Dentons Private Equity Fund Manager's Report™
Volume 1, Issue 3 – Spring 2016

From the Editor

Welcome aboard

Welcome to the third issue of the Dentons Private Equity Fund Manager's Report. It is our intention to periodically provide our friends, clients and others interested in the world of private equity with practical information that can be used by fund managers in the course of their business activities.

In this issue we address certain topics material to the current economic and political environment, such as the current state of play of cannabis investing, the effect of recently proposed Treasury regulations on general partner compensation for services and the use of interest rate hedge agreements in financing transactions. We also review the current implications of statements made outside the four corners of a contract. Finally, we provide some guidance to private equity funds regarding the retention of independent experts in working capital disputes.

We hope that the information we provide will alert you to issues of importance that you can utilize for your benefit. We welcome your input and suggestions about the type of information you want to receive as well as an honest critique of what we have provided. Should you wish to provide "war stories" that would assist others in similar situations, with or without attribution, or if you are seeking to hire investment professionals or obtain industry insights; if you want to dispose of an investment, hire a CFO or meet an equity sponsor or a mezzanine lender—we are very active in this marketplace and are pleased to act as a conduit to our readership and to our relationships. We will benefit if you benefit and we seek to align our interests. Thank you, and let us hear from you!

Stephen M. Fields,
Partner, Corporate practice

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Cannabis investing—a safe high?

By: Adam H. Dunst*

The successive legalization of adult recreational use of marijuana in four states—Colorado, Washington, Oregon and Alaska—and the District of Columbia, as well as legalization of marijuana for medical use to varying degrees in 23 states, has triggered the interest of potential private equity investors who are seeking to claim an early stake in a growing industry with potentially high returns. Altogether, nearly half of the states in the US have legalized the use of marijuana to some degree for medical and/or recreational purposes, each state with its own set of restrictions. The legal marijuana industry has been valued at $1.5 billion in 2013[1], $2.7 billion in 2014[1], $3.5 billion in 2015[1], and is projected to reach $8 billion by 2018.[2] Furthermore, several ballot and legislative actions are currently being planned with respect to legalization of marijuana in 2016 in a number of states.[3] According to one industry research group, 14 states are projected to pass new adult recreational use laws by 2020.[4] Nevertheless, while the industry and its anticipated potential growth may create excitement, investors should be cognizant of the various legal risks involved in investing in the industry, especially since the laws surrounding cannabis seem to be continuously in flux, involve federal versus state considerations, and are not likely to be consolidated in the near future.

Federal law - Illegality and Uncertainty

The US federal government's position regarding the legality of marijuana is not consistent with state-level legalization developments, causing confusion as to the legal implications for the cannabis industry. At the federal level, marijuana is still classified as a Schedule I substance, along with heroin, LSD, peyote, and ecstasy, under the federal Controlled Substances Act (CSA) of 1970.[5] According to the CSA, Schedule I substances have (a) no currently accepted medical use in the US, (b) a lack of accepted safety for use under medical supervision, and (c) a high potential for abuse.[6]

In the landmark case *Gonzales v. Raich*[7], the US Supreme Court upheld Congress' power under the Commerce Clause under the Constitution to prohibit purely intrastate cultivation and possession of marijuana, even where a state approves its use for medicinal purposes. As such, businesses that engage in any form of commerce in the marijuana industry, whether as manufacturers, distributors or dispensaries, as well as individuals who purchase and use marijuana-derived products, remain subject to possible federal prosecution and seizure of assets. The risk for a private equity investor is that federal enforcement could lead to dissolution or discontinuance of operations, leaving investors with no recourse to recover their funds. Given the illegality of marijuana under federal law, private equity investors should also be aware that investing in a marijuana-related business may violate the federal anti-money laundering statutes, 18 U.S.C. §1956 and §1957.[8]

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* With significant assistance from Taeyoung Kim.

[1] The State of Legal Marijuana Markets, 3rd Edition, ArcView Market Research, January 26, 2015.

[2] "Why Legal Cannabis Is 2015's Best Startup Opportunity," Forbes, February 5, 2015. http://www.forbes.com/sites/caroltice/2015/02/05/why-legal-cannabis-is-2015s-best-startup-opportunity/

[3] "STATE VIEW: The year of marijuana; Another prohibition is about to fall - to our benefit," MetroWest Daily News, January 3, 2016.

[4] The State of Legal Marijuana Markets, 3rd Edition, ArcView Market Research, January 26, 2015.

[5] Title 21 U.S.C.A. Controlled Substances Act § 812 - Schedules of controlled substances.

[6] Id.

[7] Gonzales v. Raich, 545 U.S.1 (2005).

[8] Title 18 U.S.C.A. §1956 - Laundering of monetary instruments; §1957 - Engaging in monetary transactions in property derived from specified unlawful activity.

The US Department of Justice under the Obama administration has published several guidances[9] regarding marijuana enforcement and the interpretation of the CSA in light of state-level legalization efforts and the ensuing legal uncertainty, the most recent of which, also known as the "Cole Memo"[10] published on August 29, 2013, reflects the administration's approach to state reform. The Cole Memo clarified that it will not challenge state laws and will generally rely on state and local enforcement agencies to address marijuana activity as long as marijuana sales do not conflict with the following eight federal enforcement priorities to:[11]

1. Prevent distribution of marijuana to minors;
2. Prevent revenue from the sale of marijuana going to criminal enterprises, gangs, and cartels;
3. Prevent diversion of marijuana from the state where it is legal under state law in some form to other states;
4. Prevent state-authorized marijuana activity from being used as a cover or pretext for the trafficking of other illegal drugs or other illegal activity;
5. Prevent violence and the use of firearms in the cultivation and distribution of marijuana;
6. Prevent drugged driving and the exacerbation of other adverse public health consequences associated with marijuana use;
7. Prevent the growing of marijuana on public lands and the attendant public safety and environmental dangers posed by marijuana production on public lands; and
8. Prevent marijuana possession or use on federal property.

Altogether, nearly half of the states in the US have legalized the use of marijuana to some degree for medical and/or recreational purposes, each state with its own set of restrictions. The legal marijuana industry has been valued at $1.5 billion in 2013[1], $2.7 billion in 2014[1] , $3.5 billion in 2015[1], and is projected to reach $8 billion by 2018[2].

The US Congress has also shown some signs that it prefers to defer to state or local enforcement agencies regarding the regulation of state-legal medical marijuana. The bipartisan spending bill passed by Congress in December 2014 and then renewed in December 2015 included a section, also known as the Rohrabacher-Farr Medical Marijuana Amendment (the Amendment), which prohibits the Department of Justice from expending any federal funds to prevent each of the District of Columbia and 32 other listed states from implementing its own district or state laws that authorize the use, distribution, possession, or cultivation of medical marijuana.[12] On October 19, 2015, in *U.S. v Marin Alliance for Medical Marijuana* (MAMM), the US District Court for the Northern District of California held that under the Amendment, the Department of Justice's permanent injunction against MAMM's distribution of medical marijuana could only be enforced against MAMM insofar as that organization is in violation of state laws that authorize the use, distribution, possession, or cultivation of medical marijuana.[13]

[9] Investigations and Prosecutions in States Authorizing the Medical Use of Marijuana, US Department of Justice, Office of the Deputy Attorney General, David W. Ogden, October 19, 2009; and Guidance Regarding the Ogden Memo in Jurisdictions Seeking to Authorize Marijuana for Medical Use, US Department of Justice, Office of the Deputy Attorney General, James M. Cole, June 29, 2011.

[10] Guidance Regarding Marijuana Enforcement, US Department of Justice, Office of the Deputy Attorney General, James M. Cole, August 29, 2013.

[11] Id.

[12] 2016 Consolidated Appropriations Act §542 (2015). States include: Alabama, Alaska, Arizona, California, Colorado, Connecticut, Delaware, Florida, Hawaii, Illinois, Iowa, Kentucky, Maine, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, Missouri, Montana, Nevada, New Hampshire, New Jersey, New Mexico, Oregon, Rhode Island, South Carolina, Tennessee, Utah, Vermont, Washington, and Wisconsin.

[13] *U.S. v. Marin Alliance for Medical Marijuana*, No. C98-00086 CRB (2015). California passed the Compassionate Use Act in 1996. In 1998, the Department of Justice filed an action in the US District Court for the Northern District of California seeking declaratory and injunctive relief against MAMM, a medical marijuana dispensary in California, on the grounds that it was engaged in the distribution of marijuana in violation of the CSA even though MAMM's activities were legal under California law. MAMM continued to operate, and another round of lawsuits ensued, as a result of which the US District Court for the Northern District of California ordered a permanent injunction against MAMM in 2002. In response to MAMM's continued operations, the US Attorney's Office pressed for enforcement action against MAMM in 2011. After the passage of the 2015 congressional spending bill that included the Amendment as Section 538 of the bill, MAMM argued that the injunction was now unenforceable under Section 538 and should therefore be dissolved.

While the guidance in the Cole Memo and the Amendment reflect the Obama administration's level of deference to state laws, investors should be reminded that guidance is not law and that the Amendment will expire when the current fiscal year concludes on September 30, 2016, if not renewed by the next congressional spending bill.[14] The congressional spending bill for the fiscal year ending September 30, 2016 does not preclude a federal prosecutor or a state attorney general from pursuing violators of the CSA who use, distribute, possess or cultivate marijuana for non-medical purposes.

Nevertheless, while there is uncertainty regarding how the federal government will interpret and enforce the CSA going forward, perhaps the Compassionate Access, Research, Expansion, and Respect States Act (CARERS) of 2015, a comprehensive piece of federal medical marijuana legislation introduced in the US Congress, may help to settle the state-federal conflict over the legality of medical marijuana. The CARERS Act would have far-reaching impacts, including: (a) allowing state programs to continue without federal interference; (b) transferring marijuana from Schedule I to Schedule II of the CSA; (c) removing cannabidiol from the definition of marijuana; and (d) creating access to banking services for legal marijuana businesses.[15]

State laws - Variations and Uncertainty

Interested investors should also be aware that a patchwork of varying state laws makes a one-size-fits-all approach to investment decisions impossible. For recreational marijuana, differences across state laws where there is any recreational legality include the amount of marijuana that an individual can possess, number of plants one can grow for recreational purposes, and license application requirements.[16] Furthermore, for a particular state that has at least in some part legalized marijuana, it is possible that not every governing authority is on board with the legalization. For example, although Oregon has legalized adult recreational use, dozens of cities and counties in Oregon have banned or put moratoriums on marijuana sales.[17]

For medical marijuana, differences across the 23 states that have legalized marijuana for medical use to some degree include restrictions with respect to the amount of marijuana that patients may possess, number of plants they may grow for medical purposes, whether dispensaries are allowed, the types of medical conditions legally treatable with marijuana, and whether other states' medical marijuana cards are recognized.[18] States also vary on the forms of medical marijuana they allow. For instance, many states allow marijuana-derived products with cannabidiol (CBD), a compound that possesses anti-inflammatory, antioxidant, anti-anxiety, and anticonvulsant effects that can help to treat diseases such as epilepsy, PTSD, schizophrenia and multiple sclerosis, but restrict marijuana-derived products with tetrahydrocannabinol (THC), a compound that induces psychoactive effects.[19]

Private equity investors should also be aware of potential criminal liability depending on their own state laws. Investors located in states where marijuana remains illegal may be at risk of prosecution under state conspiracy, aiding and abetting laws and money laundering statutes, and may be at risk of losing their investments or proceeds under state criminal and civil forfeiture laws.[20]

Investor Compliance Requirements

Investors interested in an equity stake in marijuana businesses may be required to comply with certain state requirements, such as residency requirements, and financial and criminal background checks. Equity

[14] "Congress' Conflicting Approach Toward Medical Marijuana," Law360, January 13, 2016. https://www.law360.com/articles/745597/congress-conflicting-approach-toward-medical-marijuana

[15] S.683 - Compassionate Access, Research Expansion, and Respect States Act of 2015, 114th Congress (2015-2016).

[16] Marijuana Resource Center: State Laws Related to Marijuana, Office of National Drug Control Policy. https://www.whitehouse.gov/ondcp/state-laws-related-to-marijuana

[17] "Oregon Cities/Counties Opt Out of Legal Cannabis", Cannabis Public Media, August 28, 2015. http://www.marijuanapublicmedia.org/oregon-citiescounty-opt-out-of-legal-cannabis/

[18] Marijuana Resource Center: State Laws Related to Marijuana, Office of National Drug Control Policy. https://www.whitehouse.gov/ondcp/state-laws-related-to-marijuana

[19] "5 Must-Know Facts About Cannabidiol," Leaf Science, February 23, 2014. http://www.leafscience.com/2014/02/23/5-must-know-facts-cannabidiol-cbd/

[20] In New York, for instance, the following laws may apply: N.Y. Criminal Procedure Law §20.20 - Geographical jurisdiction of offenses; jurisdiction of state; N.Y. Penal Law §470 - Money Laundering; N.Y. Penal Law §480 - Criminal Forfeiture; and New York's Civil Practice Laws and Rules Article 13-A - Proceeds of a Crime - Forfeiture.

investors in marijuana businesses may be required to meet specific criteria in order for a business to apply for and maintain a license to conduct business in the marijuana industry. With respect to private equity funds that invest in marijuana businesses in states where such investments are legal, analyses should be conducted in each such state to determine the applicability of such state's compliance requirements to the general partner, passive limited partners and the fund managers. The following table summarizes residency requirements for owners or investors in marijuana businesses in the four states where adult recreational marijuana use has been legalized:

Colorado	In order to be eligible to apply for Marijuana Enforcement Division (MED) Medical Marijuana Business License or MED Retail Marijuana Business License, all owners[21] must be residents of Colorado for two years prior to application. [22]
Washington	Six-month residency in Washington is required for new license applications and for new financiers and members of the business.[23] A marijuana license applicant means any person or entity who is considered as a true party of interest in a marijuana license, and includes (i) any entity or person who is in receipt of, or has the right to receive, a percentage of the gross or net profit from the licensed business during any full or partial calendar or fiscal year and (ii) any entity or person who exercises control over the licensed business in exchange for money or expertise. [24]
Oregon	Two-year residency requirement (until January 1, 2020) for all applicants listed on a license application, including all partners in a limited partnership, all members of a limited liability company, all directors and principal officers of a corporate entity, and any individual who owns or controls at least 10 percent of the business.[25] At least one applicant or the sum of applicants listed must be a "legitimate owner" (own at least 51 percent) of the business.[26]
Alaska	Effective as of February 21, 2016, marijuana businesses must be 100 percent owned by residents of Alaska, which means all partners of a partnership, all members of a limited liability company, and all shareholders of a corporation must be residents of Alaska.[27] To be an Alaska resident, a license applicant must meet the residency requirement for voting in Alaska and must not be registered to vote in any other state.[28] A person other than a licensee may not have a direct or indirect financial interest in the business for which a marijuana establishment license is issued. [29]

[21] According to Current Amalgamated Retail Marijuana Rules by Colorado's Marijuana Enforcement Division, R 103, "Owner" means "the Person or Persons whose beneficial interest in the license is such that they bear risk of loss other than as an insurer, have an opportunity to gain profit from the operation or sale of the establishment, and have a controlling interest in a Retail Marijuana Establishment license…," updated November 30, 2015.

[22] Business License Applicant Criteria, Colorado Department of Revenue, Enforcement Division. https://www.colorado.gov/pacific/enforcement/application-and-licensing-marijuana-enforcement

[23] Marijuana Licensing FAQ, Washington State Liquor and Cannabis Board. http://www.liq.wa.gov/mjlicense/mj_licensing_faq

[24] Title 314 Washington Administrative Code, Chapter 55 §10 and §35.

[25] Temporary Rules on Recreational Marijuana 845-025-1045 - Qualifications of an Applicant, Oregon Liquor Control Commission, Division 25, updated December 21, 2015.

[26] Id.

[27] Title 3 Alaska Administrative Code 306.015 - License conditions.

[28] Id.

[29] Id.

Other Considerations

(1) Financial Institutions

Financial institutions have been reluctant to provide services to marijuana-related businesses. Thus, on February 14, 2014, to allay their concerns of violating the CSA, US Treasury's Financial Crimes Enforcement Network (FinCEN) published guidance intending to (a) clarify how banks can provide services to marijuana-related businesses consistent with their Bank Secrecy Act obligations, (b) enhance the availability of financial services for marijuana-related businesses, and (c) enhance the financial transparency of marijuana-related businesses.[30]

The FinCEN guidance also discusses appropriate customer due diligence and thorough risk analysis to be conducted by financial institutions, and creates a three-tiered system for filing Suspicious Activity Reports (SARs) for marijuana-related businesses. For example, financial institutions must use the following labels when filing SARs based on their reasonable belief as to whether the business implicates one of the Cole Memo priorities: "Marijuana Limited" for a business that does not implicate a Cole Memo priority, "Marijuana Priority" for a business implicating one or more of the Cole Memo enforcement priorities, and "Marijuana Termination" for when a financial institution terminates a relationship with a marijuana-related business.[31]

In conjunction with the February 14, 2014 FinCEN guidance, the Department of Justice also published guidance on the same day as the FinCEN guidance regarding marijuana-based financial crimes. It clarified that if a bank offers services to marijuana-related businesses whose activities do not implicate any of the eight enforcement priorities outlined in the Cole Memo, then prosecution may not be appropriate.[32] The February 14, 2014 FinCEN guidance and Department of Justice guidance, and further developments, such as the Marijuana Businesses Access to Banking Act of 2015, which has been introduced and is pending before Congress, were created to protect financial institutions that provide financial services to marijuana-related businesses.[33]

However, nothing in the February 14, 2014 FinCEN guidance and Department of Justice guidance precludes investigation or prosecution, even in the absence of implicating one of the eight Cole Memo priorities, and providing financial services to marijuana-related businesses still remains illegal under federal law. Furthermore, on January 5, 2016, a federal judge in Denver rejected a Colorado credit union's bid to force the Federal Reserve Bank of Kansas City to grant it a master account to serve Colorado's legal marijuana businesses, on the grounds that the master account would violate federal law.[34] Because of risk aversion tendencies by financial institutions, the marijuana industry is still driven primarily by cash transactions.[35] As such, these businesses are unable to reap the potential benefits of loan services or credit cards, and must incur costs and expenses for security, such as safes, armored vehicles and security guards to prevent theft.

(2) Issues of Transportation

Interstate transportation of marijuana is prohibited under the CSA, and this includes transportation among states that have legalized marijuana such as Washington and Oregon.[36] In fact, the US Drug Enforcement Administration has provided a chart that explains the penalties for trafficking marijuana.[37] Thus, marijuana must be consumed in the same state of purchase and cannot be transported from a producer in one state to a distribution or retailer in another. Furthermore, there are legal implications of transporting marijuana within a particular state. First, if marijuana is illegal within a particular state, transportation of marijuana will also be illegal in that state.[38] In states

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[30] BSA Expectations Regarding Marijuana-Related Businesses, Guidance FIN-2014-G001, Department of the Treasury, FinCEN, February 14, 2014.

[31] Id.

[32] Guidance Regarding Marijuana Related Financial Crimes, Department of Justice, Office of the Deputy Attorney General, James M. Cole, February 14, 2014.

[33] S.1726 - Marijuana Businesses Access to Banking Act of 2015, 114th Congress (2015-2016).

[34] *Fourth Corner Credit Union v. Federal Reserve Bank of Kansas City*, No. 15-cv-01633-RBJ, 2016 WL 54129 (D. Colo. Jan. 5, 2016).

[35] For instance, Chase bank recently closed the account of a California-based online media company that operates a website discussing the health benefits of marijuana because of "reputational risk," according to Forbes. "Chase Closes A Marijuana Media Account," Forbes, February 4, 2016.

[36] "Moving Marijuana Across State Lines: Still A Felony," Canna Law Blog, January 6, 2015. http://www.cannalawblog.com/moving-marijuana-across-state-lines-still-a-felony/

[37] Federal Trafficking Penalties for Marijuana, Hashish and Hashish Oil, Schedule I Substances, US Drug Enforcement Administration. http://www.dea.gov/druginfo/ftp_chart2.pdf

[38] "Transporting Marijuana: Laws and Regulations", FindLaw, Thomson Reuters. http://smallbusiness.findlaw.com/business-laws-and-regulations/transporting-marijuana-laws-and-regulations.html

that have legalized marijuana to some degree, the laws regarding transportation are different for individual users and for marijuana businesses, with requirements differing from state to state.[39]

(3) No Tax Benefits

Investors should be reminded that due to the Schedule I status of marijuana under the CSA, a number of standard tax exemptions for businesses do not apply to sales of marijuana under the Internal Revenue Code § 280E.[40] As such, businesses can legally deduct only the cost of goods sold and cannot legally deduct significant business expenses such as employee wages, rent, health insurance premiums, utility costs and advertising.[41] Thus, while a typical business pay taxes on net profits, marijuana-related businesses should pay taxes on their gross income. Furthermore, states may impose various excise and sales taxes on the sale of marijuana and marijuana infused products. For example, Colorado imposes 15 percent marijuana excise tax, plus 10 percent retail marijuana special sales tax, plus 2.9 percent retail and medical marijuana sales tax.[42]

(4) Restricted Advertising Opportunities

Marijuana-related businesses may be limited in their marketing and advertising options, given that television networks can be subject to legal prohibitions with regards to transmitting advertisements to promote the sale of marijuana. Section 843 of the CSA prohibits using "communications facilities" to transmit advertisements for the sale of Schedule I drugs such as marijuana.[43] Despite the legalization of marijuana in Colorado, the first television commercial advertising the sale of recreational marijuana scheduled to air on Denver-based ABC affiliate KMGH was pulled at the last minute due to concerns about the lack of clarity around federal regulations that prohibit marijuana advertising on television.[44] While the Federal Communications Commission (FCC) has not yet issued any guidance or rulings with respect to marijuana advertisements, it is possible that the FCC will not renew a broadcaster's license the following year if a broadcaster has committed a felony by violating Section 843 of the CSA.[45] Therefore, broadcasters may continue to show reluctance with regards to airing advertisements promoting the sale of marijuana on television.

Furthermore, marijuana-related businesses may face restrictions with regards to using the U.S. Postal Service to distribute advertisements. For example, a notice issued by the Portland, Oregon, District Mailing Requirements Office, US Postal Service on November 27, 2015, wrote: "If an advertisement solicits the mailing of controlled substances such as marijuana, it would violate USPS mailing standards. Marijuana is classified as a Schedule I controlled substance.... CSA § 843(c) does make it unlawful to place an ad in any publication with the purpose of seeking or offering illegally to receive, buy, or distribute a Schedule I controlled substance.... If an advertisement advocates the purchase of clinical marijuana through a Medical Marijuana

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[39] Id.

[40] 26 U.S. Code §280E - Expenditures in connection with the illegal sale of drugs.

[41] "Internal Revenue Code Section 280E: Creating an Impossible Situation For Legitimate Businesses," National Cannabis Industry Association. https://thecannabisindustry.org/uploads/2015-280E-White-Paper.pdf

[42] Colorado Marijuana Tax Data, Colorado Department of Revenue. https://www.colorado.gov/pacific/revenue/colorado-marijuana-tax-data

[43] Title 21 U.S.C.A. Controlled Substances Act § 843 - Prohibited acts. The term "communication facility" means any and all public and private instrumentalities used or useful in the transmission of writing, signs, signals, pictures, or sounds of all kinds and includes mail, telephone, wire, radio, and all other means of communication.

[44] "Marijuana Advertising: You Can't Do that On TV," Canna Law Blog, July 26, 2015. http://www.cannalawblog.com/marijuana-advertising-you-cant-do-that-on-tv/

[45] *Id.*

Dispensary, it does not comply with CSA § 843(c)."[46] This notice effectively ended any distribution of any marijuana advertisement through this local office in Oregon. While it is unclear whether this notice affects other US Postal Service offices in other states, since the notice did not directly come from US Postal Services headquarters, advertising efforts via the postal service in other states may be obstructed in the future.

(5) Intellectual Property

Under the US trademark laws, federal trademark registration can be granted only in connection with goods and services lawfully regulated by commerce.[47] Thus, the US Patent and Trademark Office (USPTO) has consistently refused to register marijuana-related trademarks, given the illegal status of marijuana under the CSA. However, the USPTO may trademark ancillary products (e.g., non-infused foods and candies sold in dispensaries) that are not related to the production and dissemination of marijuana.[48] Further, a business may protect its brand by registering its trademark with one or more states where marijuana is legal and where its brand or logo actually qualifies for a trademark, as long as it does not infringe any other trademarks.[49]

Conclusion

In sum, there is a range of legal issues in the marijuana industry that warrant careful consideration by potential investors, including private equity investors. Investing in the legal marijuana industry requires an understanding of the implications of the most recent changes to laws and regulations, proposed bills, other publications by federal or state authorities, and court cases. In particular, in 2016, potential investors should stay abreast of the status of bills under discussion in Congress, such as the CARERS Act of 2015 and the Marijuana Businesses Access to Banking Act of 2015 (as mentioned above), and the status of pending marijuana legalization bills in several states, including Massachusetts, California, Maine, Arizona, Nevada, Vermont and Rhode Island.[50]

[46] Mailpieces Containing Advertisements About Marijuana, U.S. Postal Service, Portland District Mailing Requirements, November 27, 2015.

[47] 15 U.S.C. §1051 (d).

[48] "Marijuana Trademarks," Canna Law Blog, September 29, 2014. http://www.cannalawblog.com/marijuana-trademarks/

[49] In Colorado, there are approximately 700 trade names and 200 trademarks registered that include the word "marijuana" or a synonym.

[50] "STATE VIEW: The year of marijuana; Another prohibition is about to fall - to our benefit," MetroWest Daily News, January 3, 2016.

Hedging your bet—interest rate risk in financing transactions

By Jeffrey Koppele[1]

The expression that "a rising tide lifts all boats" may be easy to disregard in today's "low tide" of interest rates, but investors and companies that fail to have an appropriate hedge program in place risk being flooded by unanticipated financing costs as the tide inevitably starts to rise. The Federal Reserve appears poised to continue raising its federal funds rate target in 2016. Although many factors influence long-term rates, increases in short-term rates make material increases in long-term rates more likely. Higher long-term rates in turn could expose borrowers in various market segments to considerable hardship.

The three most common types of interest rate hedge products are rate caps, interest rate swaps and collars.

Liberal underwriting standards and a proliferation of lenders have allowed equity investors, for example, to finance huge amounts and to refinance at their convenience. Corporate debt has also increased dramatically in the seven years since the financial crisis. Effectively managing interest rate risk will be of vital importance to many market participants in the months ahead.

One of the primary ways in which borrowers can mitigate interest rate risk in financing transactions is through the use of interest rate hedge agreements, which provide both borrowers and lenders with protection against escalating rates. This article raises and addresses several key issues, from both lender and borrower perspectives, including the basic types of hedging agreements, the Dodd-Frank restrictions on eligible contract participants, security and collateral considerations, including Dodd-Frank clearing and margin requirements, and bankruptcy and offset issues.

Basic types of hedge agreements

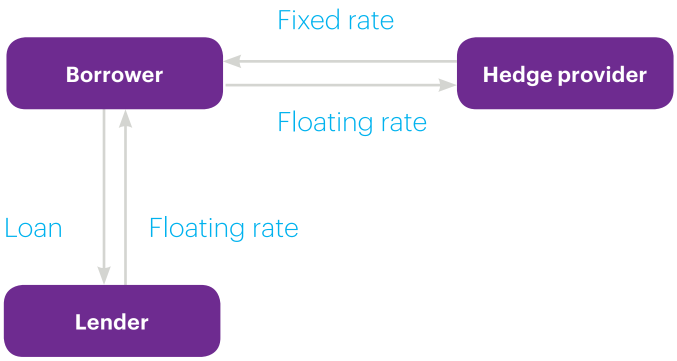
The three most common types of interest rate hedge products are rate caps, interest rate swaps and collars. The following paragraphs explain how a borrower may use these products to hedge interest rate exposure on a floating rate loan.

In a rate cap transaction, a borrower and hedge provider agree to a maximum interest rate, known as the "cap rate" or "strike rate." If the floating interest rate index governing the underlying loan (the loan index rate), typically LIBOR, climbs above this strike rate, the hedge provider pays the borrower the excess. In exchange, the borrower pays the hedge provider a one-time fee when the agreement is signed. The result is that the borrower receives protection against any subsequent increase in LIBOR above the cap rate without surrendering the benefits of any subsequent declines in rates.

An interest rate swap effectively converts a floating rate obligation into a fixed rate obligation. Under the swap agreement, the borrower agrees to pay a fixed rate to the hedge provider, and the hedge provider agrees to pay a floating rate, again, usually LIBOR, to the borrower. If the loan index rate rises above this fixed rate, the hedge provider pays the borrower the difference. If the loan index rate falls below the fixed rate, the borrower pays the hedge provider the difference. When the payments between the parties under the interest rate swap are combined with the floating rate index payable on the loan, the net rate paid by the borrower will always be equal to the fixed rate specified in the swap agreement. The borrower is thus said to have "swapped" its floating rate obligation for a fixed rate obligation. Note that a borrower would also generally be required to pay the margin set forth in the loan agreement (typically a fixed number of basis points). Although there is generally no upfront fee associated with an interest rate swap, the borrower will be required to make payments to the hedge provider during periods when the loan index rate is below the agreed upon fixed rate. The structure of an interest rate swap used to hedge a floating rate loan is illustrated below.

[1] This article is based in part on an article co-authored by the author, Gary A. Goodman, a partner in Dentons, and Malcolm K. Montgomery, a partner at Shearman & Stearling LLP. The author gratefully acknowledges their contributions. Any errors in this article are the sole responsibility of the author.

Fixed-for-floating interest rate swap



A collar transaction effectively sets both a maximum and minimum interest rate. If the loan index rate remains between the maximum and minimum rates specified in the collar (referred to as the cap strike and floor strike, respectively), the borrower neither makes nor receives payments under the collar. If the loan index rate rises above the cap strike rate, the hedge provider pays the difference to the borrower. Conversely, if the floating interest rate dips below the floor strike rate, the borrower pays the difference to the hedge provider. The borrower is thereby exposed only to the confined range of interest rate fluctuations between the cap strike and floor strike rates, and is protected in the event rates rise above the cap strike rate. In addition, although the borrower retains some of the potential benefit associated with declining interest rates, the borrower surrenders the savings that would accrue if rates were to dip below the floor strike rate. In exchange for protection in the high rate scenarios, the borrower may be required to pay the hedge provider an upfront fee, which would typically be lower than the fee required under a rate cap. In some cases the fee may be waived altogether, if the value of potential payments to the hedge provider in the low rate scenario adequately compensates the hedge provider for its potential costs in the high rate scenario.

Eligible contract participants

The Commodity Exchange Act, as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank)[2], requires that any party to a swap be an "eligible contract participant" (ECP), unless the swap is entered into through an exchange (referred to as a derivatives contract market) registered with the Commodity Futures Trading Commission (CFTC). No such exchange has been registered to date, and thus it is currently unlawful for any non-ECP to be a party to a swap or even to act as a guarantor or credit support provider of swap payments.

The Commodity Exchange Act defines the term "swap" quite broadly—the term includes all three types of hedges described above. Generally, an entity is an ECP if it has total assets of at least $10,000,000, or net worth of at least $1 million if the entity is hedging commercial risk (among other possible qualifications).

This restriction on non-ECP entities is broadly interpreted to preclude enforcement of a swap if a non-ECP is a direct party to the swap, and enforcement of a guarantee or pledge supporting swap cash flows from a non-ECP guarantor or pledgor. Thus, it is critical for both borrowers and lenders to ensure that each party to the swap, and each credit support provider of swap cash flows, is an ECP at the time the swap or credit support arrangement is entered into.

> In a rate cap transaction, a borrower and hedge provider agree to a maximum interest rate, known as the "cap rate" or "strike rate."

In many financings, particularly where the swap provider is the same entity as, or is an affiliate of, the lender, the borrower's obligations to make ongoing swap payments are included in the waterfall provisions in the loan agreement. In such case, the lender should conduct due diligence to determine if any of the borrowers, guarantors or pledgors do not qualify as ECPs. If there is any question regarding an entity's ECP status, the lender should consider additional measures to ensure that non-ECP entities do not participate as a guarantor or pledgor. For example, each guarantor or pledgor should make a representation that it is an ECP, and this representation should be deemed repeated at any time a swap or guarantee/pledge is entered into.[3] The parties may consider contractually excluding any non-ECP entity from the definition of guarantor or pledgor with respect to swap obligations. Borrowers may favor this approach. The Loan Syndications

[2] The Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376, enacted July 21, 2010.

[3] The test of whether a party is an ECP is made at the time a swap or guarantee is entered into.

and Trading Association (LSTA) has published model language for such circumstances (LSTA Market Advisory).[4] Another approach, more likely to be favored by lenders, would be to require certain borrower entities that qualify as ECPs to provide "keepwell" support to any non-ECP entities, the objective being to thereby convert the non-ECPs into ECPs. The LSTA Market Advisory contains model "keepwell" language as well. In addition, the lender should make certain that any non-swap guaranty that it obtains in connection with its financing is properly drafted to exclude any guarantee of swap obligations by any non-ECP guarantor.

Counterparty risk

The description above of typical hedge agreements could be read to suggest that the use of these agreements would eliminate the borrower's interest rate risk. A more accurate view would be that the borrower entering into a hedge agreement has merely exchanged interest rate risk for another risk: counterparty risk. The borrower's counterparty risk is the risk that the counterparty, i.e., the hedge provider, will fail to perform its obligations under the hedge agreement. If the hedge provider defaults on its obligations, the borrower generally is required under the loan documents to obtain a replacement interest rate hedge agreement. In the case of a rate cap, however, the borrower will have paid the hedge provider at closing. In this circumstance, not only would the borrower have to pay a second time for a hedge agreement that it had already purchased, but the replacement cost may far exceed the cost for the original hedge if interest rates have risen in the interim.[5]

A borrower may minimize counterparty risk by negotiating certain additional terms into the hedge agreement. One way of minimizing counterparty risk is to require the hedge provider to post margin in an amount equal to the value of the hedge agreement; the concept is that, upon a default by the hedge provider, the borrower would be able to use the collateral it is holding to purchase a new hedge agreement to cover the remaining term of the original hedge agreement. Another approach would be to obligate the hedge provider to replace itself, i.e., cause a new hedge provider to enter into a hedge agreement with the borrower covering the remaining term of the original hedge. A third approach would be to require the hedge provider to supply a guaranty from a creditworthy entity, often an affiliate of the hedge provider. In some cases the parties negotiate that these remedies would be required only if the hedge provider's credit ratings drop below specified thresholds. These provisions generally protect the lender as well as the borrower, because they minimize the risk that the borrower will have to incur an additional expense to acquire a replacement hedge agreement. Some lenders require borrowers to include these provisions in their interest rate hedge agreements.

> An interest rate swap effectively converts a floating rate obligation into a fixed rate obligation.

Mandatory clearing; margin for uncleared swaps

Under the Commodity Exchange Act, as amended by Dodd-Frank, all swaps identified by the regulators as capable of being cleared (generally, "standardized" swaps), and to which a clearing exception does not apply, must be cleared through a registered swap clearinghouse. To date, the regulators have identified interest rate swaps and certain credit default swaps as subject to this mandatory clearing requirement. Clearing adds a layer of complexity and cost to hedging transactions. Among other things, the clearinghouses require daily margin calls of all customers. As a result, many borrowers will want to avail themselves of an "end user exception" to ensure that their hedge transactions are not subject to mandatory clearing.

The Commodity Exchange Act requires that each party to an uncleared swap post margin (collateral) to its counterparty. The US banking regulators and the CFTC have published margin rules which will be phased in over a period beginning in September of this year. These rules also contain exceptions for certain end-users.

Many corporate borrowers, and most real estate borrowers, will be eligible for exceptions from these clearing and margin requirements. Certain funds and others in the financial sector, however, may not be eligible. Lenders should conduct due diligence to confirm the availability of

[4] See LSTA Market Advisory February 15, 2013, "Swap Regulations' Implications for Loan Documentation."

[5] The borrower could possibly assert claims against the original hedge provider in this circumstance. There is no certainty that such claims would be resolved quickly. Although most of the hedge claims resulting from the Lehman Brothers bankruptcy filing (circa September 2008) were settled promptly, some claims remain in litigation as of the time of publication of this article.

any such exceptions.

Cross-defaults

A default by a borrower under a loan agreement with respect to which a hedge agreement is in place will typically trigger a cross-default under the related Master Agreement. Similarly, an event of default under the hedge agreement, particularly an event of default that results in an early termination of the hedge, is typically an event of default under the loan agreement. Hedge providers often propose a broad cross-default provision which may reference defaults by affiliates (broadly defined) of the borrower in respect of separate financial obligations to the hedge provider (or its affiliates) above a certain threshold amount and defaults by affiliates under separate hedge agreements with the same provider. The parties can negotiate which parties should be included in the cross-default provisions as so-called "Specified Entities," and which parties should be excluded. If the hedge provider and the lender are not affiliates, then the lender would prefer the list of "Specified Entities" to be as limited as possible. If the hedge provider and the lender are affiliates, however, then they would prefer a broader list of "Specified Entities."

Borrowers are cautioned to consider carefully the implications of broadly defining the category of Specified Entities that may trigger a cross-default under a hedge agreement. Consider, for example, a situation in which a particular borrower and its affiliates have numerous loans and associated interest rate swap agreements with a particular lender. If the cross-default provisions of the agreements governing the swap transactions refer to affiliates of each borrower, the lender may be permitted to terminate all of the swap agreements (or, worse for the borrower, be permitted to choose which swaps to terminate and which to leave in place) upon a single event of default by a single affiliate under a single swap agreement. In turn, as noted above, the termination of each swap agreement by the hedge provider would likely trigger an event of default under the related loan documents. Borrowers should take special care to negotiate the cross-default provisions in order to avoid the potential for one underperforming business or property to trigger an avalanche of cross-defaults on "out of the money" hedges and, by extension, on the related loans. In addition, borrowers should note that courts have held certain cross-affiliate set-off provisions to be unenforceable in bankruptcy proceedings.[6]

Treatment in bankruptcy

The US Bankruptcy Code generally protects parties to swap agreements from the potentially catastrophic effects that could arise from the failure of a financial institution with significant exposure to derivatives. The Bankruptcy Code exempts swap agreements from:

- Operation of the automatic stay
- The right of the bankruptcy trustee to assume or reject executory contracts
- The prohibition on ipso facto clauses making bankruptcy an event of default
- Limitations on set-off rights

These "safe harbor" provisions have been expanded to cover a wider range of financial products and eligible participants. The overall effect of these provisions is to permit a party to a hedge agreement to terminate the agreement, offset and net out any payment obligations owed under the agreement (including the netting of termination values or payment amounts across multiple transactions between the same counterparties) and apply any margin collateral held in respect of those obligations notwithstanding the bankruptcy of the hedge counterparty—all without having to obtain permission from the court.[7]

The filing of a bankruptcy petition will trigger an event of default that can be used by the counterparty as a basis for terminating the hedge agreement and exercising its offset and netting rights. The terms of those rights may become particularly important, as they could have a significant impact on the financial value of the hedge transaction both in and outside of a bankruptcy.

Banks, however, are not US Bankruptcy Code eligible entities. The Federal Deposit Insurance Act (FDIA)[8] would govern the insolvency (or conservatorship) of certain

[6] See, e.g., *Sass v. Barclays Bank PLC* (In re *American Home Mortgage, Holdings, Inc.*), No. 11-51851 (CSS) (Bankr. D. Del. Nov. 8, 2013); *Chevron Products Co. v. SemCrude, L.P.* (In re SemCrude, L.P.), 428 B.R. 590 (D. Del. 2010).

[7] 11 U.S.C. §§ 362(b)(17), 556, 560, 561.

[8] The Federal Deposit Insurance Act of 1950, Pub.L. 81-797, 64 Stat. 873, enacted September 21, 1950, is the statute that governs the FDIC.

banks, while state law would govern the insolvency/conservatorship of other banks. The FDIA affords hedge counterparties rights that are somewhat similar to those available to hedge counterparties under the US Bankruptcy Code, yet differences do exist. For example, under the FDIA, a hedge counterparty must observe a one-business-day stay before exercising its right to terminate a hedge contract with a bank in receivership or conservatorship, and in the case of a conservatorship, certain insolvency-related events cannot be used to trigger a termination or other remedies.[9] This stay provides an opportunity to transfer the "good" assets (including swaps, to the extent the FDIC wants to keep them in place) to a solvent entity while leaving the "bad" assets behind in the insolvent entity.

Dodd-Frank provides an alternative framework for restructuring certain non-bank financial institutions (including non-bank affiliates of banks) deemed capable of jeopardizing the economy. Through an "orderly liquidation authority" (OLA) procedure, each applicable counterparty must observe a one-business day stay before exercising its right to terminate a transaction with an OLA-eligible insolvent entity (similar to the FDIA provision described above).[10]

On October 11, 2014, ISDA announced that 18 major global financial institutions (G-18) agreed to sign a new ISDA Resolution Stay Protocol, which has been developed in coordination with the Financial Stability Board to support cross-border resolution and reduce systemic risk. The protocol imposes a 48-hour stay on cross-default and early termination rights within standard ISDA derivatives contracts between protocol adherents in the event one of them is subject to resolution action in its jurisdiction. The stay is intended to give regulators time to facilitate an orderly resolution of a troubled bank. Although this protocol is not currently binding on parties other than the G-18 firms, regulators might eventually require a much broader group of market participants to adhere to the protocol.[11]

Offset rights

Certain offset rights may have a significant negative effect on the value of a hedge agreement. For example, a "disguised walk-away" provision provides that a non-defaulting counterparty has no obligation to pay a derivatives settlement amount to a defaulting party unless all liabilities of any kind then owing by the defaulting party and its affiliates to the non-defaulting party and its affiliates have first been paid.

Although one can argue about the intrinsic fairness of such a provision outside of a bankruptcy, consider its impact once a bankruptcy has been filed. If the hedge provider is an affiliate of the bankrupt borrower's mortgage lender (as is often the case), the effect of the provision is to permit the hedge provider to argue that it has no payment obligations under the hedge agreement (even where the hedge is "in the money" for the borrower) unless the mortgage loan is paid in full, notwithstanding the existence of the bankruptcy case.

Such provisions, however, may not be enforceable in an insolvency or conservatorship proceeding. For example,

[9] A complete discussion of the treatment of hedge agreements in bankruptcies and bank insolvencies/conservatorships is beyond the scope of this article.

[10] See "Treatment of a Hedge Fund's Claims Against and Other Exposures To a Covered Financial Company Under the Orderly Liquidation Authority Created by the Dodd-Frank Act," The Hedge Fund Law Report, Vol. 4, No. 15 (May 6, 2011).

[11] See: http://www2.isda.org/news/major-banks-agree-to-sign-isda-resolution-stay-protocol. And for the buy-side perspective: http://www.thetradenews.com/news/Asset_Classes/Derivatives/Buysiders_up_in_arms_over_new_ISDA_derivatives_protocol.aspx?l=tl.

the FDIA explicitly provides that such a provision is not enforceable against an institution in default that takes federally insured deposits.[12] As noted above, not all banks are regulated by the FDIA and courts applying state law have been divided on this issue.[13] As a result of the uncertainty surrounding enforceability, most hedge providers have eliminated walkaway clauses from their hedge agreements. Nonetheless, given their potentially harsh result, borrowers would be well served to remain vigilant on this point and eliminate onerous offset provisions from their agreements.

Hedges in connection with real estate financings

The discussion above is applicable to borrowers and lenders in a variety of industries. Other considerations can arise when the borrower is a real estate investor. Those issues are not addressed in this article.

Conclusion

Interest rate hedge agreements are complex and should be entered into only after receiving advice from qualified counsel. The topics discussed in this article are some of the more important issues of which borrowers and lenders should be aware when working with hedge agreements. Bearing these points in mind will help ensure that one is not taking on unforeseen risks when attempting to manage one's exposure to interest rate fluctuations.

[12] U.S.C. §1821(e)(8)(G). See also 12 U.S.C. § 5390(c)(8)(F) (similar provision in OLA proceedings).

[13] See *In re Lehman Bros. Holdings Inc. v. BNY Corporate Tr. Servs. Ltd.*, 422 B.R. 407 (S.D.N.Y. 2010) (holding that a provision seeking to modify payment priority upon a bankruptcy-related event of default is unenforceable in a bankruptcy proceeding). See also *Brookfield Asset Mgmt. Inc. v. AIG Fin. Prods. Corp.*, 2010 U.S. Dist. LEXIS 103272 (S.D.N.Y. 2010) (holding that defendant failed to establish that a walkway clause was not an unenforceable penalty or liquidated damages provision under New York State law).

Retaining neutral accounting experts in M&A working capital disputes

By: Stephen M. Fields

A typical provision in a purchase and sale agreement requires the buyer, post-closing, to provide a “true-up” of the target's net working capital agreed upon by the parties at closing. If the seller disagrees with the contents of the true-up (items or amounts) it is normally required to send the buyer a Notice of Objection to such calculation and, if the parties cannot thereafter amicably resolve their differences, such dispute is typically referred to an accounting firm designated in the purchase agreement as an independent expert to render a “final, conclusive and binding” decision resolving such dispute.

What is involved in retaining the independent expert? First, note that this is a joint retention by buyer and seller. So, notwithstanding that a certain Big 4 or other accounting firm has been designated to so act in the purchase agreement, the parties, unless otherwise specified, have the ability to agree, or not, to the terms set forth in the engagement letter as proposed by the independent expert. Thus, each side has leverage to either expedite, delay or derail the arbitration process and thwart the original selection of the independent expert. Such tactics can take the form of objecting to the terms of the engagement letter or to the selection of the individuals at the accounting firm proposed to make the final determination. Second, the parties must agree upon the terms of the independent expert's engagement. The standard independent expert engagement letter usually contains two attachments: Attachment “A,” which typically sets forth three columns, i.e., “Items in Dispute,” “Buyer's Position” and “Seller’s Position,” and Attachment B, which sets forth timeframes and events. When the decision letter is ultimately rendered by the independent expert at the end of this process, a fourth column will be added by the independent expert which will reflect such final determination and either increase or decrease the target working capital established by the parties at closing. Notwithstanding the contents of the true-up and the Notice of Objection, the parties usually have the ability to mutually add additional items and amounts in dispute to Attachment “A.” Often, the parties cannot agree as to the characterization of the items in dispute. Some independent experts allow the conflicting points of view to each be set forth in the applicable “Items in Dispute” column. Others refuse to act until the parties are in agreement.

One item in dispute that often generates considerable controversy is whether the refund to the seller of taxes with respect to pre-closing periods and loss carrybacks not yet received should be determined and/or paid only after the buyer receives same from the IRS, or whether an estimate of such refund should be included in the working capital calculation determined by the independent expert. The standard net working capital adjustment provision in most purchase agreements provides that any such refunds received by the buyer post-closing must be transmitted to the seller only upon receipt thereof by the buyer from the IRS. As we all know, waiting for the IRS to act could result in a significant delay in the seller receiving such payment. That language, however, by itself, is not necessarily dispositive as to the timing of transmission of refunds because typical purchase agreements also provide that the parties can, if they so desire, treat such refunds as part of the working capital computation. That would allow the independent expert to include such refunds within its final determination, if they are based upon reasonable estimates, which is what GAAP requires in order to do so.

To illustrate the point, in a recent dispute the independent expert stated that GAAP requires tax assets to be recognized in the period when it is more likely than not that an entity is entitled to the economic benefits of those tax assets. So, for example, if transaction bonuses in a leveraged buyout are payable and become a liability and an expense at the time of closing, then the related benefits of the net operating loss (NOL) tax asset created by the transaction bonuses also become more likely than not and should be recognized at the time of closing. As a result, such NOL tax asset was determined by the independent expert to be included in the working capital computation

One item in dispute that often generates considerable controversy is whether the refund to the seller of taxes with respect to pre-closing periods and loss carrybacks not yet received should be determined and/or paid only after the buyer receives same from the IRS, or whether an estimate of such refund should be included in the working capital calculation determined by the independent expert.

at the time of closing and the payment thereof was not required to be held in abeyance pending the buyer's receipt of the refund from IRS.

Many purchase agreements are silent on when tax refunds shall be payable, or leave it to the parties to mutually agree. If sellers wish to expedite matters, they should negotiate for the independent expert to award such refunds as part of its mandate in the absence and in advance of remittance from IRS. This will allow the seller to expeditiously receive these refunds absent being subject to intentional or other delays caused by tardy filing by the buyer of amended tax returns seeking such refunds. Including this item in the appropriate column of Attachment “A” to the engagement letter should be helpful in conferring such authority upon the independent expert even if the purchase agreement is silent or permissive (but not mandatory) with respect to the scope of authority so granted to the accounting firm so engaged. An interesting question arises as to what the disposition should be if, when the ultimate IRS refund is received years later, such refund is in an amount significantly different than the "reasonable" estimate upon which the independent expert rendered its working capital decision. That discussion is beyond the scope of this article.

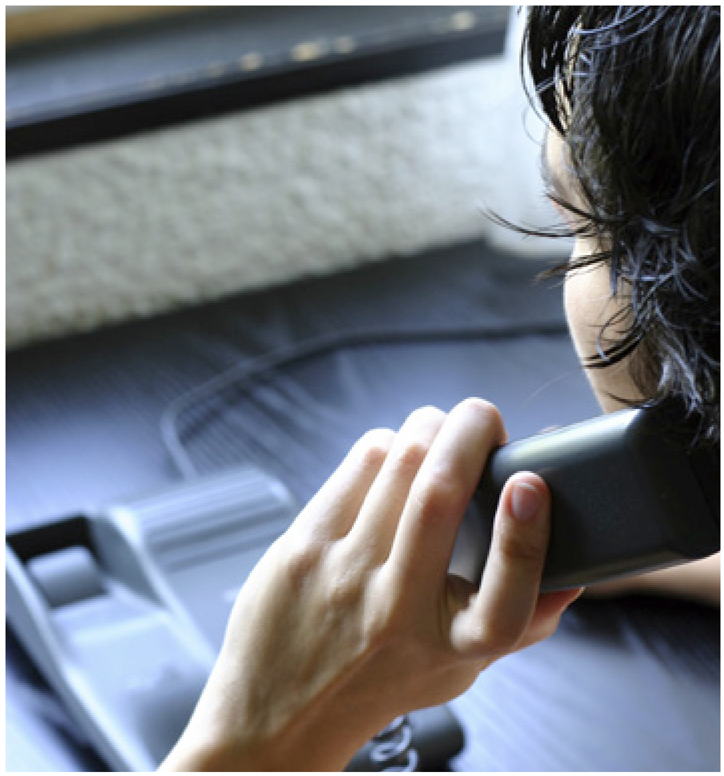
As noted above, Attachment “B” to the independent expert engagement letter usually sets forth a schedule of events and time frames which the parties are required to adhere to. The first meaningful event is the submission of each party’s “Statement of Position” to the independent expert. When each side has submitted its Statement of Position, the independent expert provides copies thereof to the opponent and time is then provided for each party to reply to the other party's “Statement of Position.” The independent expert typically reserves the right, during specified time periods, to send interrogatories to one or both parties requesting a written response thereto within additional time frames. A frequently asked question from the independent expert might be: "If there is a conflict between GAAP and the Purchase Agreement, which shall govern?" Answering that question is not always simple when the purchase agreement says its accounting terms are governed by US GAAP, consistently applied. Failing to receive responsive, satisfactory or clarifying answers, the independent expert may issue supplemental interrogatories or, in some cases, request a telephone conference or, rarely, in-person meetings with both sides. Depending upon the wishes of the parties as reflected in the content of the engagement letter itself, the independent expert may be asked to render a long form reasoned decision or a short form conclusion-oriented decision. In either case the engagement letter generally provides that either party may only contest arithmetical calculations, and all additional substantive arguments and materials received after the initial decision letter is issued will be disregarded or discarded. Note that the decision of the independent expert will not generally award interest, attorney fees or other costs unless specifically articulated in the purchase agreement. Given the paucity of precedent in this area, the best practice is probably to also provide for recovery of such items in the engagement letter if that is what is intended.

How is the independent expert's determination enforced? Once the engagement letter is executed, the independent expert should be the final authority as to matters within its purview. Courts and arbitration panels such as the American Arbitration Association appear to have given deference to the decisions of these independent experts absent fraud or conflicts of interest, the latter of which is usually initially addressed in the engagement letter. However, even though the decision letter is "final, binding and conclusive," the quoted language by itself may or may not be sufficient to confirm the working capital decision of the independent expert so as to have a judgment entered thereon similar to the confirmation and entering of a judgment based upon a commercial arbitrator's award. Litigators generally recommend that the parties add language to the purchase agreement and the independent expert's engagement letter to the effect that such award may be entered and reduced to judgment in a court of competent jurisdiction so as to enable the prevailing party to enforce the terms thereof if payment is not made when required. The terms of the typical independent expert's engagement letter are required by the independent expert to be "confidential," so any public disclosure thereof, even converting the award to a judgment which is publicly filed, may require a carve-out to the terms of such letter.

What strategic considerations should parties to working capital disputes be mindful? Given the above process, which is the modus operandi of the Big 4 accounting firms, several questions arise in how to strategically position the arguments on both sides. First, will the independent expert review the true-up and the "Notice of Objection" or only the Statements of Position and replies? If so, how detailed should those documents be? Do the parties want to state their full positions in the true-up and Notice of Objection documents, or, should they save some ammunition for the Statements of Position in the event no resolution can be achieved before having to utilize the services of the independent expert?

Other issues related to the net working capital adjustment may also arise that are outside the purview of the independent expert. For example, what happens if the buyer delivers its true-up significantly later than required under the terms of the purchase agreement? Or, what happens if one party refuses to agree to the terms of the engagement letter? The independent expert cannot resolve these issues because it has not been engaged to do so, and thus the parties will be relegated to the other dispute mechanisms set forth in the purchase agreement.

One thing is for certain. No careful lawyer or private equity executive should go down this dispute resolution path (or sign a purchase agreement) absent guidance from an expert well versed in GAAP and the nuances of such a potential dispute, especially if large sums are involved.



When is a payment arrangement treated as disguised compensation?

By: Marc D. Teitelbaum and Irene Kim

The proposed Department of Treasury regulations (REG-115452-14) under IRC section 707(a)(2)(A) set forth standards to determine when a payment arrangement to a partner shall be treated as disguised compensation. Section 707(a) generally governs payments to partners who render services to a partnership other than in a partner capacity. Additionally, the rules will affect standards under section 704(b) to reflect the principle that a payment must be subject to significant entrepreneurial risk in order to be considered a distributive share. Section 704(b) most importantly provides for pass-through treatment of capital gains and other tax-favored items from the partnership to its partners. As a result of the foregoing, the rules include changes to the scope of section 707(c) governing guaranteed payments. The rules would become effective on the date the final regulations are published.

These rules, if finalized, will have a significant effect upon the issuance of interests in private equity (PE) funds and the structure of distributive shares for its general partners and principals. In particular, these rules affect fee waiver arrangements, but also create general uncertainty as to how to treat partners that are receiving payments from a partnership that one otherwise thought would constitute a distributive share. A summary of the effect of these rules on PE funds can be found towards the end of this article.

Alternative tax characterizations

Income that a partner receives from a partnership in exchange for services can be characterized in one of three ways: a distributive share under section 704(b); a guaranteed payment under section 707(c); or a section 707(a) payment for services rendered in a non-partnership capacity, often referred to as "disguised services" income. Allocations made to a partner providing services in a partner capacity where the allocation depends on partnership income is generally a distributive share under section 704(b). The two alternative characterizations under section 707 address arrangements in which either a service partner receives income in the capacity of a partner, but without regard to partnership income (section 707(c)) or engages with a partnership in the capacity of a non-partner (section 707(a)). Tax treatment varies across each category for the service partner as well as for the partnership.

For instance, a distributive share of partnership income under section 704(b), is taxed under the general rules in sections 702, 703 and 704, and benefits from flow-through tax characterization. A distributive share may also qualify as a "profits interest" for the purpose of Rev. Proc. 93-27, which provides safe harbor protection from immediate income inclusion upon receipt.

On the other hand, a partner is taxed on a payment under section 707(a) or (c) as if the payment were made to someone other than a partner for some or all purposes of the Code. If a payment is treated as a guaranteed payment under section 707(c), that is, a payment to a service provider in a partner capacity, but without regard to partnership income, it is considered as having been made to a non-partner under sections 61 and 162(a). Often, this

results in the payment being treated as ordinary income for the purposes of those sections. A service partner who receives a section 707(a) payment is treated as having received ordinary services income for all purposes of the Code. In either case, the service partner does not receive the benefits of flow-through characterization as it would in the case of a distributive share.

Disguised payment for services

Section 707(a)(2)(A) is an anti-abuse rule under 707(a) and provides that if a partner performs services for a partnership and receives a related direct or indirect allocation and distribution, and the performance of services, together with the allocation and distribution, are properly characterized as a transaction between the partnership and the partner in a non-partner capacity, the transaction will be governed by section 707(a).

Fee waiver arrangements

In a typical fee waiver arrangement, a fund manager or the management company waives some or all of its management fee (generally two percent) that would have been taxable as ordinary income. In lieu of the fee, the fund manager, usually the GP of the fund, receives an interest in the fund's future income, sometimes in the form of a "special allocation," which usually takes priority over an ordinary interest in profits. Generally, managers take the position that the income received in this arrangement represents a distributive share of partnership income entitled to flow-through tax characterization. Since PE funds often hold portfolio investments for periods of seven to 10 years, much of the character flowing through would be long-term capital gain.

These rules, if finalized, will have a significant effect upon the issuance of interests in private equity (PE) funds and the structure of distributive shares for its general partners and principals.

Even prior to the proposed rules, it was possible for the Internal Revenue Service (IRS) to argue that certain PE fee waiver arrangements were disguised payments for services. The legislative history identified certain factors to consider, the most important being whether an allocation bore "significant entrepreneurial risk." An arrangement in which an allocation and distribution to a service partner is subject to significant entrepreneurial risk as to the amount is generally recognized as a distributive share—this remains true under the proposed rules. Various other factors are also relevant, but secondary.

Proposed rules: multi-factor test

The proposed rules, borrowing heavily from the factors outlined in the legislative history, call for a multi-factor analysis to identify payments under section 707(a). The payment arrangement is tested under these rules at the time at which the parties enter into or modify the arrangement. The primary and weightiest factor is whether, as a result of this alternative payment structure, the general partner has taken on "significant entrepreneurial risk." Under the proposed regulations, arrangements that lack significant entrepreneurial risk will be treated as disguised payments for services regardless of the other factors.

The following characteristics create a presumption that there is a lack of significant entrepreneurial risk:

- Capped allocations of partnership income (if the cap is reasonably expected to apply in most years)
- An allocation for one or more years where the service provider's share of income is reasonably certain
- An allocation of gross income to the service provider
- An allocation that is predominately fixed in amount, reasonably determinable under all facts and circumstances, or designed to assure sufficient net profits are highly likely to be available to make the allocation (e.g., because the agreement only allocates net profits from certain periods or transactions and does not depend on the long-term success of the enterprise)
- An arrangement in which a service provider waives its right to receive payment for future performance of services in a manner that is non-binding, or fails to notify the partnership and its partners of the waiver and its terms in a timely manner

The preamble clarifies that catch-up allocations to a service partner generally do not fall under the fourth category. However, priority allocations to a service partner that are measured over an accounting period of one year or less, together with an ability for the service partner (or related party) to control either the determination of asset values in the case of hard-to-value assets, or the entities in which the partnership invests—including the amount and timing of distributions by such entities—create a higher likelihood that net profits will be available for the allocation. The examples further illustrate that a failure to measure profits over the life of the partnership would cause one to examine whether the allocation is a fee for services.

Basically, only waiver arrangements which involve a fund manager taking on significant entrepreneurial risk will be rewarded with the attendant benefits of a distributive share, namely flow-through characterization. Alternatively, in cases where the terms of the purported allocation as a result of the waiver arrangement indicate that the manager is highly likely to receive income regardless of the success of the business, the rules treat the profits interest as disguised compensation under 707(a).

In additional to "significant entrepreneurial risk," there are five secondary factors that must be considered. The weight given to each of these factors depends on the facts and circumstances of each case. The secondary factors that may characterize an arrangement as a payment for services include the following:

1. Service provider holds a partnership interest for only a short duration

2. Service provider receives an allocation and distribution in a time frame comparable to when a non-partner service provider would typically receive payment

3. Service provider became a partner primarily to obtain tax benefits which would not have been otherwise available

4. The value of the service provider's interest in general and continuing partnership profits is small in relation to the allocation and distribution

5. An arrangement provides for (i) different allocations or distributions with respect to different services received; (ii) the different services are provided either by a single person or related persons; and (iii) the entrepreneurial risk associated with the different allocations and distributions varies significantly

Elimination of safe harbor protection

Rev. Proc. 93-27 defers taxation upon the receipt of a profits interest for the provision of services to a partnership in a partner capacity. However, the revenue procedure makes clear that the safe harbor does not apply where there is a "substantially certain and predictable stream of income" from partnership assets, or in cases where the interest is disposed of within two years of receipt. If an allocation is not treated as a distributive share, or is excluded from the administrative safe harbor under either of these exceptions, this raises questions of how to tax the interest, and whether the IRS can argue that the service partner must currently include income upon receipt of the purported profits interest.

The IRS has indicated that this administrative safe harbor does not apply to cases where one party provides services and another party is allocated partnership income in association with the provision of those services. This describes the organization of most funds in New York (driven by the local tax law), where the management company is a separate entity (non-partner), delegated management responsibility by the GP via contract. As a result, in addition to arguing that ordinary income treatment applies to such arrangements under section 707(a), the IRS will be able to argue that a profits interest received pursuant to this type of fee waiver arrangement is currently taxable upon receipt. Consistent with this view, Treasury and the IRS plan to issue an additional exception to the profits interest safe harbor for fee waiver arrangements.

Effect on PE funds

The following is a summary of the effect of these rules on partnership arrangements in the context of PE funds.

1. Whether an arrangement lacks significant entrepreneurial risk is relative to the overall entrepreneurial risk of the partnership with respect to its own activities. For example, entrepreneurial risk can exist with respect to participation in a venture capital fund as well as a fixed income fund.

2. Partnership allocations, including carried interests determined with respect to a subgroup of assets, may not qualify as a distributive share. The argument would be the same as the reasons for denying favorable tax treatment for an allocation of profits out of a particular tax period—that is, because there is a risk that the allocation could be limited to a subgroup of assets that is expected to be profitable.

3. Allocations of future income should include a clawback provision in order to be considered a distributive share. A "clawback obligation" is described as an enforceable obligation to repay any amounts distributed pursuant to a profits interest that exceed the partner's allocable share as computed over the life of the partnership, where it is reasonable to anticipate that the general partner can and will comply fully with this obligation. These rules appear to say that significant entrepreneurial risk requires that an allocation be a percentage of net profits over the life of a partnership with respect to all assets of the partnership. In order to achieve this, there would have to be some type of accounting at the end of the relevant period and a

possible adjustment pursuant to a clawback obligation.

4. Section 707(a) has been a looming threat to fee waiver arrangements long before this notice, especially those involving elective quarterly or monthly waivers, where at the time of the election, the fund manager may already have a sense of how profitable the fund will be in the following quarter. The rules appear to draw a line in the sand, permitting only fee waivers that are elected prior to the beginning of the service period, and not in cases where there has been, in effect, constructive receipt. Further, the proposed regulations and the examples applicable to fee waivers appear to support the existence of significant entrepreneurial risk where there is an:

   - Allocation out of net profits (not limited to a particular transaction or accounting period) that is not reasonably determinable or highly likely to be available at the time of the waiver, and service provider undertakes a binding clawback obligation (see Example 5)

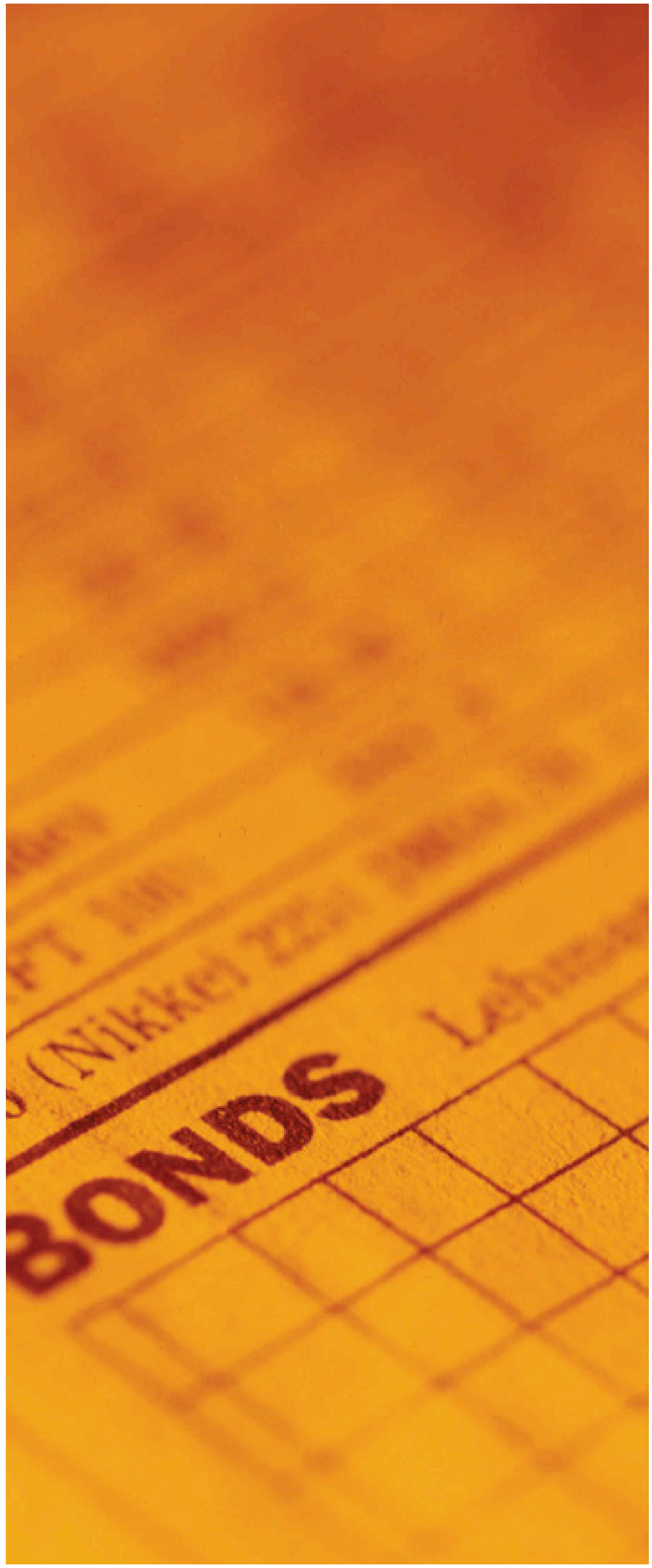
   - Execution of a legally binding and irrevocable waiver, clearly communicated to the other partners well in advance (60 days or more) of the services period under the management fee agreement (see Example 6)

Other consequences

First, the proposed regulations do not address timing issues for service payments governed by sections 707(a)(2)(A) and 1.707-2. The issue of when a payment for services should be included in the income of the service provider and when the partnership can take a deduction is determined under existing law.

Next, the preamble to the proposed regulations indicates that an arrangement that is treated as a disguised payment for services under these proposed regulations will be treated as payment for services for all purposes of the Code. It is necessary to consider whether a service partner receiving a payment governed by section 707(a)(2)(A) constitutes an employee or independent contractors.

Finally, the preamble also indicates that if an allocation is re-characterized under section 707(a) as a payment for services, the deferred compensation rules under section 409A and 457A may apply. For example, if the fund manager has "received" income for the purposes of section 409A, that section imposes immediate taxation on any deferred income, assuming no exception applies.



Protection for statements made outside the four corners of an agreement

By: Douglas S. Eingurt

A lot gets said by a lot of different people when selling a business. This is largely unavoidable in a full, negotiated sales process, as owners, management, investment bankers, employees, accountants, lawyers and others all convey information about the target company to the buyer or the buyer's representatives. When a seller has to rely on others to respond to due diligence inquiries, it is all but impossible to monitor and confirm every statement and calculation. This process has the potential to result in the dissemination of information that may be incomplete or unintentionally misleading or, in the worst case scenario, intentionally false or misleading.

Private equity owners of companies for sale usually rely heavily on management and other employees to know, understand and communicate all aspects of the business. The risk of fraud is increased when management is eager to get a deal done, perhaps because such persons may participate in the sales proceeds, receive better employment packages and/or participate in the equity going forward. How, then, do owners ensure that they are not taking on liability for every statement made, and piece of information provided by, the company in the due diligence process? Luckily, there are protections—at least under some states' laws—that can be built into the purchase agreement to address this risk. Specifically, Delaware has a significant amount of case law on point, providing sellers with a roadmap to the types of provisions necessary to protect themselves. However, the effectiveness of these provisions is dependent on the specific governing law for the purchase agreement as courts in some states have conclusively determined that there is no way to contract around fraudulent statements.

There are two basic conditions that need to be met in Delaware to absolve owners for false statements made during the due diligence process:

1. The parties must be sophisticated.
2. The parties must use unambiguous anti-reliance language in the acquisition agreement.

Importantly, even if those two conditions are met, a party cannot contract around fraud for statements made within the contract itself.

Assuming the parties are sophisticated, the question turns to what constitutes unambiguous anti-reliance language in an acquisition agreement regarding extra-contractual statements (that is, statements outside of the four corners of the document, such as information provided in due diligence). Sellers primarily use non-reliance clauses to define the universe of statements (i.e., representations) that the buyer can rely on in making its decision to consummate the transaction and, as a result, the universe of statements that can form the basis of fraud claims. Because reliance is a necessary factor in proving fraud, defining what statements the buyer did and/or did not rely upon in making its purchase decision can significantly reduce a seller's risk.

The rules regarding the enforceability of these provisions and what the provisions do or do not need to say have evolved over time. For example, as recently as 2013, the Delaware Chancery Court instructed practitioners that anti-reliance provisions that addressed extra-contractual misrepresentations did not necessarily address extra-contractual omissions.[1] To successfully protect against an extra-contractual omission as creating the basis for a fraud claim, the court looked for a disclaimer as to the "accuracy and completeness" of extra-contractual statements or a more specific disclaimer as to extra-contractual omissions.[2] In November 2015, however, the same court determined that, when an agreement clearly defines the statements that can form the basis for a fraud claim (i.e., the representations and warranties contained in the agreement), a party cannot claim an extra-contractual omission as the basis for pleading fraud even when the non-reliance language does not specifically address omissions, as every statement can be recast as an omission.[3]

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[1] *Transdigm Inc. v. Alcoa Global Fasteners, Inc., 2013 WL 2326881 (Del. Ch. May 29, 2013).*

[2] *Id.*, at *8.

[3] *Prairie Capital III, L.P. v. Double E Holding Corp., 2015 WL 7461807, at *12 (Del. Ch. Nov. 24, 215).* In this case, the buyer did not want to close the transaction if the target was not meeting its monthly sales targets. Management, eager to close the transaction, falsified records provided to the buyer leading up to closing to show the buyer that the company was meeting those targets.

The risk of fraud is increased when management is eager to get a deal done, perhaps because such persons may participate in the sales proceeds, receive better employment packages and/or participate in the equity going forward. How, then, do owners ensure that they are not taking on liability for every statement made, and piece of information provided by, the company in the due diligence process?

The Delaware courts instruct us that there are no "magic words" that a seller needs to use in crafting a non-reliance provision as long as the words used create a clear anti-reliance clause. For instance, as noted above, the anti-reliance provision does not need to specifically reference omissions nor does it have to, despite one defendant's arguments, be drafted in the negative (e.g., stating that the buyer "has not relied" on any other representations or warranties versus stating that the buyer "has only relied" on the representations or warranties in the agreement). In Delaware, the typical, successful formulation includes language providing that the seller is only making the representations and warranties contained in the agreement and no others and that those are the only representations and warranties that the buyer is relying on. Together with a standard merger/integration clause, this should unambiguously define the universe of information that the buyer can rely on for purposes of making a fraud claim. Below is the anti-reliance language from the November 2015 Prairie Capital case that provided a successful defense against extra-contractual fraudulent statements:

"The Buyer acknowledges that it has conducted to its satisfaction an independent investigation of the financial condition, operations, assets, liabilities and properties of the Double E Companies. In making its determination to proceed with the Transaction, the Buyer has relied on (a) the results of its own independent investigation and (b) the representations and warranties of the Double E Parties expressly and specifically set forth in this Agreement, including the Schedules. SUCH REPRESENTATIONS AND WARRANTIES BY THE DOUBLE E PARTIES CONSTITUTE THE SOLE AND EXCLUSIVE REPRESENTATIONS AND WARRANTIES OF THE DOUBLE E PARTIES TO THE BUYER IN CONNECTION WITH THE TRANSACTION, AND THE BUYER UNDERSTANDS, ACKNOWLEDGES, AND AGREES THAT ALL OTHER REPRESENTATIONS AND WARRANTIES OF ANY KIND OR NATURE EXPRESS OR IMPLIED (INCLUDING, BUT NOT LIMITED TO, ANY RELATING TO THE FUTURE OR HISTORICAL FINANCIAL CONDITION, RESULTS OF OPERATIONS, ASSETS OR LIABILITIES OR PROSPECTS OF DOUBLE E AND THE SUBSIDIARIES) ARE SPECIFICALLY DISCLAIMED BY THE DOUBLE E PARTIES."[4]

If the court were to allow the buyer to claim reliance on extra contractual statements in the face of the above language, then the buyer would have been in breach of that provision. This is referred to as the "double-liar" scenario that Delaware courts seek to avoid by enforcing these anti-reliance provisions. As noted above, though, not every jurisdiction views the double-liar problem as trumping public policy concerns regarding fraud (and at one point, Delaware did not either). So, although Delaware courts seem to be making it easier for sellers to contract around fraud for extra-contractual statements, it is important to check your governing law and to make sure that, if you are in Delaware (or a state with similar views on the subject), you include clear anti-reliance language. If you are a buyer and you cannot negotiate your way out of an anti-reliance provision, it is important that you include representations and warranties in the agreement for those items that are important enough for you to rely on.

[4] *Id.*, at *8.

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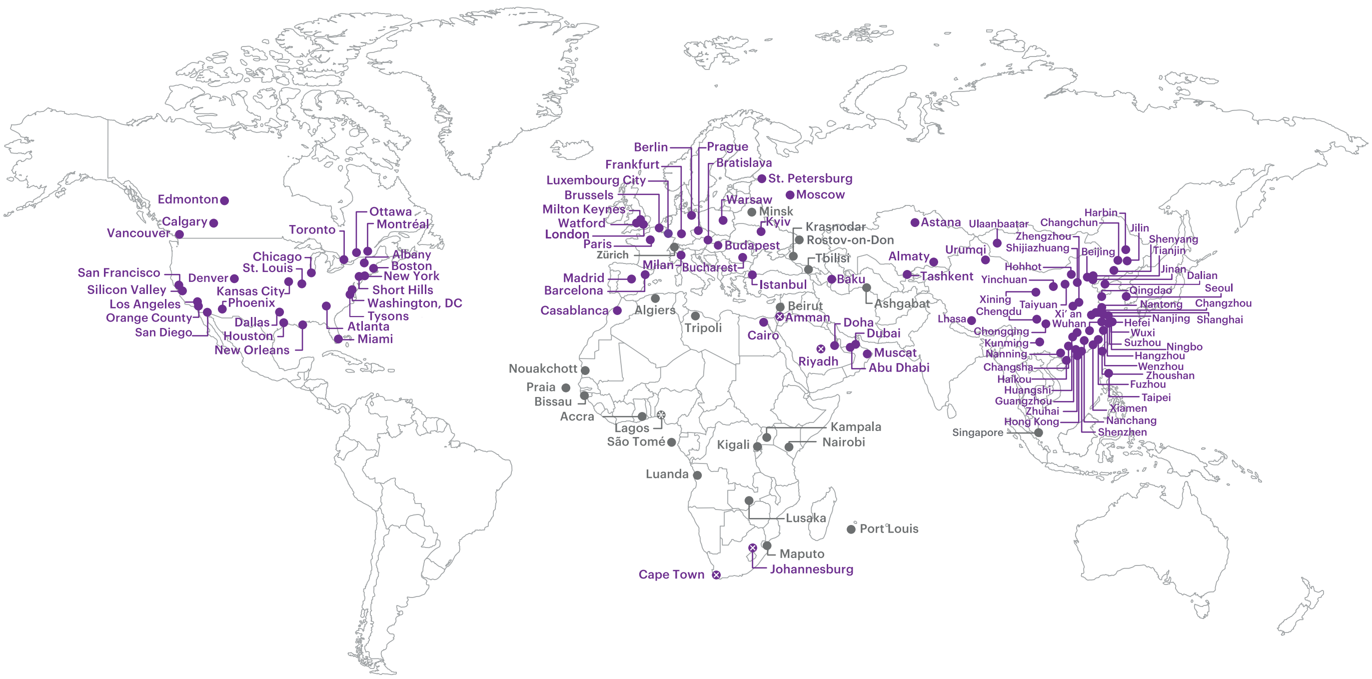

Legend

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