose FCPA-related misconduct, fully cooperate with DOJ prosecutors, and remediate flaws in corporate controls and compliance programs, as appropriate.

Features of Voluntary Self-Disclosure

DOJ will evaluate the circumstances of corporate self-disclosure during the pilot period and award credit to companies for voluntary self-disclosure of FCPA wrongdoing where:

- The voluntary disclosure occurs "prior to an imminent threat of disclosure or government investigation";
- The company discloses the conduct to the DOJ "within a reasonably prompt time after becoming aware of the offense," with the burden being on the company to demonstrate timeliness; and
- The company discloses all relevant facts known to it, including all relevant facts about the individuals involved in any FCPA violation.

"Full Cooperation" In FCPA Matters

In addition to the Principles of Federal Prosecution of Business Organizations, DOJ requires a company to do the following in order to receive full cooperation (beyond credit already available under the U.S. Sentencing Guidelines):

- Disclosure on a timely basis of all facts relevant to the wrongdoing at issue, including facts related to the criminal activity of the company's officers, employees, or agents;
- Proactive cooperation; this requires the company to disclose facts that are relevant to the investigation (even when not specifically asked to do so) and to identify opportunities for prosecutors to obtain relevant evidence not in the company's possession or otherwise known to the government;
- Preservation, collection, and disclosure of relevant documents and information relating to provenance;
- Timely updates on a company's internal investigation;
- De-confliction of an internal investigation with the government's investigation when requested;
- Provision of all facts relevant to potential criminal conduct by all third-party entities and third-party individuals;
- Upon request, making company officers and employees available for DOJ interviews (including former employee/officers and overseas personnel);
- Disclosure of all relevant facts from a company's independent investigation, including attribution of facts to specific sources, except those that create violations of the attorney-client privilege;
- Disclosure of overseas document location and details regarding who, how, and where they were found;
- Facilitation of third-party document production and witnesses from foreign jurisdiction, unless legally prohibited; and
- Document translations, when appropriate and requested.

Timely and Appropriate Remediation In FCPA Matters

If the DOJ determines that a company is eligible for cooperation credit, DOJ will then also determine if the company should receive remediation credit based on:

- Whether the company has implemented an effective compliance and ethics program featuring criteria that will be periodically updated to include:
  - Whether the company has a culture of compliance;
  - Whether the company dedicates sufficient resources to its compliance function;
  - Whether the compliance personnel have the quality and experience to understand and identify transactions with potential risk;
  - The independence of the compliance function;
  - Whether the compliance program has performed an effective risk assessment tailored to the compliance program based on the risk assessment;
  - How the compliance personnel are compensated and promoted compared to other employees;
  - Extent of auditing of the compliance program effectiveness and the reporting structure of the compliance personnel within the company;
  - Extent of discipline of employees responsible for misconduct, oversight of responsible individuals, and how compensation is affected for offending personnel and for those who fail to adequately supervise; and
  - Any additional steps that demonstrate the seriousness of the corporate misconduct, acceptance of responsibility, and implementation of measures to reduce the risk or reoccurrence of the misconduct.

Maximum Credit For Companies That Voluntarily Disclose During The Pilot Program

Companies that voluntarily disclose, fully cooperate, and engage in timely and appropriate remediation of FCPA issues could receive up to 50% reduction off of the bottom end of the Sentencing Guidelines fine range, if a fine is sought. The DOJ may also not require the appointment of a compliance monitor, if at the time of resolution the company has implemented an effective compliance program. In some instances, DOJ may also consider a declination of prosecution of a company, if the company has disclosed information that permits the prosecution of individuals, among other factors considered. Companies that do not timely voluntarily disclose (but cooperate later and remediate) may receive only up to a 25% reduction off of the bottom end of the

Sentencing Guidelines fine range, if a fine is sought.

Recommendation

Thus, if a company learns of a suspected FCPA violation by employees, contractors, business partners, or third-party intermediaries, it should conduct a timely investigation, attempt to identify individual wrongdoers, take corrective and remedial action as compliance gaps and responsibility are uncovered, voluntarily report the FCPA wrongdoing to DOJ, and then fully cooperate with the prosecutors in order to be eligible for full corporate cooperation credit.

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REAL ESTATE

Mr. Irresistible Force, meet Ms. Immovable Object

By David Jones

In the acquisition and financing of income-producing property, there are usually three parties at the table: the sponsor (often a local entrepreneur who has located and will manage and lease the building), the equity investor (often an institution, such as a life company, real estate fund or REIT) and the lender.

In closing the equity and debt, the sponsor functions as a tiny fulcrum balancing a teeter totter board with an elephant on one end and a hippo on the other, neither of whom wants to stay balanced with the other. As if the fulcrum's job wasn't already hard, a recent Memorandum from the Office of Chief Counsel of the IRS potentially up-ends one of the traditional risk allocation and tax benefit analyses that makes real estate investments appealing to equity investors in the first place.

A compelling benefit for institutional investors investing in improved real estate is the potential for recognizing taxable losses in excess of the amount invested. Real estate owners (usually limited liability companies – pass-through entities – in which the members are the sponsor and the equity investor) are able to include debt encumbering the real estate as part of the owner's (practically, the LLC members') tax bases. Generally, the rule is (or has been) that an owner may include the debt as part of his taxable basis (i) to the extent it is personally liable for repayment or (ii) to the extent that no one is personally liable (that is, the lender's only recourse for nonpayment is to foreclose on the property; a so-called "non-recourse" loan). The IRS's General Counsel Memorandum (number 201606027), released February 5, 2016, potentially redefines non-recourse loans for purposes of computing tax basis. The Memorandum indicates that, when a sponsor signs a "springing recourse" guaranty in the context of a non-recourse loan, the institutional investor can no longer take advantage of taxable losses in excess of its investment – because the sponsor's "springing recourse" guaranty functions as a "payment guaranty" that effectively shifts all the debt into the tax basis for the sponsor signing the guaranty. The Memorandum further provides that a capital call provision in favor of the guaranteeing member on the other members for reimbursement may not be sufficient to shift the basis back to the other members. The Memorandum's conclusions upset long-standing assumptions about how traditional non-recourse loan structures affect borrower members' tax treatment.

To illustrate how the debt/basis rules work in a typical LLC structure, assume that AB, LLC has two members, the Sponsor (who invests $30 of equity) and the Investor (who invests $270 of equity). Sponsor and Investor share profits and loss on a 10/90% ratio. AB, LLC borrows $700 from Scrooge & Marley Bank, N.A. ("Bank") and combines it with the equity to buy income producing real estate. Bank requires the Sponsor to guaranty the repayment of the loan. For tax basis purposes, Sponsor's guaranty results in Sponsor's basis being $730 ($700 + $30) and the Investor's being $270. As such, Sponsor will be able to recognize more tax losses than Investor. This is not what Investor wants, but Investor doesn't want to guarantee the loan either. What the Investor wants is for no one to be liable for repayment – that is, under the long-held analysis of the tax regulations, in order to make the investment attractive for the Sponsor, Sponsor would prefer the property be financed via a non-recourse loan. If the loan from the Bank is non-recourse, then Sponsor and Investor share the debt basis on a 10/90 basis such that Sponsor's basis is $100 ($30 + $70) and Investor's is $900 ($270 + $630).

The use of non-recourse loans is standard practice for ventures investing in

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income-producing properties. When lenders agree to non-recourse debt, however, they still want to protect themselves from waste, fraud and similar acts committed by borrowers (typically referred to as "bad boy/bad girl" acts). This protection is provided by a "non-recourse carve out guaranty" that is usually signed by the sponsor only. This sort of guaranty is not relevant for basis allocation. The guaranty is not a guaranty by Sponsor to repay the loan in the event of a bad boy act; it is an agreement to be responsible only for any **damages** that the Bank suffers as a result of the bad acts of the property owner.

However, in addition to non-recourse carve-out guaranties, non-recourse lenders also require creditworthy members of a borrower to execute "springing recourse" guaranties. "Springing recourse" guaranties provide that if the borrower files for bankruptcy, then the springing recourse guarantors become liable for the full repayment of principal and interest on the loan. Most practitioners have not traditionally seen sponsors' "springing recourse" guaranties as shifting the tax basis arising from a loan to the sponsor and away from the institutional investor. Historically, the IRS rules seemed clear that guaranties subject to contingencies that were unlikely to occur (like causing a borrower to file for bankruptcy if that would subject one to personal liability for a debt) would not turn an otherwise non-recourse debt into a recourse one. This risk was further mitigated by provisions of many LLC agreements which allowed a member, who paid the principal of any LLC debt, to make a capital call on the non-guaranteeing members to, in turn, reimburse the paying member for its pro rata share of the debt. Such a provision would have the effect of making all members liable, at least indirectly, for the debt, thereby resulting in them retaining a pro rata share of the debt as part of their basis.

Memorandum 201606027 upsets these assumptions. The Memorandum is not precedential, but some practitioners are concerned that this may be a warning of a more aggressive position by the IRS on this point. The logic of the Memorandum has been criticized by many commentators. It seems to ignore both express provisions of existing regulations (or explains those provisions away in a half-hearted manner) and the realities of modern real estate finance risk allocation. Nonetheless, institutional investors are starting to take notice. We can expect to see lenders insisting on standard springing recourse provisions for bankruptcy to be imposed on sponsors, sponsors being willing to undertake that risk (as has been the custom) and institutional equity investors insisting on eliminating those provisions, posing yet one more challenge to sponsors trying to close transactions with large financial players who have clear conflicting positions.

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