SEWARD & KISSEL LLP

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New Tax Shelter Regulations Ease Reporting Requirements For Confidential Transactions

On February 27, 2003, the United States Treasury Department and the Internal Revenue Service (the "IRS") issued regulations (the "Tax Shelter Regulations") under Sections 6011 and 6012 of the Internal Revenue Code expanding previously existing information reporting, record maintenance and list maintenance requirements with respect to certain "tax shelter" transactions. The information reporting and record maintenance requirements apply to direct and indirect participants in six categories of "reportable transactions," including all transactions offered under "conditions of confidentiality". Except to the extent that confidentiality restrictions were reasonably necessary to comply with securities laws, the Tax Shelter Regulations defined a Confidential Transaction as a transaction where a person's disclosure of the tax treatment or tax structure of the transaction was limited in any manner by any understanding or argument with or for the benefit of any person who makes or provides a statement as to the potential tax consequences of the transaction (a "Confidential Transaction"). As a result of this broad definition of a Confidential Transaction, most agreements in "ordinary" commercial financing transactions (including loan agreements and agreements assigning interests in loans) which contained broad confidentiality provisions came within the scope of the Tax Shelter Regulations, unless such provisions satisfied a "safe harbor" provision which permitted the parties to disclose to any and all persons, without limitation, the tax treatment and tax structure of the transaction, as well as all materials of any kind relating to such tax treatment and tax structure (the "Safe Harbor Exception"). As a result, prudent counsel recommended that all loan, assignment and participation agreements contain language satisfying the Safe Harbor Exception.

On December 29, 2003, the Tax Shelter Regulations were amended in order to substantially reduce the scope and number of transactions that would be treated as Confidential Transactions. This amendment revised the definition of a Confidential Transaction to mean a transaction where: (i) an "advisor" is paid a "minimum fee" (e.g., $250,000 if the taxpayer is a corporation); and (ii) the advisor places a limitation on a person's disclosure of the tax treatment or tax structure of the transaction that protects the confidentiality of the advisor's tax strategies. For purposes of this amendment, a "minimum fee" includes all fees paid for a tax strategy, for advisory services or for the implementation of a transaction, but does not include amounts paid to a person, including an advisor, in that person's capacity as a party to the transaction. As a result of these amendments, most "ordinary" commercial financing transactions will not be subject to the Tax Shelter Regulations merely because they contain broad confidentiality provisions and it will no longer be necessary to include the Safe Harbor Exception in financing documentation tax disclosure as a means to avoid disclosure of the transaction to the IRS as a potential "tax shelter." However, the amendments to the Tax Shelter Regulations described above do not effect any changes to the other five categories of "reportable transactions" set forth in the Tax Shelter Regulations. The revised Tax Shelter Regulations apply to transactions entered into on or after December 29, 2003, and may be relied on retroactively for transactions entered into on or after January 1, 2003.

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Lock-up Arrangements Subject of Recent Bankruptcy Court Scrutiny

"Lock-up" agreements, which are also often referred to as "voting" or "plan support" agreements, have been the focus of a great deal of recent attention. Lock-up agreements are often entered into in the context of restructuring or Chapter 11 bankruptcy between the company and participating stakeholders in which the company agrees to propose a Chapter 11 plan of reorganization containing specified terms and the stakeholders in turn agree to vote in favor of that plan. Lock-up agreements enable stakeholders to pre-negotiate the result of the Chapter 11 case, which in turn provides comfort both to the marketplace that the company will emerge from Chapter 11 as a going concern and to potential lenders, investors and employees concerning the economics and viability of the company's reorganization strategy.

Lock-up arrangements have recently faced scrutiny from some Bankruptcy Courts. Once a company has filed Chapter 11, the Bankruptcy Code requires that certain information be provided to parties before or in conjunction with the solicitation of their vote in favor of or against the plan of reorganization. Specifically, the Bankruptcy Code requires that the party being solicited receives both: (i) a copy of the plan or a summary thereof; and (ii) a written disclosure statement approved by the Bankruptcy Court. Bankruptcy Courts have viewed lock-ups as votes or solicitations of votes. Therefore, to be enforceable, lock-up agreements must be entered into either: (i) before a Chapter 11 case is filed; or (ii) after Chapter 11 has been filed, after the Bankruptcy Court has approved a disclosure statement.

Even when a lock-up agreement is reached before a Chapter 11 filing, the Bankruptcy Code requires that pre-bankruptcy solicitation of votes be made either: (i) in accordance with applicable securities laws; or (ii) if the company is privately held or if the Chapter 11 plan does not propose to distribute public securities, only after the disclosure of "adequate information" as defined in the Bankruptcy Code. It is important that parties to lock-ups observe these requirements because Bankruptcy Courts have "designated" the votes of parties who have failed to do so. Designation of a vote means that, in the plan confirmation process, the vote will not be counted in determining whether the plan of reorganization has been accepted by a majority of parties entitled to vote on the plan.

Heads Up:

Offshore Distressed Debt Funds Should Consider U.S. Tax Consequences of Engaging in Certain Loan Origination Activities

An offshore private investment fund (an "Offshore Fund") with a United States-based investment manager that merely buys, holds and sells pre-existing, publicly-traded or privately negotiated debt obligations of financially distressed United States issuers ("Debt Obligations") generally will rely upon the trading "safe harbor" exemption provided by section 864(b)(2) of the Internal Revenue Code (the "Trading Safe Harbor") to avoid being subject to United States federal income taxation on a net income basis on the interest income it derives from such Debt Obligations. Pursuant to the Trading Safe Harbor, a foreign entity is not treated as engaged in a trade or business within the United States for federal income tax purposes by reason of its "trading" in "stocks or securities" in the United States for its own account (regardless of the volume of the transactions involved).

However, Offshore Funds that engage directly in lending funds to United States companies through traditional financing transactions (e.g., making loans, providing cash advances under revolving letters of credit, participating in debtor-in-possession financings) confront the issue of whether such activities cause the Offshore Fund to be treated as engaged in a lending and financing business within the United States, which is not covered by the Trading Safe Harbor. An Offshore Fund treated as so engaged would be subject to: (i) United States federal income taxation at the regular graduated tax rates generally applicable to domestic corporations on all of the taxable income (e.g., interest and commitment fees, less applicable expenses) which is "effectively connected" to such lending and financing business; and (ii) a thirty percent "branch profits" tax on the amount of such "effectively connected" taxable income to the extent such income is distributed to the Offshore Fund's shareholders, rather than reinvested in new Debt Obligations.

There is no definitive guidance on the applicability of the Trading Safe Harbor to a foreign entity which is engaged in originating loans and lending money. However, the extent to which an Offshore Fund or any of its agents are actively and regularly engaged in arranging or negotiating the terms of a loan or any other financing transaction are likely to be significant factors in determining whether the Offshore Fund should be treated as engaged in a lending and financing business for federal income tax purposes.

Therefore, an Offshore Fund that regularly participates in arranging and negotiating within the United States the terms of the Debt Obligations in its portfolio, appears to be subject to some risk that such Offshore Fund would be treated as engaged in a United States lending and financing business and therefore would be subject to United States federal income taxation on a net income basis. The United States managers of such Offshore Funds may wish to consider taking certain protective measures to minimize the tax risk resulting from such activities (e.g., avoid having the Offshore Fund receive any commissions or other fees in connection with the acquisition of a Debt Obligation, restrict the volume of the Offshore Fund's direct lending transactions to a relatively small percentage of the aggregate transactions engaged in by the Offshore Fund, or have the Offshore Fund acquire Debt Obligations from an affiliated entity that actually arranges or negotiates the terms of the Debt Obligations, etc.). If you have any tax-related questions concerning this article, please contact Peter Pront, the head partner in the Tax Group, at (212) 574-1221 or pront@sewkis.com.

LSTA Publishes Model Credit Agreement Provisions

Effective January 2004, The Loan Syndication and Trading Association (the "LSTA") published certain model provisions for use in connection with the establishment of syndicated loan facilities (the "Model Credit Agreement Provisions"). The Model Credit Agreement Provisions reflect a consensus among participants in all facets of the syndicated lending market and were developed in order to promote liquidity, increase legal certainty and reduce transaction costs. The Model Credit Agreement Provisions developed by the LSTA include examples of "Assignment", "Participation", "Confidentiality" and "Sharing of Payment" provisions which, if incorporated in syndicated credit agreements, shall serve to facilitate the trading in the secondary market of the debt which is the subject of such credit agreements.

The Model Credit Agreement Provisions are currently posted in an unrestricted area of the LSTA website (*see*: www.LSTA.org. The article appears on the cover page entitled "LSTA Publishes Model Credit Agreement Provisions", link to Model Credit Agreement Provisions).

Trading by Fiduciaries

If a purchaser or seller of distressed debt is considered a fiduciary, such status may impact how the debt can be traded. Although the Bankruptcy Code does not define "fiduciary", as a general matter, the greater the involvement and control that a person has in the business or operations of the debtor, the more likely it is that such person will be deemed to be a fiduciary. If the court determines that there has been a breach of fiduciary duties, it has extensive equitable powers to fashion an appropriate remedy, including limiting the investor's right to enforce the claim or limiting its actual recovery under the claim. In light of the foregoing, distressed debt managers must know whether the seller of the claim could be deemed to be a fiduciary and whether they themselves may be found to be a fiduciary, since this could affect their freedom of action.

An investor could be deemed to be a fiduciary after purchasing claims, even in cases where such investor does not have "actual control or legal decision making power". In the past, courts have ruled that such purchasers were fiduciaries by virtue of their proposal of a competing plan of reorganization, receipt of non-public information and attempt to influence decisions made by the debtor.

Moreover, members of creditors committees may be deemed to be fiduciaries. Therefore, investors who intend to trade actively in the claims of a Chapter 11 debtor may choose to refrain from serving on a committee. However, this can be difficult because committees often play an integral role in shaping the reorganization of a Chapter 11 debtor. A possible solution is to create a "Chinese wall" between the members of the investor's organization who serve on the committee and those that trade the claims, since this would remove the risk that confidential information acquired while serving on a committee could influence trading decisions.

Important Development Concerning IPOs

The NASD recently amended its rule relating to the purchase of securities at public offerings. Under the old rule, exchange offers, rights offerings and convertible debt were subject to the rule, and therefore only eligible investors could purchase such instruments at the public offering. The new rule, which goes into effect on March 23, 2004, will only apply to initial public offerings of equity. For further information about this new rule, please contact Steven Nadel, a partner in the Investment Management Group, at (212) 574-1231 or nadel@sewkis.com.

This edition of the newsletter may be found on the web at www.sewkis.com under News & Publications.

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If you have any questions or comments about this newsletter, please feel free to contact any of the attorneys in our Distressed Debt Group via telephone at (212) 574-1200 or e-mail by typing in the attorney's last name followed by ***@sewkis.com***

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