

Making Investments with Alternative Investment Vehicles (AIVs)

Many private equity fund agreements contain a provision permitting, or under certain circumstances requiring, the general partner to establish an “alternative investment vehicle,” commonly referred to as an AIV, that, for a variety of tax or regulatory reasons, will make a portfolio investment in lieu of the main fund. Other terminology, such as “alternative investment fund,” is sometimes used for this concept.

An AIV is an entity separate from the main fund partnership. A portion of the investors’ capital would be invested in the AIV, and the AIV would make some of the investments made by the fund. For example, a fund organized as a Delaware limited partnership might establish as an AIV a partnership organized in the Cayman Islands to make an investment in a portfolio company organized outside the United States. The portion of the capital required to fund that investment would be invested in the Cayman Islands partnership, rather than in the Delaware limited partnership.

Use of an AIV is typically permitted (or in some cases may be required) where the making of a particular investment through the main fund vehicle could result in regulatory or tax disadvantages, or to allow investors to invest in particular investments through intermediate entities to satisfy their own tax or regulatory issues. The organizational documents of AIVs usually are clones of the documents of the main fund, modified only to reflect the AIV structure itself and for changes necessitated by legal differences between the vehicles (e.g., Cayman Islands law will govern a Cayman Islands limited partnership).

When AIVs Are Typically Used

Investments in Non-U.S. Portfolio Companies

One typical situation where AIVs are used is where a fund organized as a Delaware partnership contemplates an investment in a portfolio company organized outside the United States. As noted above, a partnership organized outside the United States, often organized in the Cayman Islands, may be used for this purpose. In this situation, the use of a non-U.S. partnership may be advantageous because partnerships organized outside the United States are treated more favorably under the rules relating to “controlled foreign corporations” (CFCs). Very generally, a CFC is a non-U.S. corporation more than 50% of the voting power or value of which is owned by U.S. persons each of whom owns (directly or indirectly, or by attribution) 10% or more of the

voting power of the corporation. If a corporation is a CFC, certain types of income of the corporation must be reported currently by 10% U.S. owners, and gains realized upon disposition of stock of the CFC by such U.S. owners may be treated as ordinary income rather than capital gain. Because of these unfavorable consequences, it is generally desirable to avoid having portfolio companies treated as CFCs. In determining the 10% U.S. owners, a partnership organized in the United States is treated as a single owner. However, a partnership organized outside the United States is not treated as a U.S. owner for this purpose. Rather, the partners in the partnership are the U.S. owners. Thus, for example, if a fund that has 20 equal partners and is organized as a Delaware partnership acquires 90% ownership of a portfolio company that is organized outside the United States, the partnership will be treated as a single U.S. owner with a 90% ownership interest, and the portfolio company will be treated as a CFC. However, if the fund establishes an AIV as a Cayman Islands partnership through which it invests in the portfolio company, each of the partners will own only 4.5% of the portfolio company, and CFC status may well be avoided.

Investments Likely to Generate UBTI or ECI

Another common situation where AIVs are used is to make investments in portfolio companies that are expected to generate UBTI or ECI. In this situation, some investors (tax-exempt entities or non-U.S. investors) may wish to invest in the portfolio company through a “blocker” structure, whereas other investors may prefer to invest in the portfolio company directly. A separate Delaware limited partnership may be established as an AIV to make the investment. The general partner of the fund (itself also a Delaware limited partnership) will act as the general partner of the AIV. A blocker entity (e.g., a Delaware corporation) will be organized. Limited partners are offered the choice of investing directly in the AIV or investing in the AIV through the blocker corporation. The investment contributions of limited partners who choose to invest through the blocker corporation are made to the blocker corporation, which in turn contributes the funds to the AIV. By this means, each investor can separately choose whether it wishes to invest directly or through the blocker corporation.

One advantage of an AIV structure is that, because carried interest can be paid by the AIV to the general partner before income is subject to taxation as it flows through the blocker entity, no issue arises as to adjusting the carried interest distribution for taxation suffered at the blocker level. In contrast, other blocker structures, such as where the main fund makes a portion of an investment through a blocker entity and a portion directly, may result in carried interest being payable only from after-tax distributions. In these situations, unless an adjustment is made for the general partner to receive carried interest based on the pretax proceeds (as is specified in many funds), the amount of carried interest received by the general partner is diminished.

Economics of AIVs

Coordination with Economics of the Main Fund

An issue that arises with respect to AIVs is the extent to which the economic provisions of the AIV will be coordinated with the economic provisions of the main fund so that the amount of distributions and carried interest are the same on an aggregate basis as if all investments were

made solely through the main fund. While generally it is intended that use of an AIV not modify the agreed economic terms, tax advisors are concerned that if the economic provisions are coordinated, the AIV and the main fund will be regarded as a single partnership by the United States Internal Revenue Service, with the result that the advantage sought by use of the AIV may be negated.

In many funds, this tension is resolved in favor of coordination of the economic provisions, as the tax risk is viewed as a lesser concern than the possibility that applying the economic provisions of the two vehicles separately will distort the intended economic results (e.g., carried interest could be payable because the investment made through the AIV is profitable, even though on an aggregate basis the fund operates at a loss or does not earn its hurdle return, so that no carried interest would be payable if the economics of the main fund and the AIV were coordinated). However, some funds provide for the economic provisions to apply separately to the main fund and to each AIV, or permit this result if aggregation of the economic results is determined to create a risk that the tax, regulatory, or other advantage sought by use of the AIV may be jeopardized by aggregated economics. In these situations, investors sometimes request that the economic results of all “nonaggregated” AIVs be themselves aggregated. By reducing the number of separate pools to which the economic provisions of the fund apply separately, the risk of unintended economic results can be somewhat diminished.

Significant Costs Associated with AIVs

Because an AIV is a separate legal entity, establishment and maintenance of an AIV involves significant costs. Even though the organizational documents (e.g., the partnership agreement) for an AIV will be closely modeled after the main fund documents, some real effort is involved in making the changes necessary to reflect the AIV provisions and conform it to the fund document. Legal opinions upon formation will typically be required. In addition, where an AIV is organized in a different jurisdiction, such as the Cayman Islands, foreign counsel will need to review the documents for changes required by foreign law and render appropriate opinions. On an ongoing basis, separate bookkeeping, as well as annual audits, will be necessary for the AIV, resulting in additional costs. Although the approach varies, often these costs will be borne by the fund, with costs of blocker vehicles borne by investors that participate in the blocker vehicles. In most cases, a separate AIV is created for each separate investment requiring an AIV. Thus, particularly for venture capital funds (whose typical investment will be small), cost may be a strong consideration against using AIVs. Instead, a venture capital fund may simply hold an interest in a portfolio company organized as a limited liability company through a corporate blocker entity and accept the resulting tax cost (i.e., corporate-level tax).

Other Issues Associated with AIVs

Mechanics of Formation

The steps to forming an AIV will generally be governed by the terms of the fund’s limited partnership agreement and such terms typically include a power of attorney that may be employed by the fund manager to facilitate execution of organizational documents of the AIV on behalf of investors. Even use of a power of attorney will have its limitations if an investor is

allowed to substitute a new investment entity to hold its interest in the AIV. In addition, such substitute entity will need to meet investor qualification requirements applicable to the other investors in the fund. Fund terms may also require opinions of counsel, circulation of organizational documents prior to closing, and ERISA compliance.

ERISA and VCOC Compliance

Great care must be taken when forming an AIV to consider ERISA matters and whether or not a fund is currently operating as a VCOC or is relying on the “significant participation test” (i.e., less than 25% ERISA investors). Often, tax-exempt investors will be grouped in blocker vehicles when investing in AIVs and, consequently, ERISA investors may comprise a much higher percentage of the blocker vehicle’s assets than when commingled in the main fund with all other investors. If the percentage of ERISA-related assets exceeds 25%, the assets of the blocker may be subject to ERISA, thereby raising fiduciary issues for the fund manager that must be addressed. In addition, VCOC exemptions may be implicated because the blocker vehicle may not be investing directly into an operating company, but rather into a holding vehicle. Each of these issues requires consultation with ERISA counsel that can address the specific facts and circumstances surrounding the formation of a particular AIV.

Transfers of Fund Interests

Once AIVs have been formed they should not be neglected by investors or fund managers in the transfer process. The existence of an AIV should be addressed as early in the transfer process as possible because, depending on the particular structure or jurisdiction of the AIV or the differences in regulatory status of the buyer and seller, transfer of the interest in the AIV may give rise to significant issues.

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For more information on the issues discussed here, please contact your Morgan Lewis [Private Investment Funds Practice](#) attorney.

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