PROSKAUER ROSE LLP

Private Investment Funds

Update

June 2008

In this month's issue:

This newsletter for clients of our Private Investment Funds Practice and friends summarizes recent developments affecting hedge funds, private equity funds, venture capital funds, and their managers.

June 30 Deadline for Reporting Foreign Accounts to U.S. Department of Treasury

U.S. persons who have, or who exercise signatory authority over, foreign accounts generally must file Form TD F 90-22.1 with the Department of Treasury. The filing requirement applies if the aggregate value of all of the U.S. person's foreign financial accounts exceed $10,000 at any time. This law applies to any person who resides in the United States or is a United States citizen, as well as a domestic partnership, corporation, estate, or trust who has a financial interest in or signing authority for a foreign financial account. The filing deadline to report foreign accounts is June 30, 2008. Each instance of failure to file will cost the violator $10,000.

A U.S. person who holds legal title to a foreign account must file. It does not matter whether the title holder manages the account for personal benefit or for the benefit of others. Also, if a person holds more than 50% of stock in a corporation that holds legal title to a foreign account, that person has a financial interest in a foreign account and must file.

Foreign accounts include any bank, securities, securities derivatives, or other financial instruments accounts, as well as commingled funds. The examples below set forth how this law affects U.S. persons holding foreign accounts.

Foreign fund, foreign master fund or foreign feeder fund	A foreign fund is not a U.S. person and therefore does not need to file.
Domestic fund	A domestic fund must file if it has an interest in a foreign account.
Domestic feeder investing in master fund	If a domestic feeder owns more than a 50% interest in either a domestic or foreign master fund that has a foreign financial account, the domestic feeder must file.

General partner or manager of domestic or foreign fund	The general partner or manager only has a financial interest in a foreign account of a fund if it owns an interest in more than 50% of the profits of the fund. The general partner would not have signature or other authority over the fund's accounts because an entity itself cannot have such authority.
Employees of the management company (or others with signature authority) who are U.S. citizens or residents	Any individual having signature or other authority over a foreign financial account must file.
U.S. investors in foreign funds	Since a foreign fund is not a financial account, a U.S. investor in a foreign fund would not have to file unless it owned more than 50% of the fund.

Private Funds Do Not Need To Deliver ADV Part II to Fund Investors

Gene Gohlke, Associate Director of the SEC's Office of Compliance Inspections and Examinations, recently stated that registered investment advisers who manage private funds will not be required to deliver Form ADV Part II to their investors in such funds. This announcement comes in the wake of the February 13, 2008, SEC proposal suggesting that ADV Part II be amended in an effort to require firms to provide more detailed brochures written in plain English.

Private fund chief compliance officers have raised a number of concerns about the SEC's proposal. These include the cost of delivering the forms, the increased disclosure that the proposal would mandate, and the potential disconnect between SEC officials and examiners in the absence of formal guidelines.

In response to the chief compliance officers' fears, Mr. Gohlke has stated that the requirement to provide ADV Part II does not require the delivery of such form to private fund clients. Mr. Gohlke did, however, reaffirm that investors must be provided with detailed offering documents, including any information regarding conflicts of interest.

The Northeast Regional Office of the SEC also has taken a more liberal position with respect to registered investment advisers who advise private funds and fail to deliver a disclosure statement as required by Rule 206(4)-3 (the "Cash Solicitation Rule") of the Investment Advisers Act. The SEC has stated that registered advisers who advise unregistered funds do not need to require delivery of a disclosure statement to fund investors under the rule, although they are still subject to the anti-fraud rules.

Judge Rules Against Hedge Funds in CSX Case, Requires Disclosure of Swap Positions

On June 11, 2008, Manhattan Federal District Court judge Lewis Kaplan ruled that two hedge funds, London-based The Children's Investment Fund and New York-based 3G

Capital, "deliberately evaded disclosure obligations" by forming a group to amass swap positions and waiting months before providing the necessary securities filings. Kaplan said, however, that he could not keep them from voting their holdings at the railroad's June 25 shareholder meeting. Kaplan stated that any penalties for defendants' violations must come by way of appropriate action by the Securities and Exchange Commission or the Department of Justice.

CSX sued to block TCI and 3G from winning five seats on its 12-member board. CSX asserted that TCI and 3G failed to adequately disclose their holdings and should be barred from voting their shares.

TCI and 3G countersued, saying CSX executives engaged in insider trading, which Kaplan dismissed in his ruling. TCI and 3G want CSX to buy back more stock, raise debt and separate the roles of chief executive officer and chairman.

In his decision, Kaplan found that TCI and 3G violated federal rules by not disclosing to the public within 10 days that they had acquired more than 5 percent of CSX and had formed a group. This case is particularly noteworthy because the SEC submitted a letter agreeing with the hedge funds that they did not have to report the shares held pursuant to swaps.

Proposed Legislation Passed by the U.S. House of Representatives Would Limit Deferral of Compensation for Offshore Hedge Fund Managers

On May 21, 2008, the House of Representatives passed the Renewable Energy and Job Creation Act of 2008 (H.R. 6049) (the "Act") that provides for tax breaks for families, businesses and clean energy production and will partially be funded by a new Internal Revenue Code Section 457A that limits a service provider's ability to defer compensation paid by "nonqualified entities." Introduced by House Ways and Means Committee Chairman Charles Rangel (D – NY), the most significant aspects of the proposed new Code Section 457A include the following:

- The Act is aimed at managers of offshore funds and generally eliminates the ability of service providers to certain "nonqualified entities" (e.g., offshore hedge funds) to defer compensation for services performed after December 31, 2008 to the extent such compensation is no longer subject to a "substantial risk of forfeiture" (which is generally limited to the service provider's continued performance of substantial services).

- "Nonqualified entities" include (i) any foreign corporation unless substantially all of its income is effectively connected with a U.S. trade or business or subject to a comprehensive foreign income tax and (ii) any partnership (domestic or foreign) unless substantially all of its income is allocated to persons other than tax-exempt organizations or foreign persons with respect to whom income is subject to a comprehensive foreign income tax.

- Compensation that is not determinable in amount at the time it is no longer subject to a substantial risk of forfeiture and required to be included in income will be subject to an additional 20% penalty and interest at the underpayment plus 1% when such amount is determinable.
- Deferred compensation for services performed prior to 2009 must be included in income by the end of 2017.
- Compensation will not be treated as deferred if the service provider receives payment of the compensation from the nonqualified entity no later than 12 months after the end of the nonqualified entity's taxable year during which the substantial risk of forfeiture lapses.
- Service providers will be allowed to make a charitable contribution of deferred amounts included in income in 2017 without being subject to certain contribution limits.
- The Treasury Department is directed to issue guidance providing for a transition period during which deferred compensation arrangements (including certain back to back deferrals) can be amended to comply with the new law.

New York City Proposes New Taxes on Fund Managers

Lawmakers in The City of New York are considering legislation that would require general partners and managers of a private equity or hedge fund to pay local business income taxes on their share of profits generated by investments.

The City of New York currently taxes management fees that partners receive as their base compensation. The City of New York's 4% unincorporated business tax does not apply, however, to the "carried interest," which typically amounts to 20% of profits and is already subject to personal income taxes. Any change in this tax by The City of New York would require the approval of the New York State legislature.

The City of New York's unincorporated business tax is imposed on incorporated businesses based or partly based in the City, including partnerships, limited liability companies, fiduciary associations, estates, and trusts.

Carried interest earned by hedge fund and private equity managers was previously targeted by Congress. So far such efforts have failed.

California Shelves Registration Proposal

The California Department of Corporations ("CDOC") announced on May 1, 2008, that it would temporarily table a proposed amendment to the California Securities Law that would have required hedge fund and private equity fund advisers to obtain a license from the CDOC.

Section 25230 of California Securities Law requires investment advisers with either a place of business in California or more than five in-state clients to register with the CDOC unless they are already registered with the SEC. Registration may also be avoided under Rule 260.204.9 if the investment adviser:

- does not hold itself out generally to the public as an investment adviser;
- has less than 15 clients;
- is exempt from SEC registration under Section 203(b)(3) of the Investment Advisers Act; and
- either has a minimum of $25,000,000 of assets under management or provides investment advice solely to venture capital companies.

Hedge fund and private equity managers in California are generally able to avoid both federal and state registration under the current regime because only the funds themselves, not individual investors, are considered to be "clients."

The proposed amendment to the California Securities Law would have eliminated the less than 15 clients exemption, as well as the $25,000,000 asset minimum currently included in Rule 260.204.9.

UK FSA Adds New Short Selling Rules During Rights Offerings

On June 13, 2008, the UK Financial Services Authority made a surprise announcement that from June 20, 2008, short sellers would have to disclose significant short positions in stocks admitted to trading on prescribed markets where there is an ongoing rights issue. A significant short position will be defined as 0.25% of the issued shares or any instruments giving rise to an equivalent economic interest. The obligation will be to disclose positions exceeding this threshold to the market by means of a Regulatory Information Service by 3.30 pm the following business day.

The FSA considered it necessary to take these immediate steps given the severe volatility in the shares of certain companies currently conducting rights issues. The FSA confirmed that it regards short selling generally as a legitimate technique which assists liquidity and is not in itself abusive, but pointed out that the rights issue process does provide greater scope for what might amount to market abuse, particularly in current market conditions.

These steps could prove temporary in effect, however, depending on the results of a wider UK review of how capital raising by listed companies can be made more orderly and efficient. At the recent G8 finance ministers meeting, the UK Treasury made it clear that these rules were a temporary response to a particular problem that had arisen over rights issues, particularly in the UK banking sector.

Third Decision on Hedge Fund Disclosure in Bankruptcy Case

Last month, a Delaware Bankruptcy Court judge weighed in on the issue of requiring hedge funds to publicly disclose information, including purchase price information, regarding their holdings in bankruptcy cases when they participate in an informal or ad hoc committee. The Delaware ruling, the third on the issue, allowed purchase price information to be kept confidential, departing from an earlier ruling by a New York Bankruptcy judge that generated significant concern in the hedge fund industry regarding the potential to 'chill' participation in bankruptcy cases.

The disclosure controversy began in February of this year when Judge Allen L. Gropper, presiding over the *Northwest Airlines* case, strictly enforced Bankruptcy Rule 2019. That rule requires any entity or committee representing one or more creditors to file a statement setting forth (1) the name and address of the creditor or shareholder; (2) the nature, amount of claim, and date of acquisition; (3) the pertinent facts regarding the employment of the entity; and (4) the amounts of the claims, the members of the committee, the times acquired and the amounts paid. In the *Northwest* case, an ad hoc committee of hedge funds was required to publicly disclose all their trading data.

After the *Northwest* decision, in the *Scotia Pacific* case (pending in Texas) a similar motion was made to require an ad hoc committee of noteholders to make the Rule 2019 disclosures required by Judge Gropper. The noteholder group opposed the motion, arguing that it was not purporting to represent other noteholders and thus the Rule 2019 was not applicable. The *Scotia* court accepted the noteholders' argument, and held that the disclosure rule was not applicable because the group was not a "committee."

The recent Delaware decision which occurred in the *Sea Containers* case took a different approach and required the noteholder group to file all the information other than price required under Rule 2019. Because three judges have adopted three different approaches to hedge fund disclosure, this unsettled issue may impact hedge fund participation in bankruptcy cases.

U.S. District Court Affirms Denial of Recognition of Foreign Hedge Fund Bankruptcy

Many offshore hedge funds in financial distress have attempted to commence foreign insolvency proceedings, which many consider more debtor friendly and less costly and intrusive than a U.S. bankruptcy case, and use Chapter 15 of the U.S. Bankruptcy Code to obtain an injunction to protect their assets in the U.S. In early June, the U.S. District Court for the Southern District of New York affirmed a Bankruptcy Court decision denying recognition under Chapter 15 of the U.S. Bankruptcy Code of two Cayman Island winding-up proceedings commenced by two Bear Stearns hedge funds, thereby precluding their use of the "best of both worlds" approach.

The court held that the hedge funds lacked either of the two jurisdictional requirements for Chapter 15; i.e., that there must be a foreign "center of main interests" similar to a principal place of business, or a foreign "establishment" where it conducts business overseas. Because the hedge funds at issue conducted all their material activities in the U.S. and their only nexus with the Cayman Islands was that it was their registered office, the court held that they lacked either of the two prerequisites. The court held that these hedge funds could only utilize the U.S. bankruptcy laws by commencing a plenary Chapter 7 or Chapter 11 case in the United States. The same approach was adopted by another Bankruptcy Court judge in the *Basis Yield* case. It is notable that recognition was denied in the *Bear Stearns* and *Basis Yield* hedge funds cases even though no creditor objected.

Accordingly, offshore hedge funds cannot count on commencing a foreign insolvency proceeding and getting assistance from a U.S. bankruptcy court in preventing creditors from pursuing U.S. assets. Instead, they may have to commence full-blown U.S. bankruptcy cases.

New York Appellate Court Upholds Nonsolicitation and Liquidated Damages Claims Under Partnership Agreements

On May 30, 2008, New York's Appellate Division, First Department rendered a unanimous decision upholding client non-solicitation, employee no-raid and liquidated damages provisions in an accounting firm partnership agreement against former partners who had resigned and formed a competing entity.

On July 30, 1999, Jeffrey Coopersmith, Michael Simon and William Vogel entered into a merger agreement to combine their accounting firm, Lopez, Edwards, Frank & Co., LLP, with Weiser and become Weiser partners. In addition to the merger agreement, the former partners signed a partnership agreement which included, among other things, a restrictive covenant and a liquidated damages provision. In April 2005, the former partners gave notice of withdrawal from Weiser and stated their intent to continue to service the clients they had brought to the firm, clients referred to them by these clients, and clients from referral services utilized prior to the date of merger-approximately 482 clients in total.

The Appellate Division held that Weiser had established a *prima facie* case for enforcing the restrictive covenant and liquidated damage claims. Specifically, the Appellate Division held that:

- The restrictive covenant was ancillary to the 1999 sale of the business to Weiser and it was enforceable because "it is not more extensive than reasonably necessary to protect Weiser's legitimate interest in enjoying the assets and goodwill it had acquired pursuant to the merger agreement." Significantly, by characterizing the case as a "sale of business case" rather than an employment agreement dispute, the Appellate Division rejected the application of the *BDO Seidman v. Hirshberg,* 93 N.Y.2d 382 (1999), carve-out – namely, that an accounting firm employer had no "legitimate employer interest" in extending a restrictive covenant to "personal clients" of an employee who came to the firm solely to avail themselves of the employee's services and as a result of the employee's own 'independent recruitment efforts."

- The amount stipulated as liquidated damages was "tied to what an arm's length purchaser would have paid for a lost client account as a firm asset on a sale of Weiser's practice, and, as such, is a reasonable measure of the anticipated probable harm from a breach of the restrictive covenant." The claimed liquidated damages in the case totaled approximately $3 million. It remains to be seen whether, on remand, the former partners will be able to rebut this *prima facie* case and whether the claimed $3 million in liquidated damages will be considered reasonable.

- Weiser presented viable claims for breach of fiduciary duty based on the former partners' pre-departure acts that "conflicted with Weiser's interests, including using its staff and equipment to set up their new firm and soliciting its [Weiser] clients and employees to follow them to their new firm." Such acts, the Appellate Division held, "amounted to more than merely informing Weiser's clients and employees of their impending withdrawal" and, thus, violated the WPA.

Please click below to view the full client alert prepared on this decision by the firm's Non-Compete and Trade Secrets Practice Group: http://www.proskauer.com/news_publications/client_alerts/content/2008_06_04/_res/id=PDF/16408-060408-NY%20Appellate%20Court%20Upholds%20Client%20Non-Solicit-ca-v2.pdf

Private Investment Funds Practice

Our Private Investment Funds Group comprises more than 100 lawyers and advises clients worldwide on all of the legal and business issues important to private equity and hedge funds and their managers, including structuring investment vehicles of all types, portfolio company investments, institutional investor representation, and secondary purchases and sales.

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