

## Heard on the Listserve

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### **Applying Transfer Restrictions to Hedge Funds**

Our Committee benefits from a significant and active international membership – with numerous members from countries around the world. This edition of Heard on the Listserve focuses on a question posed by Hakki Gedik from Istanbul, Turkey.

Hakki began the discussion on April 16, 2008 with the following question:

“I wanted to seek other members’ guidance on the customary practice, if any, in connection with transfer restrictions that can be reasonably expected to apply to a hedge fund after its investment into a target company.

While shareholders agreements often provide for a lock-up period, which subjects the transfer of stock in the target company to third parties to the other party’s prior consent, hedge funds often argue that they should be free to transfer shares to “Affiliates”. Normally we would refer to a concept of “control” for purposes of establishing whether or not a person is an Affiliate, i.e., a permitted transferee. A definition of “control” could read as follows:

(“Control”, “Controlling” or “Controlled” as to any Person means the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of such Person, whether through ownership of voting securities, participation interests or partnership interests (or their equivalent), by contract or otherwise.)

We, however, often notice that Hedge Funds are reluctant to accept the concept of “control” and instead suggest a definition that refers to a concept of “management” (e.g. “Affiliate” means: (i) with respect to Investor, any other Person or Fund or subsidiary of a Fund which is advised by, or the business, operations or assets of which are managed or held (whether solely or jointly with others) from time to time by or whose parent is managed by, directly or indirectly, [Name of Management Co managing Investor]; or, ...).

According to those Hedge Funds, in order to be considered an Affiliate of an Investor, it should suffice for an entity to be, directly or indirectly, managed by the same management company. To our understanding, an Affiliate definition turning on management as opposed to control in effect removes the transfer restriction imposed by the lock-up.

I would be grateful for any feed back.”

Hakki received four replies. Not surprisingly, two of them were from outside the U.S. (India and Canada). The replies generally supported the notion of a test based on or at least involving a management concept within the definition of affiliate. However, the responders also generally

agreed that the pure control test for affiliate status is not unreasonable and should not be abandoned purely on arguments of “market” or custom.

Vishal Gandhi, from India, pointed out that agreeing to any position based on market practice is not always a good idea.

“I don’t think agreeing to a position based on customary practice is advisable in all situations and ultimately it depends on the bargaining position and risk appetite of the parties. Funds argue as per their convenience.

I think the control test is a reasonable one.

Also, consider imposing restrictions on transfer to a competitor.”

Andrew Flowers from Pittsburgh, Pennsylvania responded next and gave his perspective based on representing private equity and mezzanine funds. Andrew stated:

“ . . . we typically request (and get) permitted transfers to (1) the traditional control test affiliates, (2) entities managed by the same group that manages the initial investor, and (3) the LPs or other owners pro rata in the event of a fund liquidation. There are sometimes restrictions on transfers to competitors, but not always.”

Andrew also pointed out that in mezzanine transactions, the ability to transfer equity is sometimes required to be stapled to a strip of the debt. In echoing Vishal’s comments, Andrew added that “ I . . . find that as long as a requested deal point is not wildly out of line with current market trends, it really is a matter of what’s important to the parties and their respective negotiating leverage.”

Next, Myron Dzulynsky from Toronto, Canada provided the following reply:

“I have seen the “managed” versus “controlled” issue play out in institutional fund management groups where assets may move as between funds in certain circumstances (for example, where the fund life is shorter than the desired hold on the asset in question). In such a case, there is an argument for the managed approach, although the exact nature of the management relationship (and more particularly the distinction between delegated authority as compared to advisory arrangements) may be an open issue.”

Finally, Robert Webb from Arlington, Virginia replied. Robert agreed with Andrew’s comments and added, in support of the management-based test, that:

“ . . . increasingly, hedge fund managers are sourcing capital from foreign (non-US) sources, and to accommodate that, often establish side by side funds that are contractually committed (or thru a third jointly owned entity) to invest in similar proportions in order to provide assurance that the manager does not favor one over the other with respect to desirable investments. The advisor may own a part of a fund as general partner, LLC manager, or owner of a class of stock, or an entity may

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have an independent board (or investor controlled board) and in the latter case, the relationship is simply a management one. Another practice is that the source of funds may simple give the advisor management authority to invest x dollars via an advisory contract, but retain title and ultimate control in itself - very large capital sources increasing have this clout and often do so that they can custom design the ownership structure for their own objectives - be they tax (of their native country), political (avoidance of political confiscation risk, .e.g. Venezuela, certain former CIS states, other non-democratic nations).”

Robert closed by pointing out that foreign investment are becomingly increasingly important to U.S. funds, and “those who seek investment capital need to be accommodating to the new investment world or these dollars will simply not be available.”

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