About the Authors

Jack S. Levin, disguised as a professional corporation, is a senior partner in the international law firm of Kirkland & Ellis LLP, where it is widely rumored that the professional corporation does more of the work than does Mr. Levin.

In person Mr. Levin has also long been a lecturer at Harvard Law School (since 1997) and University of Chicago Law School (since 1988), teaching a course on *Structuring Venture Capital, Private Equity, and Entrepreurial Transactions*, indoctrinating thousands of young minds in the devious art of combining complex business, legal, tax, and accounting concepts.

Mr. Levin graduated summa cum laude from Northwestern University School of Business in 1958, where unlike Professor Ginsburg—whose meager lifetime accomplishments are painstakingly chronicled under Special Editors below—Mr. Levin was regrettably not on the golf team. In May 1958 Mr. Levin won the Illinois Gold Medal on the CPA examination, an accomplishment secretly admired by Professor Ginsburg.

In 1961 Mr. Levin graduated summa cum laude from Harvard Law School, ranking first in a class of 500, and served as Recent Case Editor of the Harvard Law Review, accomplishments that required no athletic prowess at all.

After graduation Mr. Levin served as law clerk to Chief Judge J. Edward Lumbard of the United States Court of Appeals for the Second Circuit and later as Assistant to the Solicitor General of the United States for tax matters under Archibald Cox and Thurgood Marshall, where he served as lead trial and appellate counsel in numerous U.S. Supreme Court, Federal Courts of Appeals, and Federal District court cases, while slowly developing the modest tennis game in which he long took immodest pride.

In addition to this *Structuring Venture Capital, Private Equity, and Entrepreneurial Transactions* treatise which has been updated and republished each year since 1994, Mr. Levin is also co-author (along with Donald E. Rocap and the late Professor Martin D. Ginsburg) of an exciting 5,000 page multi-volume treatise *Mergers, Acquisitions, and Buyouts* (Wolters Kluwer), updated and republished semi-annually since 1989, allowing Professor Ginsburg for many years to falsely claim sole credit for the many creative and few well written portions.

In 2013 *American Lawyer* magazine named Mr. Levin one of the 50 American lawyers who "over the last 50 years . . . have had an outsize impact on the [legal] profession," by helping (in *American Lawyer*'s words) to "lay the legal groundwork for the then nascent private equity industry," developing "frameworks for dealing with ratios for sharing profits between management and capital providers, general . . . versus limited partners, tax ramifications, carried interest, and senior versus subordinated borrowing."

In 2014, in connection with its 30th anniversary, *Best Lawyers in America* publication recognized Mr. Levin as one of the few attorneys who have been honored continuously in every annual edition of *Best Lawyers* since its 1983 inception, during which period Mr. Levin has been recognized in the areas of Leveraged Buyouts

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and Private Equity Law, Corporate M&A and Securities Law, Tax Law, Venture Capital Law, Corporate Law, and Corporate Governance and Compliance Law.

In 2010, *Best Lawyers* named (1) Mr. Levin the best tax lawyer in Chicago and (2) Professor Ginsburg the best tax lawyer in Washington, D.C. Jack and Marty each responded that the publication had gotten it at least half right.

In 2013, *Best Lawyers* named Mr. Levin the "Chicago Corporate Lawyer of the Year."

In May 2000 the American Jewish Committee bestowed on Mr. Levin the Learned Hand Award for contributions to the legal profession and the community. Although disagreeing with AJC's selection, Professor Ginsburg nevertheless delivered a warm keynote address entitled A Salute To Imperfection, while Justice Ruth Bader Ginsburg, the family's better part, presented the award.

In December 2002 the Illinois Venture Capital Association gave Mr. Levin a lifetime achievement award for service to the private equity/venture capital industry, which was presented by Senator (now President) Barack Obama, an honor Professor Ginsburg questioned, only in small part because not invited to speak at the awards dinner.

In May 2005 Chambers, running low on more distinguished attorneys, bestowed on Mr. Levin its global attorney lifetime achievement award, which was presented by then U.K. Prime Minister Tony Blair's spouse at a black tie dinner in London attended by 800 cheering attorneys and their guests.

In November 2005 the Illinois Holocaust Museum and Education Center honored Mr. Levin with its Humanitarian of the Year award at a dinner attended by 1,200 paying guests. Frugally unwilling to become a paying guest, Professor Ginsburg boycotted the dinner but was reported to have remarked with surprise on the apparent dearth of Illinois humanitarians.

In March 2011 the Association for Corporate Growth Chicago presented a lifetime achievement award to Mr. Levin for his role (much overstated during the evening's speeches) in helping to develop the legal and tax framework for the private equity/venture capital industry.

Mr. Levin has been a frequent speaker at major tax institutes, Practising Law Institute programs, and ALI-ABA seminars, mainly in warm climates, and at private equity/venture capital conferences, principally at ski resorts, and has authored more than 60 inspiring articles and book chapters on a variety of captivating tax, M&A, and private equity topics, although to the best of anyone's knowledge no one has ever read any of them.

Mr. Levin is a member of the Illinois State Treasurer's Advisory Board on Growth & Technology Investing (2004–present), the Harvard Law School Leadership Council of Chicago, the American College of Tax Counsel, the Illinois Holocaust Museum & Education Center's Board of Trustees, the American Jewish Committee's National Board of Governors as well as former president of AJC's Chicago Chapter from 2011 to 2013, and the American Israeli Public Affairs Committee's Illinois State Council Executive Board.

Mr. Levin has testified before Congress on tax legislation, most recently in 9/07 to the House Ways & Means Committee on taxation of private equity funds.

Over past times Mr. Levin has also served as Advisor (on business and entity taxation) to Pres. Bush's 2005 Tax Reform Panel, a member of the Harvard Board of Overseers Committee for Visiting the Harvard Law School, Chair of the ABA Subcommittee on Corporate Distributions, Chair of the Chicago Federal Tax Forum, Chair or Co-Chair of Harvard Law School Fund Raising Drives in 1986, 1991, 1996, 2001, 2006, and 2011, Mid-West co-chair of Harvard Law School's

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2004–08 Capital Campaign, a member of Little, Brown and Company's and CCH's Tax Advisory Boards, a member of the Tax Advisory Group to the American Law Institute's Federal Income Tax Project on Revision of Corporate Tax Laws, an Executive Committee member of the Chicago Bar Association's Taxation Committee, Chair of the Lawyers Division of the Chicago Jewish United Fund, president of the Birchwood Club, board member of the Mid-America Club, and, more important, for 13 years as Parliamentarian of the Winnetka Town Meeting (Winnetka, Illinois, being for the very few who do not know, the nation's model for honest and efficient government as described further below).

Through many patient years of practice and the selection of an extraordinary partner, Mr. Levin won the Kirkland & Ellis LLP doubles tennis tournament four successive times during the summers of 1987 through 1991, and it has been downhill ever since.

Overcoming a lifetime of fear, Mr. Levin some years ago at age 45 (through his professional corporation, in case of debilitating injury) took up downhill skiing, a sport he enthusiastically pursues shoulder-to-shoulder with a number of his private equity clients, who (unlike Mr. Levin) are professional risk takers.

While neither Mr. Levin nor Professor Ginsburg has ever achieved election to any public office, Mr. Levin's wife Sandy (the family's socially useful member and a bridge Silver Life Master) has at various times been elected President of the Winnetka Public School Board and a Trustee of the Winnetka Village Council. As Winnetka elected officials serve without monetary recompense and Sandy does not play bridge for money, Mr. Levin devotes most of his time to the remunerative practice of law, less to teaching, none to the professional tennis or skiing circuits.

Jack and Sandy have four daughters, two with law degrees and three with MBAs, two sons-in-law, one with a law degree and one with an MBA, and ten grandchildren, one of whom has successfully graduated from college.

Donald E. Rocap is a partner in the Chicago office of Kirkland & Ellis LLP, where he specializes in the tax aspects of complex transactions. Mr. Rocap is also a lecturer at the University of Chicago Law School.

Mr. Rocap received his undergraduate degree from Duke University and his J.D. from the University of Virginia Law School, where he was a member of the Order of the Coif.

Mr. Rocap has been selected as one of America's Leading Lawyers for Business in Tax by *Chambers USA* every year since 2004 and as one of The World's Leading Lawyers for Business in Tax by *Chambers Global* each year since 2002.

Prior to joining Kirkland & Ellis LLP, Mr. Rocap was Deputy Tax Legislative Counsel (Regulatory Affairs) at the U.S. Treasury Department's Office of Tax Policy.

Don and his wife Julie have two daughters and one son, none of whom have successfully graduated from high school.

About the Special Editors

Martin D. Ginsburg was Professor of Law at Georgetown University Law Center in Washington, D.C. His professional corporation was of counsel to the firm of Fried, Frank, Harris, Shriver & Jacobson LLP.

Professor Ginsburg attended Cornell University, stood very low in his class, and played on the golf team. He graduated magna cum laude from Harvard Law School which, in those years, did not field a golf team.

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Professor Ginsburg entered private practice in New York City in 1958. Although beloved by partners, clients, and opposing counsel, including Mr. Levin, he withdrew from full-time practice when appointed the Beekman Professor of Law at Columbia Law School. He moved to Georgetown University in 1980 when his wife obtained a good job in Washington.

In addition to Columbia and Georgetown, Professor Ginsburg taught at New York University School of Law, Stanford Law School, the University of Leiden in Holland, the Salzburg Seminar in Austria, Harvard Law School, and the University of Chicago Law School.

In 1986, someone who probably prefers never to be identified endowed a Chair in Taxation in his name at Georgetown; no one appears willing to occupy the Ginsburg Chair, and it remains vacant. In 1993 the National Women's Political Caucus gave Professor Ginsburg its "Good Guy" award; history reveals no prior instance of a tax lawyer held to be a "Good Guy," or even a "Decent Sort."

Professor Ginsburg was co-author (along with Mr. Levin) of a multi-volume treatise *Mergers, Acquisitions, and Buyouts* (first published in January 1989 and currently updated and republished semiannually by Mr. Levin and Mr. Rocap as co-authors with Wolters Kluwer Law & Business as publisher), in which he claimed to have written all the entertaining and intellectually challenging portions. He was a frequent speaker at tax seminars mainly in warm climates, and the author of a ghastly number of articles on corporate and partnership taxation, business acquisitions, and other stimulating things. Professor Ginsburg served on many bar association and government advisory committees, managing in each case to perform no useful service at all. Perhaps in recognition of this extraordinary achievement, in 2006 the American Bar Association presented him a lifetime Distinguished Service Award.

Professor Ginsburg's spouse was a lawyer before she found better work. Their older child was a lawyer before she became a schoolteacher. The younger child, when he feels grumpy, threatens to become a lawyer.

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Professor Ginsburg, the finest tax lawyer and human being of all time, passed away on 6/27/10.

Russell S. Light is a partner in the New York office of Kirkland & Ellis LLP where he concentrates his practice on the tax aspects of mergers, acquisitions, buyouts, and private equity and venture capital investing, on complex cross-border investments, and on debt restructuring and bankruptcy transactions. Mr. Light also focuses on tax planning for public and closely held entities, and on real estate transactions and transactions involving real estate investment trusts.

Mr. Light received Master of Engineering and Bachelor of Science degrees from the Massachusetts Institute of Technology and a J.D. degree from the University of Chicago Law School, where he graduated with High Honors and served as Managing Editor of the *University of Chicago Law Review*.

Mr. Light has been selected as one of America's Leading Lawyers for Business in Tax by *Chambers USA* and is author, co-author, or contributor to several tax publications.

Mr. Light would never even think of playing competitive tennis against Mr. Levin or competitive soccer against Mr. Rocap.

CHAPTER 1

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¶101 NATURE AND USE OF THIS TREATISE

This treatise addresses (1) the general nature of venture capital, private equity, and entrepreneurial transactions and (2) the legal, tax, accounting, economic, and practical concerns in structuring these transactions.

This treatise is suitable for use by a lawyer, accountant, investment banker, venture capitalist, private equity investor, subordinated debt lender, mezzanine ("mezz") lender, or anyone dealing with these professionals who desires to learn more about the nature of these transactions and the principal considerations in structuring them. It is also suitable for a law school or business school course focusing in whole or in part on venture capital, private equity, and entrepreneurial transactions.

This treatise covers many of the entrepreneurial transactions in which private equity and venture capital ("PE/VC") investors typically engage, including:

- Structuring a start-up transaction.
- Using a tax flow-through entity, such as an S corporation, a partnership, or an LLC, rather than a C corporation which attracts tax at both the corporate and the shareholder levels.
- Structuring a growth-equity investment in an existing company.
- Structuring a leveraged or management buyout of:
  - a wholly owned subsidiary or division of a big company,
  - a free-standing privately held company (i.e., a company which is neither publicly traded nor a subsidiary of a big company),
  - a publicly held company, or
  - any company in a transaction designed to qualify for no-purchase accounting.
- Structuring an industry consolidation.
- Structuring a bankruptcy or non-bankruptcy workout of an over-leveraged or troubled PE-financed portfolio company, including a turn-around investment into such a company.
- Designing subordinated debentures, mezz debt, preferred stock, various types of common stock, warrants, and convertible securities suitable for purchase by PE/VC or other investors.
- Designing an equity-based executive compensation arrangement for a PE/VC-financed portfolio company.
- Effectuating PE/VC's exit from a successful investment.
- Structuring the formation of a venture capital, private equity, or buyout fund (a "PE/VC fund").

The abbreviations most frequently used in this treatise are set forth at ¶108.

Most of the precedents necessary for an understanding of the principles discussed in this treatise are reproduced in the Appendix, including tax, SEC, bankruptcy, fraudulent conveyance, and Delaware corporate, partnership and LLC statutes, as well as tax and SEC regulations and rulings, a few court decisions, key articles, and other precedents.

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Scattered throughout this treatise as "Appendix References" are citations to those precedents most relevant to the topic being discussed which can be found in the Appendix to this treatise (except that referenced portions of the 5-volume Ginsburg Levin and Rocap, Mergers, Acquisitions, and Buyouts treatise [updated and republished by Wolters Kluwer semi-annually] are not reproduced in the Appendix).

Unless otherwise specifically stated, this treatise assumes that all individuals are either U.S. citizens or residents, that all entities are formed in the U.S., and that all businesses and assets are located in the U.S. (i.e., this treatise generally does not deal with the complexities of cross-border transactions).

¶102 GENERAL DESCRIPTION OF PRIVATE EQUITY AND VENTURE CAPITAL INVESTING

The PE/VC community includes PE, VC, and merchant banking subsidiaries (or divisions) of large institutions, such as BHCs, insurance companies, investment banks, or even large industrial companies. The PE/VC community also includes many free-standing specialized investment entities formed solely or principally to make PE/VC investments, such as publicly held or privately held SBICs, publicly held BDCs, and privately held PE/VC funds formed (generally as partnerships or LLCs) to make such investments.

A PE/VC fund generally raises its capital from a limited number of sophisticated investors in a private placement (including public and private employee benefit plans, university endowment funds, wealthy families, sovereign wealth funds, bank holding companies, and insurance companies) and splits the profits achieved by the fund between the PE/VC professionals and the capital providers/investors on a pre-negotiated basis (typically with 20% of the net profits allocated to the PE/VC professionals as a carried interest and the remaining 80% of the profits allocated among the PE/VC professionals and the capital providers in proportion to the capital supplied by each).

PE/VC professionals generally plan and execute PE/VC transactions, including start-ups, growth-equity investments, leveraged and management buyouts, leveraged recapitalizations, industry consolidations, and troubled-company turn-arounds.

¶103 DISTINGUISHING PRIVATE EQUITY/ VENTURE CAPITAL INVESTING FROM OTHER TYPES OF INVESTING

The *first* feature tending to distinguish PE/VC investing is the PE/VC professional's active involvement in identifying the investment, negotiating and structuring the transaction, and monitoring and guiding (but not managing on a day-to-day basis) the portfolio company after the investment has been made. Often the PE/VC professional serves as a board member and/or financial adviser to the portfolio company. Hence, PE/VC investing is significantly different from the purchase, holding, and sale of a diversified pool of stock and debt investments by a mutual fund or other money manager.

A *second* feature tending to distinguish PE/VC investing is that PE/VC investments generally are not intended to be held indefinitely. Rather, they are intended to be held for a limited number of years with the expectation that there will be substantial growth in equity value followed by a sale. For example, a PE/VC fund ordinarily has a limited term, often 10 to 13 years, and hence goes through cycles, with PE/VC investments being made during the first 5 years, value-added monitoring and growth continuing during the several years following each investment, most investments sold within 3 to 7 years after the original investment in the portfolio company, and all investments sold (or occasionally distributed in kind to the investors) within 10 to 13 years after the fund's formation.

The PE/VC investor normally does not intend to maintain long-term control over the portfolio company or to build a career running the portfolio company. Rather, the PE/VC investor generally evaluates alternative exit strategies when making the initial investment in the portfolio company. Often the original investment documents contain the terms, or at least the outline, of the PE/VC investor's anticipated exit strategy. Hence, PE/VC investing is significantly different from acquiring a company with the intent of managing it for the indefinite future and profiting indefinitely from the operating cash flow produced by the business.

A *third* feature tending to distinguish PE/VC investing is that the securities purchased are generally privately held by a small group as opposed to publicly traded.

- When a PE/VC investor organizes a new business start-up, the newly formed company ("Newco") is almost always privately held at the outset.
- Where a PE/VC investor makes a growth-equity investment in an existing company ("Oldco"), Oldco is usually privately held.

  In those few circumstances where PE/VC makes a growth-equity investment in a publicly held Oldco, PE/VC generally buys a class of Oldco securities that is not publicly traded. For example, where Oldco's common stock is publicly traded, PE/VC may buy Oldco (1) convertible preferred stock or convertible subordinated debentures (convertible into Oldco common stock) or (2) non-convertible preferred stock or non-convertible subordinated debentures together with warrants to purchase Oldco common stock.

  And even when PE/VC infrequently buys a class of publicly traded Oldco common stock, PE/VC typically acquires such stock from Oldco in a private placement subject to SEC restrictions and with additional negotiated rights (e.g., registration rights, preemptive rights, warrants to buy additional Oldco stock at a fixed price, one or more board seats, etc.) which make PE/VC's stock different from Oldco's publicly traded common stock.
- Even where the target company in a buyout is publicly held (before the buyout), the new company formed to effectuate the buyout ("Newco") is almost always privately held immediately after the buyout, i.e., the buyout transaction takes the target company private.

In sum, a PE/VC investment is normally made in a privately held company, and in the relatively infrequent cases in which the investment is into a publicly held company, PE/VC generally holds non-public securities.

While PE/VC's exit strategy often involves taking the portfolio company public and ultimately selling PE/VC's stock into the public market, public trading of the portfolio company's stock is generally part of the end game, not the opening gambit. Thus, PE/VC investing is considerably different from buying, holding, and selling publicly traded equity securities.

A *fourth* feature tending to distinguish PE/VC investing is that PE/VC generally undertakes risky investments in order to obtain a very high return on its capital. PE/VC does not purchase debt instruments simply to obtain an interest yield. Rather, the principal goal of a PE/VC transaction is to obtain geometric returns when the portfolio company is successful and its common stock or common equivalents soar in value. Hence, a PE/VC transaction generally involves the purchase of one or more of the following:

- Common stock.
- Convertible preferred stock or convertible subordinated debt with a relatively low yield (all or a portion of which may be deferred) but with attractive features allowing conversion into common stock.
- Non-convertible preferred stock or non-convertible subordinated debt with a relatively low yield but accompanied by warrants to purchase common stock.
- Debt instruments that can be purchased at a deep discount to face, generally because the portfolio company is over-leveraged or financially troubled and PE/VC plans to participate in a turn-around transaction.

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PE/VC generally purchases a relatively risky slice of the portfolio company's capital structure (and is frequently subordinated to a substantial amount of the portfolio company's leverage, i.e., debt), risks losing most or all of its investment if the portfolio company does not prosper, and expects to be handsomely rewarded if the portfolio company does prosper. PE/VC requires a high return on successful investments to cover its losses suffered on portfolio companies which fail—i.e., to provide a high compound internal rate of return ("IRR") on its *aggregate* invested capital to compensate for the high risk of such investments.

This feature—purchasing risky equity-oriented securities and seeking a high compound yield on successful transactions—distinguishes PE/VC transactions from the purchase of debt securities.

One type of transaction which falls just short of the PE/VC transactions featured in this treatise is mezz lending, i.e., a layer of financing which is more risky than senior bank debt but less risky than the PE/VC investment, thus placing the mezz investment between PE/VC's common and preferred stock investment and the bank's senior debt investment (as the mezzanine in a theater sits between the ground floor and the balcony). The mezz lender (like PE/VC) generally employs active investment professionals who negotiate the purchase of privately placed securities in PE/VC transactions, such as buyouts, but the mezz securities are normally purchased directly from the portfolio company and are predominantly debt securities, generally high-yield subordinated debt (or possibly senior preferred stock), with a relatively small equity kicker, i.e., a slice of common stock, warrants, conversion rights, or contingent additional interest to compensate the mezz lender for the risk of buying *subordinated* debt.

The senior bank lender generally locks in its entire yield in the form of contractual interest payments (albeit often at rates which fluctuate with market interest indexes) and specified fees, although infrequently the senior lender may take a small equity kicker when financing a buyout. The mezz lender, by contrast, normally takes a portion of its yield in the form of an equity kicker, and thus shares an expectancy (with PE/VC) in the portfolio company's future equity appreciation. However, mezz debt is at least one level more senior in the capital structure than PE/VC's investment and hence is significantly less risky than PE/VC's investment. Moreover, the mezz lender's focus, more like the senior lender's and less like PE/VC's, is on its high interest yield and relative safety of debt principal. The mezz lender's equity kicker is designed to augment its interest yield but does not play the central role that it does with PE/VC.

The PE/VC investor, on the other hand, focuses on common stock or common equivalent securities, with any purchase of subordinated debentures and/or preferred stock generally designed merely to fill a hole in the financing or to provide PE/VC with some priority over management in liquidation or return of capital.

A *fifth* feature tending to distinguish PE/VC investing is that PE/VC generally invests in a portfolio company only when convinced that the company has (or that PE/VC has recruited) a superior management team. PE/VC generally cannot be induced to put its money behind a management team in which it does not have confidence, no matter how attractive the portfolio company's product, concept, or business plan. A frequently heard PE/VC maxim is that an attractive portfolio company has 3 key attributes: superior management, superior management, and superior management.

Where PE/VC disregards this maxim and backs weak management, PE/VC too often is soon faced with an unpalatable choice: *either* continue with suboptimal management and risk the portfolio company's falling behind its business plan *or* fire management and seek superior replacements, risking significant business disruption during which well-managed competitors often can overcome the portfolio company's early lead. A second, but less obvious, reason to avoid weak management is that, when management must be replaced mid-stream, PE/VC must devote an inordinate amount of time recruiting and training new management, diverting PE/VC from its other portfolio companies.

A *sixth* (although not inevitable) feature tending to distinguish PE/VC investing is that PE/VC often seeks control of the portfolio company in the early years or, if control is not obtainable, at least board representation. This is because PE/VC does not view itself as supplying capital alone, but also as providing important advice on financial and strategic planning and oversight for the portfolio company's management in order to add value to PE/VC's investment.

Where a portfolio company needs more money than the lead PE/VC is willing to commit, the lead PE/VC may bring one or more additional PE/VCs into the deal. The lead PE/VC normally plays the principal role in structuring and negotiating the investment, but each PE/VC (at least each PE/VC with a substantial investment) monitors its own investment, and PE/VCs do not inevitably act in concert (except insofar as their interests coincide) on issues involving the portfolio company.

In recent years, hedge funds have begun to invade the PE/VC turf. Hedge funds (like PE/VC funds) are generally private partnerships, composed of wealthy,

sophisticated investors, seeking very high returns on capital by using aggressive investment strategies. However, a hedge fund (unlike a PE/VC fund) traditionally:

(1) invests principally in publicly traded assets (e.g., stocks, bonds, currency futures, interest rate futures), in which the fund may take both long and short positions, and generally uses substantial leverage (i.e., debt) at the fund level,

(2) plans to continue forever, i.e., does not sell investments and return investors' capital (and profits) by a specified date, while a PE/VC fund by contrast generally completes its investment cycle within 3-to-5 years after formation, completes its sale cycle within 10-to-13 years after formation, and then dissolves, so that the PE/VC principals generally form a new PE/VC fund every 3-to-5 years, and

(3) allows investors to withdraw capital and/or profits quarterly after an initial (approximately 1-to-2 year) lockup period (or to contribute new capital quarterly).

However, as competition for traditional hedge fund high-yield investments has intensified, resulting in a decline in hedge fund yields, many hedge funds, seeking higher yields, have increasingly devoted a portion of their capital to PE/VC-type non-traded investments, while concomitantly imposing a restriction on the investors' right to withdraw quarterly the portion of their capital devoted to such long-term PE/VC investments (so-called side-pocket investments).

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¶104 HIGH COST OF PRIVATE EQUITY/VENTURE CAPITAL MONEY

PE/VC money may not on its face cost the portfolio company as much as a bank loan, a private placement of senior debt securities, or a public issuance of senior debt securities. That is, there frequently are few or no fixed interest or debt service payments on PE/VC money. However, if the portfolio company is successful, PE/VC money is inevitably more expensive to the portfolio company's other common shareholders. This is because PE/VC, as a condition to investing in the portfolio company, demands a substantial portion of the portfolio company's common equivalents—common stock, warrants, and/or conversion privileges—which will have substantial value if the portfolio company is successful.

Hence, as a general rule, where a portfolio company can obtain traditional debt financing, it finds this route less expensive to its existing common shareholders than PE/VC financing. However, the very factors which make a portfolio company attractive to PE/VC—a speculative situation with substantial opportunity for value enhancement if (but only if) the business succeeds—often make the portfolio company too risky to qualify for unsupported bank or other traditional debt financing. Once the portfolio company obtains PE/VC financing, it usually can leverage its new-found PE/VC equity by obtaining bank (or subordinated/mezz) loans senior to the new PE/VC money.

Moreover, obtaining a PE/VC investor generally brings the portfolio company more than capital. As discussed above, one or more top-flight PE/VC professionals generally

serve on portfolio company's board, providing the portfolio company with high quality financial and strategic advice and management oversight. Thus, a PE/VC relationship gives the portfolio company substantial benefit not normally obtainable through a traditional bank financing or a private or public debt floatation (although strong-willed portfolio company management not desiring any such PE/VC oversight may not appreciate the benefit). Such advice can, of course, be a two-edged sword and, where PE/VC obtains control and the portfolio company then fails to meet its business plan, can leave portfolio company's management seeking new jobs.

¶105 TYPICAL PRIVATE EQUITY/VENTURE CAPITAL TRANSACTIONS

¶105.1 Traditional Start-Up Transaction

The phrase "venture capital" is sometimes used narrowly to refer only to financing the start-up (or early stage growth) of a new business, a transaction which generally involves negotiation between one or more professional VCs and one or more entrepreneurs seeking to start the business. Such a Newco start-up transaction is discussed in Chapter 2, and the pros and cons of organizing Newco as an S corporation, a partnership, or an LLC, rather than as a traditional C corporation, are discussed in Chapter 3.

Such start-up transactions can be categorized into (1) seed money and (2) early stage. Seed money refers to financing a potential business requiring substantial research, development, and/or other threshold activities before the entrepreneur can begin revenue-generating activities. Early stage venture capital, on the other hand, refers to financing an entrepreneur who has passed the seed-money stage and is ready actually to begin (or has recently begun and now seeks to expand) revenue-generating activities.

Start-up transactions can further be broken down into high tech, low tech, and no tech, depending on the degree of cutting edge technology necessary for the business to succeed. Businesses financed by VC investors can range from a high-tech bio-genetic engineering company to a low-tech manufacturing enterprise to a no-tech retail or fast food chain.

Naturally, a VC investor is more likely to supply start-up money where the entrepreneur is a successful inventor and/or executive with a proven track record.

¶105.2 Growth-Equity Transaction

Frequently, an existing business enterprise needs money for expansion—to build a new plant, to develop a new product, to begin national distribution of a local or regional product, to acquire an add-on business, etc. The enterprise's capital requirements may exceed the amount it is able to raise from traditional sources, such as a secured loan from a bank lender, a private placement of debt with an insurance company, a private offering of equity to Oldco's shareholders

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and their friends and family, or a public offering of debt or equity securities (or, with respect to the last alternative, it may be premature for Oldco to go public).

In these circumstances, a business seeking money for expansion might turn to a PE investor to supply its capital needs, or perhaps to supply enough equity capital to serve as a base for borrowing the remainder of its capital needs from traditional lenders. Such a PE investment in an existing company ("Oldco") is called a growth-equity investment.

While a PE growth-equity investment is generally into a privately held Oldco, PE may under certain circumstances invest in a publicly traded Oldco. In this case, PE is likely to buy securities of a type not publicly traded (e.g., preferred stock convertible into publicly traded common stock). Less commonly, PE may buy securities (directly from Oldco) of the publicly traded class (typically common stock), but at a substantial discount from the public-market price and/or with other valuable rights (e.g., preemptive rights, options or warrants to buy additional stock at a fixed price, one or more board seats, etc.). Although Oldco is publicly traded, such stock acquired in a private transaction (rather than in the public market) is subject to SEC restrictions on resale, so that PE normally obtains registration rights from Oldco as a condition of making the investment.

Where the investment in Oldco is relatively large, PE may organize a consortium or syndicate of PE investors, who will usually co-invest in the same strip of securities.

While a growth-equity investment is generally designed to provide Oldco with expansion capital, there are cases where Oldco is seeking the new investment in order to redeem (for cash) Oldco stock from existing large shareholders. One or more Oldco shareholders may be seeking such a stock redemption to pay estate tax (where a large shareholder has died) or for liquidity (where the shareholder has recently retired or is engaged in estate planning). Such a growth-equity investment to finance a redemption is called a recapitalization and, when financed primarily with borrowed money, a leveraged recapitalization.

Because Oldco in a growth-equity investment is generally more mature than is Newco in a start-up, a growth-equity transaction is often called a later-stage investment (as compared to a seed-money or early stage growth investment in a start-up or young company). Where the investment is into a more mature Oldco seeking growth-equity money, PE's investment risks and potential gains are generally lower than in a start-up.

A traditional growth-equity investment into Oldco is examined in Chapter 4.

In many proposed growth-equity investments, PE concludes that the key management executives do not own sufficient Oldco stock to incent their future performance, i.e., that too large a percentage of Oldco's stock is in the hands of passive shareholders and too small a percentage is in the hands of key managers. In this case, a front-end restructuring of Oldco's equity ownership is often an essential step to induce PE to invest in Oldco. Chapter 4 discusses several methods for achieving this equity restructuring objective.

¶105.3 Troubled-Company Turn-Around Investment

Occasionally, PE may make a growth-equity investment in a company ("Badco") which is suffering losses, is over-leveraged, and/or is experiencing other financial or business reverses. PE may also purchase Badco distressed

debt trading at a deep discount with the goal of obtaining equity in, and even control of, Badco through a bankruptcy or other restructuring of Badco.

PE may make such a "turn-around" investment into an unrelated Badco in which PE has not previously invested. Or PE may have been Badco's original sponsor, i.e., today's Badco may, a few years ago, have been the Newco which, with much optimism and with PE's money, acquired Target in a highly leveraged buyout.

Whether or not PE made a prior investment in Badco, PE's new turn-around investment generally presents the same issues, except that, where PE was Badco's original sponsor, there is greater pressure on PE to make the new turn-around investment, to protect both its original Badco investment and its business reputation. Such turn-around financing into a troubled Badco is almost always riskier than traditional growth-equity financing of a sound, well-managed company.

A turn-around investment in an over-leveraged, financially troubled Badco is analyzed in Chapter 8.

¶105.4 Leveraged or Management Buyout

When an established business ("Target") is for sale, there are at least 3 classes of potential buyers:

- A *strategic buyer* is a company which already owns a business similar or complementary to Target's and believes that combining the buyer's existing business with Target's business will produce a synergistic increase in value.
- A *long-term investor* is a person or group desiring to enter Target's industry (e.g., a company engaged in other businesses seeking diversification or the former managers of another company in Target's industry seeking a new situs for their talents) which has (or can borrow) the capital necessary to buy Target.
- A *financial buyer* is a PE investor (or group of such investors) able to raise the funds necessary to buy Target, generally with the goal of holding Target for 3 to 7 years, improving Target's business performance, and then reselling Target at a substantial profit.

Where a PE investor (or group) is planning a leveraged buyout (an "LBO"), PE generally forms a new company ("Newco") to buy Target, arranges for Newco or Target to borrow a majority of the necessary funds (hence the use of the term "leveraged" buyout), and contributes a minority of the necessary money as equity capital. In one LBO variation PE does not form Newco but instead invests directly in Target, which borrows additional funds and redeems most of its old shareholders with the new equity and debt money, in a manner designed to avoid push-down purchase accounting (i.e., to avoid restating upward the accounting book value of Target's assets on Target's financial statements and hence to minimize post-buyout depreciation/amortization reductions in Target's accounting earnings).

Newco frequently arranges its LBO borrowings in several tranches—from senior lenders, senior subordinated lenders, and junior subordinated lenders. In order to obtain each successively more junior layer of debt financing, Newco must offer a progressively higher interest rate and/or a progressively larger equity

kicker (Newco common stock, warrants, a conversion privilege, or contingent additional interest based on Newco's results) to each more subordinated layer.

However, the essence of an LBO is that only Newco and/or Target is liable to the lender for the borrowed money. That is, PE typically does not guarantee any of Newco's debt (other than possibly a guarantee with recourse only to Newco's stock owned by the guarantor, which does not expose the PE's assets other than its Newco investment).

Typically, as part of the LBO arrangements, PE obtains top management talent (either newly recruited executives or Target's most talented existing executives) to run Newco-Target after the LBO and incents them with cheap common stock or with common equivalents, such as stock options, often subject to complex time and/or performance vesting.

Sometimes, Target's management (rather than PE) originates the deal, and Target's management executives then seek to recruit a PE (or group) to provide equity financing for the acquisition. This most often happens where Target's old owners have offered to sell Target to Target's existing management team if they can raise the necessary financing. In such case, the transaction is generally called a management buyout (an "MBO").

Throughout this treatise the term "buyout" is used to include both traditional PE-led LBO and a management-led MBO.

Buyouts come in at least 3 varieties, with the applicable tax, SEC, accounting, and other legal and practical implications of each varying significantly from the other 2 variations:

- The simplest version of a buyout is the purchase of a Target division or wholly owned subsidiary from a large corporation ("Bigco"), often where Bigco acquired Target to diversify (when Bigco was seeking to become a conglomerate) but Bigco has since concluded that Target no longer fits Bigco's long-term—back to core business—strategy.
- A somewhat more complicated buyout variation is presented where Target is privately held by a family or relatively small group of persons, i.e., Target is not a Bigco division or consolidated subsidiary.
- The most complicated buyout variation is presented where Target is itself a publicly traded corporation, often with stock trading at a disappointing price, so that Target's board of directors decides to maximize shareholder value by selling Target, in which case Newco's purchase of public Target is called a going-private transaction.

These 4 buyout variations are discussed in Chapter 5.

Chapter 6 discusses the terms and tax ramifications of debt and equity securities frequently used in buyouts, as well as all the other PE transactions described above and below.

¶105.5 Industry Consolidation

Often PE identifies a fragmented industry, i.e., an industry in which there are many small or relatively small competitors and no or few market leaders have

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appeared. PE then recruits a top-flight management team with experience in the industry and, together with the management team, forms Newco as a "platform" to assemble a significant, or perhaps even leadership, presence in the fragmented industry by (1) acquiring selected strategically located industry players in a series of buyouts or roll-ups, (2) starting up new businesses in those markets where there is no desirable target business or the existing businesses in such market are overpriced, and (3) amalgamating the buyouts and start-ups into a regionally or nationally important player in the otherwise fragmented industry.

Often the term "platform" is used where the consolidation begins with a reasonably large buyout of an established business, followed by numerous add-on acquisitions, and the term "roll-up" is used where there is no large initial acquisition but only a series of reasonably small acquisitions.

Chapter 7 discusses industry consolidations, including the advisability of using a holding corporation, holding partnership, or holding LLC as an umbrella entity over the various business enterprises being assembled.

¶105.6 Exit Strategies

When PE/VC invests in a transaction of the types identified above, its goal is to liquefy the investment at a substantial profit when portfolio company's value has been maximized through astute management supplemented by PE/VC's supervision and advice, add-on acquisitions, and the like (i.e., when portfolio company has matured to the point where its value is no longer growing geometrically), generally 3 to 7 years after PE/VC's initial investment in portfolio company.

When structuring its original investment—in a start-up, growth-equity, buyout, industry consolidation, or troubled company—PE/VC is already planning its ultimate exit strategies. Indeed, contracts signed at the time of the initial investment generally give PE/VC certain future rights to control its exit strategy. This is especially important where PE/VC will not (or may not) control portfolio company at the back end when the exit strategy is executed. Even where PE/VC will control portfolio company at the time of the end game, the actual exit strategy employed (e.g., a sale of portfolio company's stock) may require cooperation from some shareholders who will not (or may not) be in agreement with the timing, price, or other terms as proposed by PE/VC. For these reasons, it is important that PE/VC obtain, at the front end when making its investment, contractual rights to control the back-end exit strategy.

PE/VC's exit scenarios may include (1) sales of portfolio company stock to the public in an IPO or a post-IPO registered offering or pursuant to SEC Rule 144 *or* (2) sale of portfolio company to a large company ("Bigco") in exchange for Bigco stock (in a tax-free reorganization), for cash, or partly for cash and partly for Bigco debt instruments on the installment method *or* (3) sale of PE/VC's securities back to portfolio company, possibly at a fixed time and price (e.g., a scheduled redemption of PE/VC's preferred stock) or possibly at PE/VC's option and for FV determined by appraisal or by formula (e.g., a common stock variable-price put).

Chapter 9 discusses exit strategies.

¶105.7 Formation of Private Equity, Venture Capital, or Buyout Fund

Where PE/VC professionals are employed by a large institution, such as a bank holding company or an insurance company, they generally invest the institution's money and hence do not form a fund. Frequently, however, a group of individuals experienced in PE/VC investing (often former executives of a large institution's PE/VC operation) form a PE, VC, or buyout fund (a "PE/VC fund").

In this case the PE/VC professionals often raise capital from a limited number of sophisticated investors, including public and private employee benefit plans, university endowment funds, wealthy families, insurance companies, and bank holding companies. Such a PE/VC fund is generally formed as a partnership or LLC (to avoid entity level taxation) and generally splits the fund's profits between the PE/VC professionals and the capital providers/investors on a pre-negotiated basis, typically with 20% of the net profits going to the PE/VC professionals as a carried interest and the remaining 80% to the PE/VC professionals and the capital providers in proportion to the capital supplied.

A PE/VC fund may in limited circumstances seek to qualify as an SBIC.

Occasionally a PE/VC fund offers equity interests to the public (rather than only to a limited number of sophisticated investors), in which case the fund generally qualifies as a publicly held BDC.

The PE/VC fund generally makes new investments into portfolio companies for a limited period of time, e.g., 5 years after formation, engages in value-adding monitoring during the several years following each investment, sells each investment as soon as it matures, distributes the proceeds to the fund's partners as sales occur, and completes the sale of virtually all its investments (or distributes in kind to the investors) within 10 to 13 years after the fund's formation. Hence, approximately 4 to 5 years after a PE/VC fund's formation, the PE/VC professionals, if they have developed (or are able to convince investors that they are developing) a successful track record, generally seek to form a second fund, so that they have money for future investments, with future funds to follow every 4 to 5 years or so.

Chapter 10 discusses the formation of a new PE/VC fund.

¶106 HISTORY OF PRIVATE EQUITY/VENTURE CAPITAL INVESTING

¶106.1 Ancient History

While professional PE/VC investing as described above is a fairly recent phenomenon, "private risk capital" investing has existed in one form or another in every society that had significant commercial activity. A few examples:

- Marcus Licinius Crassus, reputedly the richest man in Julius Caesar's Rome, financed many enterprises, including a private fire department. Though most of Rome's buildings were made of wood in the first century B.C.,

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republican Rome lacked a public fire department. Crassus capitalized on this deficiency: When a building caught fire, his business agents and firefighters would repair swiftly to the scene of the conflagration. If they believed the building (or the adjoining structures) worth saving, the agents would offer to buy it (or them) for cash (at an appropriate discount). If the owner refused, the firefighters would leave without taking remedial action. If the owner agreed to sell, Crassus' agents would close the purchase and his firefighters would then attempt to save the building. While not every such Crassus investment was a success, Crassus apparently did very well on a fully distributed portfolio basis.

- In 1492, Christopher Columbus obtained from Ferdinand and Isabella of Spain the PE/VC capital necessary to finance his exploration of the New World.
- In 16th and 17th century England, aristocrats and other wealthy families financed risky commercial and industrial enterprises—mostly foreign trade, exploration, and privateering, constituting the high-tech of that era—and were known as "adventurers." For example, the Merchant Adventurers, licensed by Henry VII, played an important part in opening trade with "Muscovy" and served as a model for companies formed later to exploit the New World.

¶106.2 Industrial Revolution and Merchant Bankers

With the 19th century industrial revolution, banks became the main source of business financing. Business enterprise had become so common that it was no longer viewed as inherently high-risk.

Hence, PE/VC began to focus on financing a business that lacked access to bank financing, frequently by providing equity capital as the underpinning for a bank loan. As in earlier times, such equity financing was largely provided by amateur venture capitalists—wealthy families, the entrepreneur's friends, local business acquaintances, etc.

However, as the scale of business endeavors, and hence their capital needs, escalated (building transcontinental railways, shipping wheat from the Ukraine or the American West to growing European cities, etc.), PE/VC became more institutionalized. In England, merchant banks emerged as the principal providers of high-risk capital to business enterprises around the world, investing both capital obtained from their partners and capital obtained from other rich individuals and families. While the English aristocracy and other wealthy English families had long invested in risky business enterprises, the merchant banks were more professional and could raise more capital than the amateur investors.

English merchant banks helped to finance the U.S. industrial revolution and provided a model for U.S. merchant banks (such as J.P. Morgan) financing new industries, like steel and oil. However, merchant banks tended to focus more on new enterprises requiring substantial capital from the start than on small business. Hence, small businesses continued to rely on family, friends, and wealthy amateurs willing to take a flyer on a new enterprise.

¶106.3 U.S. in the 1940s and Thereafter

PE/VC investing in the U.S. today largely reflects the marriage of the 2 traditions discussed above: "professional" merchant banking and "amateur" venture investing by wealthy individuals and families.

Beginning in the 1940s, several very wealthy American families began the move from amateur to professional PE/VC status by developing the continuity of focus and the staffing which enabled them regularly to find, evaluate, consummate, and monitor risk-oriented investments.

Passage of the Small Business Investment Act in 1958 was a critical event, because it gave public recognition—and government financial backing—to professional PE/VC investing as an independent, profitable activity. The Act also permitted banks (and BHCs) to invest in SBICs. The entry of banks into PE/VC investing in the late 1950s, and the growth of these endeavors through the 1960s and 1970s, were key steps in the formation of a professional, institutionalized, PE/VC industry in the U.S. Many professionals throughout the PE/VC industry obtained their training at bank SBICs.

Beginning in the late 1970s, private and public employee benefit plans and university endowment funds began investing a small (but steadily increasing) portion of their enormous available funds in PE/VC funds. As this huge pool of previously risk-averse capital began to seek skilled PE/VC professionals to handle a slice of their investment capital, the formation of PE/VC funds—often staffed by experienced former executives from the PE/VC subsidiaries of banks and insurance companies—received a tremendous boost.

Today the PE/VC industry is an extraordinary mixture of institutional PE/VC subsidiaries (investing money supplied by a parent bank or insurance company), private funds (investing money supplied by sophisticated investors, including public and private employee benefit plans and university endowment funds, wealthy U.S. families, insurance companies, banks, wealthy foreign families, and foreign governments), and wealthy individuals and families (angel investors) investing their own money. These institutional PE/VC subsidiaries and private funds focus on a wide range of risk-oriented investment opportunities from seed money and early stage start-ups to later-stage growth-equity investments, recapitalizations, buyouts, turn-arounds, and industry consolidations, while angel investors typically focus on smaller seed money and early stage investments.

PE/VC funds formed in the late 1970s were generally $100 million or less in size and made investments ranging from a few hundred thousand dollars to a few million dollars. Many recent PE/VC funds have capital exceeding $1 billion (and a few exceeding $10 billion), and make equity investments exceeding a billion dollars. Thus the PE/VC industry has moved from specialty financing into the top ranks of mainstream American (and global) business.

¶107 THE SHIFTING SANDS OF FEDERAL TAX RATES

Most of the transactions discussed in this treatise (e.g., a PE/VC fund formation, a Newco start-up, or an LBO), if effectuated now, would produce tax ramifications

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far into the future. However, predictions as to whether future top individual or corporate tax rates will rise or decline are unfortunately pure guesswork because of the conflicting political and economic philosophies of the U.S.'s two principal political parties.

The top 2016 *corporate* income tax rate (for OI or CG) is 35%.

The top 2016 *individual* income tax rates are 39.6% for OI, 20% for qualified dividend income ("QDI"), and 20% for LTCG (with an even lower rate for LTCG on "small business stock" held more than five years).[1] However, two income-based Medicare taxes and two deduction phase-outs effectively increase these top individual income tax rates, at least for high income individuals. These rates apply not only to income directly earned by an individual, but also to partnership, LLC, and S corp-level income flowing through to an individual equity owner.

> Discussion of individual tax rates throughout this treatise, unless otherwise specifically stated, takes into account only regular income taxes and does not take into account (a) the uncapped Medicare tax on compensation and self-employment income, (b) the uncapped Medicare tax on passive income, (c) the 3%-of-AGI itemized deduction disallowance, or (d) the personal exemption phase-out, all of which increase the effective tax rate as discussed at ¶107(4).
>
> Unless otherwise stated, when this treatise discusses the LTCG tax rate for an individual taxpayer, we are referring to the regular LTCG rate, not to the reduced §1202 rate.

(1) The top federal income tax rate for an individual's OI and STCG (i.e., gain on disposition of a capital asset held over one year or less), 39.6% for many years before 2001, was reduced (in several steps) to 35% where it remained through 2012, but returned to 39.6% for 2013 and thereafter.

(2) The top federal income tax rate for an individual's LTCG (i.e., gain from disposition of a capital asset held more than one year), 20% for many years before 2003, was reduced to 15% from 5/03 through 2012, but returned to 20% for 2013 and thereafter.

However, for an individual's LTCG on sale of "qualified small business stock" held more than five years there continues to be a reduced federal income tax rate (14%, 7%, or 0%, depending on the qualified stock's acquisition date) and a tax-free rollover on sale of stock that would have qualified for this reduced rate (except that the necessary holding period for rollover is more than six months rather than more than five years) where the proceeds from the stock are reinvested in new qualified small business stock within 60 days after the stock sale. See ¶907 for discussion of these qualified small business stock tax breaks.

¶107 [1]For this purpose, "individual" generally includes a trust or the estate of an individual.

(3) The top federal income tax rate for an individual's QDI, long the same as the individual tax rate on other types of OI, was reduced in 2003 to the same rate that applies to LTCG, i.e., 15% from 2003 through 2012 and 20% for 2013 and thereafter.

QDI means dividends (out of corporate E&P[2]) taxable to an individual (directly or through a flow-through entity) from either a U.S. corporation or a "qualified" non-U.S. corporation.

A dividend from a non-U.S. corporation can qualify for QDI tax treatment if (a) the stock (including ADRs) on which the dividend is paid is readily tradable on an established U.S. securities market, or (b) the non-U.S. corporation is incorporated in a U.S. possession, or (c) the non-U.S. corporation is eligible for benefits of a comprehensive U.S. income tax treaty which includes an exchange of information program, but in each case only if the corporation is not, in the dividend year or the prior year, a passive foreign investment company.

A dividend (from a U.S. or qualifying non-U.S. corporation) constitutes QDI only if an individual holds the stock (directly or through a flow-through entity) more than 60 days during the 121-day period beginning 60 days before the stock goes ex-dividend (for certain preferred stock, more than 90 days during the 181-day period beginning 90 days before the stock goes ex-dividend). For this purpose, the period an individual is treated as holding stock does not include any day on which the individual has a contractual obligation (or an option) to sell substantially identical stock. As a result of this rule, a dividend the ex-dividend date for which is subsequent to the date the individual enters into a contract to sell the stock (e.g., where an individual sells stock of a target corporation and the sales contract permits the target corporation to pay a dividend to the selling shareholders immediately before closing) may fail to qualify for QDI treatment—even if the individual has held the stock for a long period before entering into the contract to sell the stock.

Additionally, a dividend does not qualify to the extent the shareholder is under an obligation (whether pursuant to a short sale or otherwise) to make payments related to the dividend with respect to positions in substantially similar or related property.[3]

(4) Disguised additional federal individual income-based taxes. The effective federal tax rates for an individual are higher in many cases than the regular income tax rates discussed in (1) through (3) above (e.g., 39.6% OI rate and 20% LTCG and QDI rate for 2013 and thereafter) because of additional federal income-based taxes and deduction phase-outs discussed in (a) through (e) below.

[2]E&P—earnings and profits—is a concept similar to accounting retained earnings, but determined in accordance with tax principles, and is calculated in two components (without duplication): (1) for the entire year in which the dividend is paid (current E&P) and (2) cumulatively from the corporation's formation or 1913 if later (accumulated E&P), with the dividend treated as first coming out of current E&P, including current E&P attributable to the portion of the year after payment of the dividend, to the extent thereof and then out of accumulated E&P to the extent thereof.

[3]A dividend from a regulated investment company ("RIC") or a real estate investment trust ("REIT")—entities generally not taxed at the RIC or REIT corporate level but rather subject to a modified form of flow-through taxation—generally qualifies only to the extent the RIC or REIT itself received QDI from another corporation.

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CHAPTER 5

Structuring Buyout

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The existing owners of a reasonably successful business ("Target") have decided to dispose of the business. PE (a fund which purchases operating businesses, generally using leverage) would like to acquire Target.

- In ¶501, Target is a wholly owned subsidiary of Bigco, a large C corp which operates many businesses as subsidiaries and divisions. Bigco acquired Target during Bigco's conglomerization phase but now wishes to sell Target during Bigco's back-to-core-business phase.
- In ¶502, Target is variously a C corp, S corp, partnership, or LLC owned by an individual or group, and is not a Bigco subsidiary. Target's principal shareholders, unable to locate the fountain of youth, are focusing on estate planning and would like to liquify their estates.
- In ¶503, Target is a publicly traded corporation. Target's board of directors has concluded that (1) although Target's business is sound, the stock market does not properly value a company of Target's modest size in Target's industry and (2) Target's shareholder value can be maximized by selling Target. In addition, Target's CEO and largest shareholder (owning 15% of Target) has tired of the game and is ready to seek sunnier climes.

In each of these circumstances, PE (or a group of PEs) believes that, with additional post-acquisition capital for expansion, some add-on acquisitions over several years, proper PE supervision, and more equity incentives for Target's younger executives (or new executives for Target located by PE), Target's business will rise geometrically in value. Hence PE purchases Target's stock (or forms Newco to purchase Target's assets or stock).

In this Chapter 5, unless otherwise stated, Target is, and long has been, a C corp subject to double tax under the U.S. federal income tax system, and unless otherwise stated Newco (created by PE to acquire Target) is also formed as a C corp. If either (or both) of Newco and/or Target is a tax flow-through entity, i.e., an S corp, a partnership, or an LLC, none of which are subject to double tax,[1] many of the applicable tax rules are different, as discussed in ¶502.1.2 (S corp) and ¶502.1.3 (partnership/LLC) as well as in Chapters 3 and 7 and in ¶406.

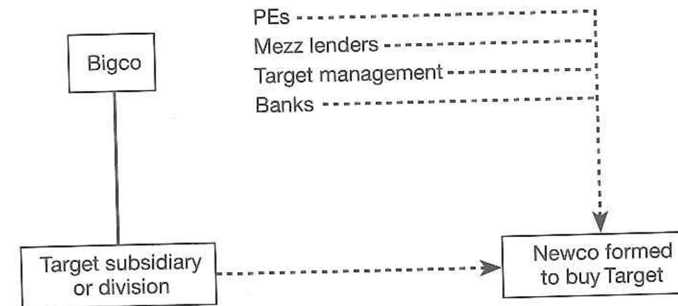
[1]Throughout this treatise, whenever a partnership's or an LLC's income tax considerations are discussed, we assume (unless otherwise stated) that the entity is taxed as a partnership for federal income tax purposes because: (1) the entity has not elected to be taxed as a corporation under the Code §7701 check-the-box regulations (or, if the entity is organized outside the U.S. with no equity owner liable for the entity's liabilities, the entity has made an affirmative election to be taxed as a partnership, which, if not made, would cause the non-U.S. entity to be taxed as a corporation), (2) the entity is not a PTP (which PTP status would generally cause the entity to be taxed as a corporation), and (3) the entity does not have only a single equity owner (which would cause the entity to be disregarded for federal income tax purposes). See ¶302.4 and ¶303.2.

Discussion of individual tax rates throughout this treatise, unless otherwise specifically stated, takes into account only regular income taxes and does not take into account (a) the uncapped Medicare tax on compensation and self-employment income, (b) the uncapped Medicare tax on passive income, (c) the 3%-of-AGI itemized deduction disallowance, or (d) the personal exemption phase-out, all of which increase the effective tax rate as discussed at ¶107(4).

Unless otherwise stated, when this treatise discusses the LTCG tax rate for an individual taxpayer, we are referring to the regular LTCG rate, not to the reduced §1202 rate.

¶501 BUYOUT OF BIGCO SUBSIDIARY OR DIVISION

In this ¶501 (as described above) Bigco, a large C corp operating many businesses as subsidiaries and divisions, now wishes to sell Target, a C corp unless otherwise stated—originally acquired during Bigco's conglomerization phase—so that Bigco can now concentrate on Bigco's core businesses, while PE (or a group of PEs) believe that Target's business will—with additional capital for expansion, some add-on acquisitions, proper PE supervision, and more incentive for Target's younger executives (or new executives located by PE)—rise geometrically in value. Thus, one or several PEs—along with Target's management (or new executives located by PE) and several lenders—begin the task of structuring Newco to acquire Target from Bigco.



¶501.1 Financing $100 Million Buyout

¶501.1.1 Financing Structure

PEs, believing Bigco would be willing to sell its subsidiary, Target, for $100 million, have formed Newco and arranged $100 million of financing for Newco corp in 4 tranches:

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Securities to Be Issued	*Millions*
Senior bank debt	$50
Subordinated/mezz debt	20[1]
Preferred stock	29
Common stock (1,000 shares)	1
Total	$100[2]

	Millions			
Sources of Funds	*Total financing*	*Non-convertible debt*	*Non-convertible preferred stock*	*Common stock*
Bank lenders	$ 50.0	$50		
Subordinated/mezz lenders	20.1	20		$ .1
PEs	29.7		$29	.7
Management	.2	—	—	.2
Total	$100.0	$70	$29	$1.0

¶501 [1]The $20 million of subordinated or mezzanine ("mezz") debt might be supplied by a group of subordinated debt buyers, by one or more mezz funds, or (if Newco is not able to raise the full $100 million) by Bigco in the form of seller paper or seller financing (generally subordinated debt, but possibly preferred stock).

[2]This example ignores for simplicity the additional amounts Newco must raise for transaction expenses and working capital.

Split of Securities	*Normal Transaction*	*Alternate Transaction*
Bank lenders	$50 million of non-convertible debt	Same
Subordinated/ mezz lenders	$20 million for non-convertible subordinated/mezz debt *plus* $.1 million for 100 common shares (i.e., 10% of Newco's common)	$20.1 million for subordinated/mezz debt *plus* warrants or conversion rights to acquire 100 common shares in exchange for either (a) $.1 million of such debt or (b) $.1 million cash
PEs	$29 million for non-convertible preferred *plus* $.7 million for 700 common shares (i.e., 70% of Newco's common)	$29.7 million for preferred *plus* warrants or conversion rights to acquire 700 common shares in exchange for either (a) $.7 million of such preferred or (b) $.7 million cash
Management	$.2 million for 200 common shares (i.e., 20% of Newco's common)	Options to buy 200 common shares for $.2 million, in which case Newco must (in order to obtain the full $100 million) raise an additional $.2 million elsewhere

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¶501.1.2 Magic of Leverage

By borrowing 70% of its acquisition price for Target (i.e., $70 million out of the $100 million Target purchase price), Newco leverages its yield from its ultimate sale of Target (or Newco's equity owners leverage their yield from their ultimate sale of Newco).

If Newco does not borrow any of Target's $100 million purchase price and if the Newco/Target business rises in FV by (e.g.) 30%—i.e., if Newco's owners invest $100 million of equity in Newco and ultimately resell Newco for $130 million—Newco's equity owners (viewed as a single group) make only 30% on their $100 million unleveraged investment (assuming Newco makes no distributions to its equity owners out of its operating income).

However, if Newco borrows 70% of the purchase price—so that Newco's equity owners invest in Newco only 30% ($30 million) of Target's purchase price—the Newco equity owners' yield on a successful resale of Newco is greatly magnified, a concept called the magic of leverage. Thus, if the Newco/Target business—bought

with $30 million equity and $70 million debt—rises in FV by (e.g.) 30%, i.e., if Newco is ultimately sold for $130 million, Newco's equity owners (viewing Newco's common and preferred shareholders together, as a single group) make 100% on their $30 million investment, as demonstrated below:

Magic of leverage—30% FV appreciation	
Newco's original purchase price for Target	$100
Sale price if Newco FV appreciates 30%	$130
Debt payoff (assuming interest was paid periodically as accrued)	70
Proceeds for Newco's equity owners	$ 60
Original equity investment	$ 30
Ratio of equity proceeds to original equity investment	2x
Conclusion: 30% FV increase = 100% equity profit[3]	

¶501.1.3 Nightmare of Leverage

However, if the Newco/Target investment is not successful—i.e., if Newco/Target declines in FV—the Newco equity owners' loss is similarly magnified by leverage. If (for example) Newco/Target declines 30% in FV, so that Newco/Target is ultimately sold for $70 million, Newco's equity owners (again viewed as a single group) lose 100% of their $30 million leveraged investment, as demonstrated below:

Nightmare of leverage—30% FV decline	
Newco's original purchase price for Target	$100
Sale price if Newco FV declines 30%	$ 70
Debt payoff (assuming interest was paid periodically as accrued)	70
Proceeds for Newco's equity owners	$ 0
Original equity investment	$ 30
Ratio of equity proceeds to original equity investment	0x
Conclusion: 30% FV decline = 100% equity loss[4]	

Obviously, if the portion of Newco's purchase price financed by leverage exceeds 70%, the magnifying effect (upside or downside) is higher than described above. Similarly, if the leverage is below 70%, the magnifying effect (upside or downside) is lower.

[3]Money on money or MOM ratio = 2x.
[4]Money on money or MOM ratio = 0x.

¶501.1.4 PE's Limited Exposure

Another important aspect of the $70 million of leverage (i.e., debt) incurred to purchase Target: PE almost always structures the acquisition debt so that only Newco and/or Target are liable to the lenders (the banks and the subordinated/mezz lenders), and PE is not liable (either as borrower or guarantor).

Thus, if Newco/Target fails, PE's maximum loss on the transaction is the $29.7 million PE invested in Newco's preferred and common stock, and the other equity owners' maximum loss is the $0.3 million they invested in Newco common stock. The remaining $70 million of potential loss (i.e., the $70 million of borrowed money, to the extent not repaid by Newco/Target, either from operating cash flow or the proceeds from sale of the Newco/Target business) is borne only by the lenders.

A financing structure under which PE both leverages its upside yield and limits its loss on the downside is the essence of a leveraged buyout.

¶501.1.5 Bifurcated Capital Structure

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If Newco's $30 million of equity financing were structured solely as common stock, each 1% of Newco's common stock would cost $300,000 (i.e., 1% of $30 million). Thus, for example, if management wanted to buy (and PE wanted to incent management by selling them) 20% of Newco's common stock (giving management 20% of the transaction's upside potential), management would have to invest $6 million, a very substantial amount. By instead structuring 97% of Newco's equity (by dollar amount) as non-convertible preferred stock ($29 million preferred stock out of $30 million total equity), management is able to buy 20% of the transaction's upside potential by investing only $200,000 (i.e., 20% of $1 million aggregate common stock).

Similarly, if all $30 million of Newco's equity were common stock (i.e., Newco issued no preferred stock), the subordinated/mezz lenders who are buying an upside equity kicker consisting of 10% of Newco's common stock would have to invest $3 million, again a very substantial amount. By instead structuring 97% of Newco's equity as non-convertible preferred stock, the subordinated/mezz lenders can buy a 10% upside equity kicker (i.e., 10% of Newco's common stock) for only $100,000.

Finally, if all $30 million of Newco's equity were common stock (i.e., Newco issued no preferred stock), any subsequent distributions to Newco's shareholders would be shared between PE, management, and the subordinated/mezz lenders. By instead structuring 97% of Newco's equity as preferred stock held by PE ($29 million preferred stock out of $30 million total equity), PE has priority over all of the common stockholders with respect to the first $29 million (plus preferred stock yield) of distributions (just as VC has priority to the first $940,000 [plus subordinated debt and preferred stock yield] in the start-up capital structure described in ¶202).[5]

[5]See ¶501.5.4.2 for discussion of tax reasons the parties might want to reduce the percentage of Newco's $30 million equity instrument which is represented by preferred stock from 97% ($29 million out of $30 million) to a less aggressive (e.g.) 90% (i.e., $27 million out of $30 million).

¶501.2 Three Separate Transactions

A buyout is really 3 separate transactions, each complex and time consuming and all mutually interdependent in their consummation, as described below.

¶501.2.1 Acquisition

The first transaction—Newco's acquisition of Target from Bigco—presents all of the issues inherent in any corporate acquisition:

(1) Negotiating the purchase price for the Target business.
(2) Negotiating representations, warranties, and indemnification provisions, closing conditions, non-compete covenants, transition services agreement, etc. between Newco and Bigco.
(3) Newco's due diligence on the Target business.
(4) Structuring federal income tax aspects of the acquisition transaction, including:
   - The pros and cons of structuring the acquisition as an asset purchase, a stock purchase, or a forward or reverse merger.
   - Whether the structure selected results in single tax or double tax to the seller.
   - Whether the structure selected gives Newco asset SUB or asset COB.
(5) Analyzing other legal aspects of the acquisition transaction, including:
   - Liabilities to be inherited by Newco or its subsidiaries, including contingent liabilities.
   - Transferability of Target's assets, including contract rights.
   - Sales and transfer taxes.
   - State income tax issues.

Acquisition issues are discussed further in ¶501.3.

¶501.2.2 Debt Financing

The second transaction—Newco's $70 million debt financing for the acquisition—includes negotiating the terms of Newco's senior and subordinated/mezz debt, as well as any seller financing, and is critical to consummation of the LBO acquisition.

Debt financing issues are discussed further in ¶501.4.

¶501.2.3 Equity Financing

Newco's equity financing is the third transaction. Negotiating Newco's complex $30 million equity financing arrangements is similar to (but more complex than) negotiating the equity structure of a start-up or growth-equity investment, as discussed in Chapters 2 and 4, including:

- The common stock split among PEs, management, mezz lenders, and possibly the seller.
- Whether management (a) buys common stock to obtain LTCG tax treatment, (b) receives ISOs, with possible LTCG treatment, or (c) is granted NQOs, generally resulting in OI tax treatment.
- Vesting arrangements on management's stock or options, including Code §83(b) tax issues.
- Any FASB 123R accounting issues presented by management's stock purchase or option grants.
- Whether Newco's securities are structured so that PEs are entitled first to receive back their investment plus a fixed yield (through non-convertible debt and/or straight preferred stock) before splitting the residual (common stock) profits with management and the mezz lenders.
- Board control of Newco and veto powers for PEs and/or other Newco equity owners and creditors.
- Right of PEs and/or other Newco equity owners to mandate or veto an ultimate Newco sale or IPO.
- Whether Newco is formed (1) as a regular C corp subject to double tax *or* (2) as a flow-through entity (i.e., an LLC, partnership, or S corp) subject to only single tax, in which case ultimate sale of Newco/Target to BuyerCo can be structured to deliver asset SUB to BuyerCo with single (not double) tax to Newco and its equity owners.

Equity financing issues are discussed further in ¶501.5.

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¶501.2.4 Key Issues and Appendix References on Buyouts in General

How does a buyout differ from other mergers or acquisitions?

References:

- Ginsburg Levin and Rocap M&A treatise ¶101 (buyout definition) and ¶102

What does it mean when one layer of invested money (debt or preferred stock) is "subordinated" to another layer? Why would an investor be willing to take an instrument (debt or preferred stock) which is subordinated to other instruments?

What are the typical terms of the debt and equity securities issued in a buyout?

References:

- Chapter 6 of this treatise
- ¶108 of this treatise (defining mezz debt and mezz lender)

Why is Newco's capital account bifurcated, with PEs buying both preferred and common stock, while management buys only common stock?

Appendix references:

- See ¶202 of this treatise, discussing the same issue in the context of a start-up transaction

- See Levin, Perl, and Hirschtritt, Divide and Conquer: Why and How to Bifurcate Your LBO's Equity Structure (Venture Capital Review, Winter-Spring 2004, as subsequently updated to cover developments through publication of this treatise)

Will all of the interest on Newco's debt be deductible for tax purposes? What tax hurdles must be overcome?

References:

- ¶601.1.6 of this book (regarding terms and tax ramifications of subordinated debt) and the precedents cited therein

Was the highly leveraged buyout craze of the late 1980s good for America?

Was the high-tech and Internet start-up craze of the late 1990s thru early 2001 good for America?

Was the over-leveraging binge of the first decade of the 21st century good for America?

Do our current tax laws encourage high leverage?

Should our tax laws be changed?

Appendix references:

- Testimony Before the House Ways & Means Committee of Jack S. Levin, 2/2/89
- American Law Institute, Federal Income Tax Project, Reporter's Study Draft 6/1/89 Subchapter C Supplement Study, by Professor William D. Andrews, pp. 13-37

¶501.3 Key Acquisition Issues

¶501.3.1 Purchase Price and Related Issues

¶501.3.1.1 Purchase Price

After the parties have agreed on the nominal purchase price, a number of pricing issues still remain to be negotiated, including:

(1) Amount payable in cash.

(2) Amount payable in the form of Newco subordinated debt or preferred stock (i.e., seller paper or seller financing).

(3) Purchase price adjustments to reflect such items as (a) Bigco's retention of Target's cash on hand at closing *or* (b) changes in Target's net book value or net working capital between date of Target's financial statements relied upon in negotiating the purchase agreement and closing.

- Requirement of an audit and right of appeal to (a) an independent CPA firm, (b) arbitration, or (c) court to resolve any disputed purchase price adjustment.

- Reference to GAAP consistently applied or to Target's accounting principles consistently applied to calculate any purchase price adjustment.

Where there is no purchase price adjustment for Target's closing date net book value or net working capital, it may be desirable (although not as effective) for Newco to seek covenants (a) forbidding distributions from Target to Bigco prior to closing and/or (b) obligating Bigco to conduct Target's business prior to closing in the ordinary course and in accordance with past custom and practice, especially with respect to activities the deferral of which would allow Bigco to generate and retain more cash from Target's business, including covenants:

- Requiring normal repairs, maintenance, cleanup.
- Requiring normal purchases of new capital assets.
- Requiring normal purchases of inventory.
- Prohibiting accelerated or discounted inventory sales.
- Prohibiting accelerated or discounted receivable collection.
- Requiring normal trade creditor payments.

If the parties cannot agree on a fixed purchase price, they may want to use a contingent purchase price or earnout based on the future performance of Target's business, although such an approach generally raises complex issues as to (a) whether buyer or seller controls management decisions during the earnout period, (b) whether adjustments to actual earnings will be made for unanticipated events, including strikes or fires, recessions, and increases or decreases in discretionary expenditures such as advertising, (c) whether to include earnings (losses) from subsequent Target add-on acquisitions (and, if not, how to allocate certain expenses between Target's original businesses and any businesses subsequently acquired), and (d) the like.

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¶501.3.1.2 Representations, Warranties, and Indemnification

Representations and warranties ("R&W") are a series of statements in the acquisition contract confirming, for example, that (except as set forth in a disclosure schedule to the acquisition agreement prepared by Target's owners—here Bigco) Target has no liabilities, Target's financial statements are accurate, Target's assets are in good condition, etc. (as described in more detail below). There are at least 4 reasons Newco seeks such contractual representations and warranties from Target's owners (here Bigco):

- Disclose information useful to Newco in deciding (a) whether to buy Target, (b) what price to pay for Target, and (c) whether to insert specific contract clauses dealing with specific items.
- Back up Newco's R&W to its lenders who are financing Newco's acquisition of Target.
- Allow Newco to call off the deal after contract signing and prior to closing (where signing and closing are not simultaneous) if the contractual representations and warranties are incorrect.

- Allow Newco to seek money damages from Target's owners (here Bigco), or in an extreme case to rescind the transaction, if the representations and warranties are incorrect.

Some key R&W Newco may seek from Bigco:

(1) There are no Target liabilities (and no facts or status which could give rise to a Target liability) not shown on Target's balance sheet (including known and unknown contingent liabilities), such as:

- Environmental/pollution violations or cleanup obligations.
- Employment discrimination claims.
- Pension underfunding or unfunded retiree medical or insurance benefits.
- Uninsured or under-insured product liabilities.
- Product warranties.
- Patent/copyright/trademark infringements.
- Antitrust violations.
- Tax deficiencies.
- Breach of contract claims.
- OSHA violations.
- Guarantees.
- Other lawsuits, claims, or contingent liabilities.

(2) Target's inventory is good and salable in the ordinary course of business.
(3) Target's receivables are collectible in the ordinary course of business within a specified period.
(4) Target's plants, equipment, and other tangible assets are in good operating condition and without defect.
(5) Target's financial statements are either true and correct or fairly present Target's financial condition and operating results in accordance with GAAP, consistently applied.
(6) Target has good title to its assets and Bigco has good title to Target's stock.
(7) Target has committed no violations of law or governmental regulations (especially important where Target is engaged in a regulated industry).
(8) No governmental or third-party consents are necessary to complete the buyout, except as listed on a schedule.

Each R&W generally contains an exception for matters listed on the disclosure schedule prepared by Target's owners. Thus, when Target and its owners (here Bigco) list an exception in the disclosure schedule, they shift the risk for that matter (e.g., contingent liability, questionable inventory, doubtful receivable, GAAP variation, violation of law, etc.) to the buyer (here Newco), absent a contractual indemnification clause explicitly shifting the risk back to Bigco.

Bigco's R&W can be unqualified *or* can be qualified by references (a) to Bigco's knowledge (or to the knowledge of specified Bigco executives) or (b) to a materiality standard *or* (c) to both.

Only if Bigco's R&W survive the closing can Newco make a contractual claim against Bigco for damages, in which case the 3 principal issues are (1) the time period permitted to make claims, (2) the stated basket (*either* a deductible amount *or* a threshold amount which must be reached before a claim can be made for the entire amount), and (3) the maximum claim amount.

Security for Newco claims against Bigco (e.g., escrow portion of purchase price, holdback portion of purchase price, right to set off against seller paper (debt or preferred stock), lien on Bigco assets) is more or less important, depending on Bigco's financial health.

Newco might also seek third-party insurance against a specific Target contingent liability, depending on the premium a third-party insurer would charge for a specified amount of protection and whether the insurer can underwrite and issue the policy in time to meet Newco's acquisition time schedule.

Persons who are interested in the extent of Bigco's R&W, and Newco's rights to recover for breach, include not only Newco and its shareholders, but Newco's lenders as well.

The parties' negotiating positions on these issues are generally as follows:

- **Extent of R&W.** In the typical negotiation, Newco seeks extensive R&W from Bigco regarding Target. Bigco, however, seeks to give Newco far fewer R&W (or possibly none at all—i.e., an "as is" sale) and to qualify them with concepts of materiality and knowledge.
- **Survival.** Newco seeks to have the R&W survive the closing for a lengthy period (possibly forever) and seeks to have Bigco indemnify Newco against any breaches Newco discovers during the survival period. Bigco, however, seeks to have the R&W expire at the closing (i.e., to give Newco no right whatsoever to sue Bigco after the closing for breaches of R&W) or, at least, to have the R&W survive only for breaches discovered by Newco within a short period (e.g., 6 to 12 months after the closing).
- **Deductible and/or ceiling.** Newco seeks indemnification which begins with the first dollar of damages from breach and is unlimited in amount. Bigco, however, seeks to have its indemnification obligation subject to (1) a deductible so that Bigco pays claims only in excess of (e.g.) $1 million (or if Bigco cannot obtain a deductible, at least a substantial minimum threshold which, if exceeded, will result in payment of the full amount), (2) a ceiling so that it pays no more than a specified dollar amount or percentage of Newco's purchase price for Target, and (3) where Target has more than one owner, several, rather than joint and several, liability (so that each owner is liable for only a pro rata share).
- **Escrow or other security.** Newco seeks security for Bigco's indemnification obligation, e.g., a holdback of part of the purchase price, escrow part of the purchase price, set off rights against any seller paper, and/or liens against Bigco assets. Bigco, however, does not desire to provide any such security for its indemnification obligation.

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- **Assumption of liabilities.** Newco seeks to assume responsibility for only specified Target ordinary-course-of-business liabilities and to leave behind the remainder (including unknown and contingent liabilities) for Bigco to pay (or, in a stock purchase, to have Bigco agree to indemnify Newco and Target for such non-assumed liabilities). Bigco, however, desires that Newco assume responsibility for all of Target's liabilities, known and unknown, liquidated and unliquidated, fixed and contingent.

¶501.3.1.3 *Closing Conditions*

Newco seeks expansive closing conditions allowing Newco to bow out of the transaction (after the acquisition agreement has been signed) if things do not go as Newco anticipated (i.e., Newco seeks a contract which is in effect an option to acquire Target). Some of the closing conditions Newco may seek include:

- Failure of Newco's debt or equity financing (i.e., a financing out).
- Unsatisfactory completion of Newco's due diligence examination of Target (i.e., a due diligence out).
- Failure to comply with all applicable laws and regulations, including Hart-Scott-Rodino antitrust clearance from FTC.
- Failure to obtain necessary third-party consents.
- Material adverse change to Target's business.

Bigco generally resists both a financing out and a due diligence out or at least attempts to limit the time during which Newco can exercise such outs.

¶501.3.1.4 *Transition Services*

Newco may seek a contract obligation for Bigco to supply transition services to Newco/Target for a reasonable period after the acquisition at reasonable prices:

- Computer and information management.
- Purchasing.
- Payroll and employee benefit administration.
- Insurance administration.
- Space rental.
- Accounting services.
- Receivables collection or payables management.

¶501.3.1.5 *Seller Paper*

If Newco cannot raise all the financing necessary to purchase Target, Newco may need to fill its financing hole by issuing seller paper (i.e., Newco subordinated debt or preferred stock) to Bigco as part of the purchase price. See ¶501.4 for some

of the issues such seller paper raises, including subordination to, and maturity after, Newco's other financing.

¶501.3.2 Transferring Target Assets and Contracts

¶501.3.2.1 *Hard to Transfer Assets and Contracts*

Where Newco is purchasing Target's assets, some properties may present difficulties in effectuating the transfer from Target to Newco, including:

(1) with respect to a Target contract right (e.g., a technology license or real estate leasehold), a prohibition in the contract between Target and the other contracting party (the "OCP") on Target's transfer of the contract without the OCP's consent (in which case the OCP may demand a substantial consent fee where Target's rights under the contract are valuable and are being transferred),

(2) with respect to a governmental license, a prohibition in the license (or in governmental regulations) on Target's transfer of the license without the consent of the governmental agency, and

(3) with respect to real estate, vehicles, aircraft, patents, trademarks, copyrights, and other assets the transfer of which must be registered with a governmental agency, the preparation and filing of papers with (and the payment of fees to) the governmental agency.

Examples of such hard to transfer assets:

- Long-term low-rent leasehold.
- Long-term low-interest borrowing.
- Long-term low-royalty patent or other technology license.
- Governmental license or permit.
- Large number of vehicles or aircraft.
- Large number of real estate parcels.
- Large number of patents, trademarks, or copyrights.

Where Target is a Bigco subsidiary (rather than a Bigco division), structuring the acquisition as a purchase of Target's stock by Newco or a reverse subsidiary cash merger of a Newco subsidiary into Target (rather than a purchase of Target's assets) generally eases the burdens of transferring such Target assets, unless the contract or license (or governmental regulations regarding a government license) treats a change in Target's control (here from Bigco to Newco) like an asset transfer and hence requires consent of the OCP or governmental entity.

A forward cash merger of Target into Newco or a Newco subsidiary may ease the burdens, depending on the contractual language (or governmental regulations regarding the license) and whether state law applicable to the contract or license treats a conveyance by operation of state merger law as a transfer.

It is necessary to read each contract or license (or governmental regulation regarding a license) to ascertain whether a third-party consent is necessary for a

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stock sale, a reverse subsidiary merger, a forward merger, an asset sale, and, where the contract or license (or governmental regulation) is silent, to review applicable state law precedents.

However, buyer may decide to ignore a contractual provision requiring advance consent for transfer of a contract if the contract is not material to the business, perhaps in the expectation that the other contracting party will have no interest in canceling such a contract or, if the other contracting party does cancel, that it can be easily replaced.

¶501.3.2.2 Sales Taxes and Real Estate Transfer Taxes

Many states impose sales tax (often 6% to 8%) on a sale of tangible assets which will not be held by the buyer for resale, i.e., machinery, equipment, furniture, and other fixed assets. Some states also tax transfers of computer software.

However, some states exempt the sale of a business in bulk or other casual sale.

Some governmental entities impose real estate transfer tax (state, county and/or municipal) at rates which vary greatly from jurisdiction to jurisdiction.

Where such a sales tax or real estate transfer tax is imposed, it generally applies to a sale of assets. Whether the tax applies to a forward cash merger depends on state transfer-tax law. Such tax generally does not apply to a sale of stock or a reverse subsidiary merger, except that some jurisdictions (e.g., New York) impose real estate transfer tax on a change in control of an entity owning real estate while other jurisdictions (e.g., Illinois) impose such tax on an entity's change in control only if the entity's assets consist predominantly of real estate.

¶501.3.2.3 Real Estate Title Insurance

Normally relatively clean title insurance can be obtained on real estate included in an asset purchase.

It is often possible to obtain an additional endorsement (at extra cost) giving relatively clean title insurance on real estate in a stock purchase or merger.

If real estate is pledged as collateral to secure acquisition financing, the lender generally requires title insurance payable to the lender, in which case an additional owner's policy to protect Newco can be obtained for a nominal additional charge.

Premium costs vary significantly from state to state (e.g., between $1 and $5 per $1,000 of coverage).

¶501.3.2.4 Union Contracts

A union contract may contain a successor clause or otherwise seek to bind Newco even in an asset purchase. In any event, Newco probably must deal with Target's unions.

¶501.3.3 Hart-Scott-Rodino Antitrust Filing for Acquisition

¶501.3.3.1 Filing and Waiting Period

An HSR filing with FTC/DOJ is required if (1) the size of an investment or acquisition as described in ¶501.3.3.2 exceeds $312.6 million *or* (2) the size of an investment or acquisition exceeds $78.2 million and the size-of-person test described in ¶501.3.3.3 (one person with at least $15.6 million and one with at least $156.3 million generally measured by annual net sales or total assets) also is satisfied, unless the transaction qualifies for exemption as described in ¶501.3.3.4.[6]

There generally is a 30-day waiting period (before closing the acquisition) after the parties have made their required HSR filings which period is extended if FTC/DOJ requests additional information.

Newco must pay a filing fee:

Fee	*Transaction value*
$ 45,000	greater than $78.2 million but less than $156.3 million
$125,000	at least $156.3 million but less than $781.5 million
$280,000	$781.5 million or more

If other HSR reportable events are occurring, additional filing fees may be due.

The parties to an HSR reportable transaction must file a substantial amount of information with FTC/DOJ, including (1) any confidential information memorandum ("CIM") (or other document(s) serving such function if no CIM exists), regardless of whether the CIM discusses market shares or competition-related topics, and (2) each study, survey, analysis, and report prepared by or for an officer or director (or person exercising similar functions for an unincorporated entity) of Bigco, Target, or Newco, including by or for an officer or director of a controlling parent or controlled subsidiary, which was prepared for the purpose of evaluating or analyzing the transaction with respect to either (a) synergies and/or efficiencies or (b) markets, market shares, competition, competitors, or the potential for market expansion (either geographic or with new products), including "pitch books" or "bankers' books" prepared by investment bankers, consultants, or other third-party advisers either during an engagement or for the purpose of seeking an engagement.[7]

[6] The size of various HSR tests are adjusted annually for inflation, and the amounts set forth in text reflect the 2/25/16 adjustment applicable to any transaction closing on or after such effective date.

[7] FTC/DOJ staff takes the expansive position that (1) an "analysis" includes any interoffice memorandum, handwritten note, correspondence, email message, computer file, slide presentation, or board minutes, if such document contains even a brief evaluation or analysis of the acquisition's competitive advantages, even where such document contains substantial other information not required to be filed, (2) failure to include any such analysis may render the HSR filing deficient, so that the HSR waiting period restarts when the omitted analysis is subsequently submitted (unless FTC staff waives restart),

(footnote continues)

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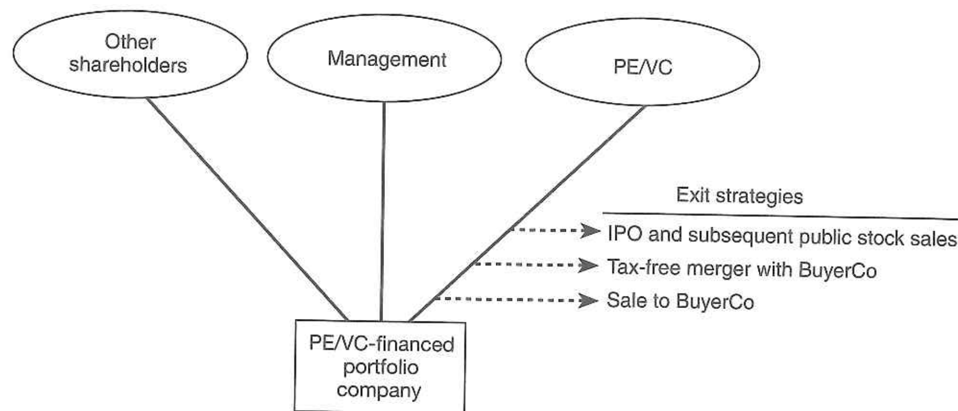
pany's stock) may require cooperation from other shareholders who may not (or will not) be in agreement with PE/VC's timing, price, or other disposition terms.

In addition, state corporate law generally imposes fiduciary obligations on a majority shareholder (and on the board of directors) with respect to the treatment of minority shareholders, which may inhibit PE/VC's ability to obtain certain desired advantages over other shareholders (e.g., priority in a public offering) where PE/VC controls Portfolio Company at the back end. Such a fiduciary duty would not, however, extend to or adversely affect PE/VC's back-end invocation of contractual rights PE/VC obtained in connection with its initial investment in Portfolio Company.

Thus, it is important at the front end, when PE/VC is making its investment in Portfolio Company, that PE/VC obtain contractual rights to control back-end exit strategies.



For that reason, it is typical for PE/VC to insist at the front end that Portfolio Company and its other shareholders sign (e.g.) a registration rights agreement. Such an agreement may give PE/VC control over the timing of a future IPO, selection of underwriters, priority over other shareholders in the public resale of its stock, the right to demand additional SEC registrations subsequent to the IPO, and the right to have PE/VC's IPO and subsequent registration expenses paid by Portfolio Company. See ¶207.7 regarding SEC aspects of reselling PE/VC's Portfolio Company securities and ¶207.7.3 regarding a front-end registration rights agreement.

Similarly, where PE/VC is Portfolio Company's majority shareholder (or perhaps merely Portfolio Company's largest single, although not majority shareholder), it is typical for PE/VC to insist that Portfolio Company and its other shareholders sign "drag-along" agreements, giving PE/VC the right to find a buyer or several buyers for part or all of Portfolio Company's stock (or a merger partner or asset buyer) and binding Portfolio Company and its other shareholders to cooperate in effectuating such transactions. See ¶206.

Particularly where PE/VC is a minority investor, PE/VC will often want "tag-along" rights to sell alongside management and other principal shareholders if they sell their Portfolio Company stock (or a significant portion of their stock).

PE/VC's exit strategy may include (1) sales of Portfolio Company stock to the public in an IPO or a post-IPO registered offering *or* (2) sales of restricted Portfolio Company stock to the public pursuant to SEC Rule 144 *or* (3) distributions

in kind of Portfolio Company stock to PE/VC's limited partners, each of whom can then decide, subject to Rule 144 limitations, whether to sell or hold the stock *or* (4) a sale of Portfolio Company to a large company ("BuyerCo") in a taxable sale or a tax-free reorganization, in exchange for BuyerCo stock, for cash, partly for cash and partly for BuyerCo stock, or partly for cash and partly for BuyerCo debt instruments reportable for federal income tax purposes on the installment method.

Finally, PE/VC may (at the time of its initial investment in Portfolio Company) seek a right to put its stock back to Portfolio Company at some future time either at a formula price (e.g., 10 times earnings per share) or at appraised FV.

In this Chapter 9, unless otherwise stated Portfolio Company is, and long has been, a C corp. If Portfolio Company is a tax flow-through entity, i.e., an S corp, partnership, or LLC, not subject to double tax, many of the applicable tax rules are different, as discussed in Chapters 3 and 7 and ¶502.1 and ¶406.

> Discussion of individual tax rates throughout this treatise, unless otherwise specifically stated, takes into account only regular income taxes and does not take into account (a) the uncapped Medicare tax on compensation and self-employment income, (b) the uncapped Medicare tax on passive income, (c) the 3%-of-AGI itemized deduction disallowance, or (d) the personal exemption phase-out, all of which increase the effective tax rate as discussed at ¶107(4).
>
> Unless otherwise stated, when this treatise discusses the LTCG tax rate for an individual taxpayer, we are referring to the regular LTCG rate, not to the reduced §1202 rate.

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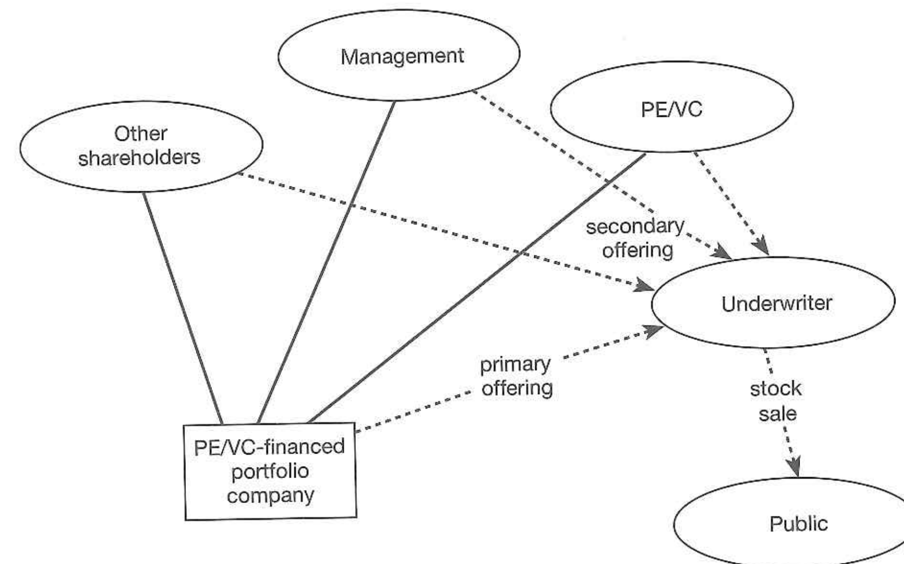
¶901 INITIAL PUBLIC OFFERING



¶901.1 *Methods for Reselling Restricted Securities*

Generally PE/VC and others originally acquired their Portfolio Company securities without SEC registration in a Reg. D private placement or a Rule 701 unregistered sale to service providers as described in ¶207. Hence their Portfolio Company securities are generally "restricted securities." A holder of "restricted securities" can generally resell such securities only:

- in a public offering registered with SEC under the 1933 Act (requiring a full-blown 1933 Act registration statement), *or*
- in an unregistered public sale of restricted stock under SEC Rule 144 (generally after Portfolio Company has already become a 1934 Act reporting company, as defined in ¶207.3.2(2)), *or*
- where Portfolio Company is not already a 1934 Act reporting company, in a public sale pursuant to a Reg. A offering statement filed with SEC (which is far shorter and less complex than a full-blown 1933 Act registration), usable for only a limited amount of secondary securities, as described in ¶207.6(8), *or*
- in a private sale (in which case the buyer receives and holds restricted securities) pursuant to 1933 Act implicit exemption §4(a)(1½), 1933 Act explicit exemption §4(a)(7), or SEC Rule 144 (as described in ¶904), *or*
- in a Reg. S "offshore transaction" (with sales solely to persons who are not U.S. residents, no "directed selling efforts" into the U.S. market with respect to such securities, and the securities restricted from resale to a U.S. resident for a specified period [one year in the case of Newco equity securities and 40 days for Newco debt securities]).

¶901.2 *1933 Act Registration Statement on Form S-1*

The most likely mode for effectuating an IPO for a privately held Portfolio Company is a full-blown 1933 Act registration statement on Form S-1. Such a registration statement on Form S-1, which is generally time consuming and expensive, must be effective when the securities are actually sold to the public.

Since only the issuer of a security can register such security under the 1933 Act, a holder of Portfolio Company restricted stock would be wise to obtain from Portfolio Company (at the time of purchase) contractual SEC registration rights, obligating Newco to register with SEC the holder's resale of the restricted securities *either* at the holder's demand (a "demand registration right") *or* as an add-on to another SEC registration statement being filed by Newco (a "piggyback registration right"), as discussed at ¶207.7.3.

¶901.3 *Underwritten Offering*

The most common approach to an IPO is for PE/VC and Portfolio Company to arrange for an underwriter (or group of underwriters) to buy Portfolio Company stock from Portfolio Company or from its existing shareholders or from both when the 1933 Act registration statement becomes effective and resell them to the public.

The lead underwriter generally places a limit ("an underwriting limitation") on the number of Portfolio Company securities which can be sold in the offering.

In addition, the lead underwriter undoubtedly requires that Portfolio Company and each major holder agree not to sell additional Portfolio Company securities (including under SEC Rule 144) for a specified (and often lengthy, e.g., 90 to 180 days or occasionally longer) period after the underwritten offering (a "hold-back period"). Often the registration rights agreement obligates holders offered the opportunity to take part in the offering not to sell (other than in the underwritten offering) during the hold-back period.

¶901.4 *Primary vs. Secondary Sales*

To the extent that Portfolio Company is seeking new money for expansion, redemption of PE/VC-owned preferred stock or subordinated debt, and other corporate purposes, the IPO includes "primary" securities to be sold by Portfolio Company. To the extent PE/VC and the other holders are seeking to liquify their holdings of Portfolio Company securities, the IPO includes "secondary" securities to be sold by existing shareholders.

Frequently, in an underwritten IPO, the underwriters insist that all or a substantial portion of the offering consist of primary securities (to demonstrate that Portfolio Company is improving its financial position) and that at most a smaller portion (or possibly none) of the IPO consist of secondary securities (to demonstrate that Portfolio Company's existing holders are not bailing out).

In an underwritten offering, because there is generally an underwriting limitation on the number of securities which can be sold, the parties should agree at the time of PE/VC's initial investment (or where there is no front-end registration rights agreement, they should agree in advance of the underwritten offering) as to the prorated amount of primary securities to be sold by Portfolio Company and secondary securities to be sold by the selling holders.

¶901.5 *Stock Exchange Listing vs. Nasdaq Stock Market*

Portfolio Company and PE/VC must decide whether to seek listing of the securities on a national securities exchange (e.g., NYSE or Nasdaq Stock Market), each of which requires issuers to meet certain net tangible asset and net income thresholds and certain corporate governance rules to be admitted (or continued) for trading. Alternatively, if an issuer is unable to meet the applicable listing standards of such markets, it is possible to be traded on the over-the-counter market (i.e., the Over-the-Counter Bulletin Board [OTCBB] Pink Sheets).

¶901.6 *Simplified Form for Small Business Issuer*

As an alternative to filing a full-blown SEC registration statement on Form S-1, Portfolio Company can utilize a simplified SEC Form SB-1 or SB-2 if it qualifies as a "small business issuer." A "small business issuer" is:

- a U.S. or Canadian entity,
- with revenues of less than $25 million, and

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- a public float (the aggregate market FV of voting stock held by non-affiliates, generally meaning persons who are not board members, officers, or large shareholders with the power to influence company policy) less than $25 million.

If an issuer is engaged in an IPO, the float test is calculated on the basis of the anticipated offering price.

The primary benefit to using Forms SB-1 and SB-2 is a simplified disclosure format similar to that of SEC Reg. A (see ¶207.6) and less stringent financial statement requirements. In addition, following its IPO, a small business issuer is able to satisfy its periodic 1934 Act reporting requirements (see ¶207.3.2(2)) by filing Forms 10-KSB and 10-QSB, which also allow simplified disclosure.

A "small business issuer" ceases to qualify for the simplified disclosure format once its revenue exceeds $25 million for two consecutive years or it exceeds the $25 million public float test for two consecutive years (tested on a date within 60 days after the end of its fiscal year).

¶901.7 Short-Form 1933 Act Registration Statement for Subsequent Resales

Normally, Portfolio Company's IPO is a full-blown long-Form S-1 registration statement. Subsequent 1933 Act registered offerings can be on shorter Form S-3 once Portfolio Company satisfies SEC's requirements for the use of such form. See ¶902.

¶901.8 Blue Sky Compliance

In addition to the SEC rules, any offering of Portfolio Company securities must comply with all applicable state blue sky laws. However, under 1996 federal legislation, where Portfolio Company or a Portfolio Company shareholder sells securities to be traded on the NYSE, Nasdaq Stock Market, or any other national securities exchange designated by SEC, no state may impose merit review or require any filing.

¶901.9 No Gun Jumping

Prior to filing the preliminary registration statement with SEC, Portfolio Company and its holders must avoid statements which could be viewed as offers to sell securities and any unusual publicity about Portfolio Company designed to condition the market for the public offering ("gun jumping"), especially within 30 days before filing the registration statement.

¶901.10 Balanced Prospectus

It is desirable for the SEC registration statement and prospectus to give an optimistic, favorable view of Portfolio Company to assist in selling the securities

to the public. However, it is essential that the prospectus also adequately describe any unfavorable aspects of Portfolio Company and set forth the risk factors, so that Portfolio Company, its directors, its control persons, and the selling holders are not liable to public buyers of Portfolio Company securities if the securities subsequently decline in value.

Hence, a well-balanced prospectus, fully describing all favorable and unfavorable aspects of Portfolio Company, its business, and its competitive and legal situation, and accurate in all material respects, is essential.

¶901.11 IPO Where Portfolio Company Was Formed as a Partnership or LLC

(1) Traditional IPO. If Portfolio Company was originally formed as a partnership or LLC and later desires to go public, it must generally first incorporate, because public investors are more familiar and comfortable with the corporate form.

Incorporating would have the disadvantage of triggering gain for any equity owner who has received partnership or LLC distributions and/or deducted flow-through net losses exceeding the sum of such equity owner's investment in the partnership/LLC plus the equity owner's share of partnership income, thus creating a "negative" outside basis in such equity owner's Portfolio Company stock received in exchange for the partnership/LLC interest, triggering gain equal to the amount of "negative" basis. This result follows because while Portfolio Company is a partnership or LLC each equity owner can add his share of the entity's liabilities to his outside basis in the entity (thus generally avoiding "negative" outside basis) but cannot do so once Portfolio Company is incorporated.

As discussed in ¶302.4.1, even if the partnership/LLC does not incorporate before its IPO, the Code generally treats a publicly traded partnership/LLC as a corporation, in which event the IPO (and resulting deemed incorporation) would trigger gain for a negative-tax-basis equity owner as described above.

(2) Up-C structure. As an alternative to simply incorporating the partnership/LLC in anticipation of an IPO, the parties may utilize an "Up-C" structure to raise funds in the public markets in a manner that generally produces more favorable tax consequences and also enables the entity to continue conducting its business as a partnership/LLC:

- The partnership/LLC (the "old partnership/LLC") first recapitalizes its equity into a single class of common units, with each existing equity owner's recapitalized common units reflecting the relative value of his or her pre-recapitalization partnership/LLC equity.
- A new corporation ("Newco-C") is formed and issues common stock pursuant to an IPO.
- Pursuant to a pre-existing contract, Newco-C uses its IPO cash proceeds to purchase newly issued old partnership/LLC common units directly from old partnership/LLC (to the extent old partnership/LLC is to receive the cash for working capital, debt repayment, or expansion) and/or to purchase

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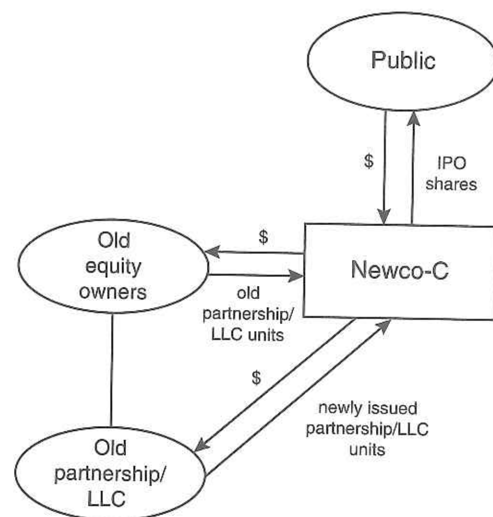
previously outstanding old partnership/LLC common units from the existing equity owners (to the extent the equity owners are to receive proceeds), with the existing equity owners retaining a portion of the old partnership/LLC's common units.



Newco-C and partnership/LLC's old equity owners also typically enter into an agreement entitling the partnership/LLC's old equity owners to effectuate future exchanges of their retained partnership/LLC common units for publicly tradable Newco-C common stock, thereby providing liquidity for their retained partnership/LLC equity.

Two significant tax benefits can be achieved by using an Up-C structure as an alternative to simply incorporating the old partnership/LLC in a tax-free Code §351 transaction:

(a) Newco-C obtains stepped-up tax basis in its share of the old partnership/LLC's assets under Code §743(b): (i) upon Newco-C's initial purchase of old partnership/LLC's common units from existing equity owners and (ii) upon any subsequent exchange of old partnership/LLC common units for Newco-C common stock (each of which exchange is taxable to the old partnership/LLC exchanging equity owner). If Newco-C purchases newly issued partnership/LLC common units from the old partnership/LLC, Newco-C can obtain tax benefits equivalent to a stepped-up tax basis in its share of old partnership/LLC's assets under the rules of Code §704(c).

Newco-C often agrees (in a so-called tax receivables agreement) to pay to the old partnership/LLC's selling equity owners a percentage (e.g., 85%) of any tax benefits Newco-C realizes from the asset basis step-up produced by these sales of old partnership/LLC common units, with such payments made as the tax benefits are realized.

(b) The portion of old partnership/LLC's future taxable income allocated to its equity owners other than Newco-C is not subject to corporate-level tax and therefore is taxed only once at the old partnership/LLC equity owner level. Any such

taxable income not distributed to old partnership/LLC's equity owners increases the basis of their old partnership/LLC common units, so that the gain they recognize on subsequent dispositions of their old partnership/LLC common units is correspondingly reduced.

¶901.12 Post-IPO Obligations

After the IPO, when Portfolio Company is publicly traded, it is important that Portfolio Company, its board, and its principal shareholders pay attention to a number of legal obligations imposed on public companies, including:

- Filing of periodic SEC reports—annual 10-Ks, quarterly 10-Qs, and periodic 8-Ks for many events.
- Filing SEC proxy statements, and mailing them to shareholders, in connection with each shareholder vote.
- Timely public announcements of material developments.
- 1934 Act §16(b) disgorgement to Portfolio Company of short-swing profits on a purchase and sale (or a sale and purchase) of Portfolio Company stock (or certain derivatives) within a six-month period by a person who is an executive officer, director, or 10% beneficial owner of Portfolio Company.
- SEC Rule 10b-5 prohibition on a person in possession of material non-public information about Portfolio Company (an "insider" or a "temporary insider") using such information to buy or sell Portfolio Company securities or to "tip" others who do so. Information is "material" if a reasonable investor would consider it relevant to his or her investment decision.
    - Portfolio Company should adopt a policy statement prohibiting all officers, directors, employees, and agents (1) from buying or selling Portfolio Company securities when in possession of material non-public information or (2) from disclosing such information to any third party not authorized by Portfolio Company to receive it.
    - Portfolio Company should consider prohibiting insiders and temporary insiders, i.e., persons possessing such information, from ever buying or selling Portfolio Company securities except:

(a) during a specified trading window period, generally beginning two business days after the Portfolio Company's quarterly or annual earnings report and ending a specified number of business days (e.g., 10 to 20 business days) after such report *or*

(b) pursuant to an SEC Rule 10b5-1 pre-arranged binding contract (e.g., with a buyer) or written plan (e.g., with a broker) satisfying all the following requirements: the contract or plan (i) was adopted before the insider became aware of material non-public information, (ii) was not thereafter altered or deviated from, and (iii) *either* (x) specifies the amount of securities to be purchased or sold and the date for such purchase or sale *or* (y) contains a formula for determining the amount of securities and the price and date *or* (z) grants to a third party not possessing material non-public

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information authority to purchase or sell the securities and does not permit the insider to exercise, after adoption of the contract or plan, any subsequent influence over such purchase or sale.

If such a 10b5-1 contract or plan is promulgated during Portfolio Company's trading window period (or at another time) and when as the insider is not in possession of material non-public information, shares can be purchased or sold for the insider's account (in accordance with the contract's or plan's terms) outside a normal trading window period and/or at a time when the insider is in possession of material non-public information.

An insider is generally permitted to amend or revoke such a contract or plan. However, SEC views an amendment as the adoption of a new contract or plan and hence the insider must not be in possession of material non-public information at the time of the amendment. While SEC views revocation when in possession of material non-public information as not violating Rule 10b-5, a Rule 10b5-1 contract or plan must be entered into on good faith and not as part of a plan or scheme to evade Rule 10b-5's prohibitions, so SEC would view as a Rule 10b-5 violation a pattern of adopting a contract or plan, then revoking when in possession of material non-public information, and then adopting another.

Generally trading under any contract or plan should not commence before expiration of an adequate seasoning period after adoption or amendment (e.g., at least 30 days), nor should a new contract or plan be adopted after revocation of a prior plan until expiration of an adequate post-revocation seasoning period with trading under such new contract or plan not commencing until expiration of an adequate seasoning period after adoption.

- 1934 Act §13(k)(1) prohibition on Portfolio Company extending or maintaining credit, or arranging for the extension of credit (with arranging interpreted by SEC as more than ministerial or administrative activities by Portfolio Company), in the form of a personal loan to any executive officer or director, which includes an executive officer's note to Portfolio Company as the purchase price (or as part of the purchase price) for Portfolio Company stock, or the Portfolio Company's guarantee of a loan to the executive from a third party lender.
  - This prohibition applies once Portfolio Company becomes an "issuer," generally a company with publicly issued or publicly traded securities or a company which has filed with SEC a 1933 Act registration statement covering either equity or debt securities that has not yet become effective but has not yet been withdrawn, as described in more detail in ¶501.5.4.3.
- 1934 Act §10D mandatory claw back of incentive-based compensation from executive officers of company listed on national securities exchange because of material misstatement of financial information, once proposed SEC rules finalized.
  - Proposed 7/15 SEC rules (once final) would impose strict liability on all executive officers of a company listed on a national securities exchange to give back incentive-based compensation (including stock options and compensation where vesting or amount is based on any type of financial information), calculated on a pre-tax basis, if the company restates its financial performance on account of a material error, even if such error was inadvertent and such executive had no involvement in preparing the financial statements, to the extent the compensation exceeds the amount the officer would have received based on the restated financial statements, for the three completed fiscal years preceding the restatement.
- Many additional obligations imposed by SOX (and by stock exchanges following SOX's enactment), including CEO/CFO certification of periodic 10-Q and 10-K reports, auditor independence rules, audit committee independence rules, board and other board committee independence rules, board and board committee charter rules, codes of conduct for officers, directors, and employees, internal control certification, adoption of whistleblower hotlines, etc.

¶902 1933 ACT REGISTERED PUBLIC RESALES SUBSEQUENT TO IPO

¶902.1 Short-Form Registrations

Once Portfolio Company is a 1934 Act reporting company (as defined in ¶207.3.2(2)), it may qualify for a short-form 1933 Act registration statement (on Form S-3) allowing Portfolio Company or holders of its restricted securities to sell Portfolio Company securities with less delay and at less expense than a full-blown S-1 registration statement.

See ¶901.6 for a description of the simplified form available if Portfolio Company qualifies as a small business issuer.

¶902.2 Form S-3

SEC Form S-3 allows Portfolio Company to incorporate most information by merely referring to Portfolio Company's periodic 1934 Act filings. To qualify for Form S-3, Portfolio Company must satisfy *both* of the following Registrant Requirements:

(1) Portfolio Company must have been a 1934 Act reporting company (as defined in ¶207.3.2(2)) for at least 12 calendar months and must have timely filed with SEC all of its 1934 Act filings for the prior 12 calendar months, and

(2) Portfolio Company and its consolidated and unconsolidated subsidiaries must not have failed to make any dividend or sinking fund payments on preferred stock and not defaulted on repayment of borrowings or long-term lease rental payments for approximately a year.

In addition to meeting both of the Registrant Requirements, an offering on Form S-3 must meet one of the following 3 Transaction Requirements:

(a) For a primary or secondary offering of Portfolio Company securities for cash, the aggregate market value of the voting and non-voting common

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equity held by Portfolio Company non-affiliates (generally meaning persons who are not board members, officers, or large shareholders with the power to influence company policy) must be at least $75 million (calculated as of any date within 60 days of the SEC filing).

(b) For a primary offering of Portfolio Company securities by Portfolio Company for cash, Portfolio Company must have a class of voting or non-voting common equity securities listed and registered on a national securities exchange, must not be (or in the past 12 calendar months have been) a shell company, and must not sell more than the equivalent of one-third of its public common float in primary offerings pursuant to this (b) during the prior 12 calendar months (including this offering).

(c) For a secondary offering of Portfolio Company securities by Portfolio Company shareholders, Portfolio Company must have the same class of securities listed and registered on a national securities exchange.

¶902.3 *Demand and Piggyback Registrations*

In a front-end registration rights agreement signed when PE/VC made its original investment in Portfolio Company (as discussed at ¶207.7.3), PE/VC frequently obtains the right to periodic demand registrations of its Portfolio Company restricted securities once Portfolio Company has completed its IPO and any contractual underwriter hold-back period has expired. In addition, PE/VC frequently also obtains the right to piggyback on SEC registrations filed by Portfolio Company in which Portfolio Company or any of its shareholders are selling Portfolio Company stock to the public.

¶903 SEC RULE 144 UNREGISTERED PUBLIC RESALES, GENERALLY BUT NOT EXCLUSIVELY AFTER IPO

Once Portfolio Company has completed its IPO and any contractual hold-back period imposed by the underwriter in the IPO or in a subsequent underwritten registered offering has expired, PE/VC and other holders can begin public resales of their restricted securities (i.e., their Portfolio Company restricted securities not previously registered with SEC, e.g., purchased from Newco in private placements under SEC Reg. D—see ¶207.3 and ¶207.7) without filing an SEC registration statement for those securities, so long as *all* the requirements of SEC Rule 144 (as described below) are met.

The Rule 144 requirements that must be satisfied vary depending on (1) whether Portfolio Company is a 1934 Act reporting company, (2) whether the selling shareholder is a Portfolio Company affiliate (i.e., a member of Portfolio Company's control group, generally meaning each person who is a board member, officer, or large shareholder with the power to influence company policy), and (3) the length of the selling shareholder's holding period for the Portfolio Company stock being sold.

Rule 144 is an SEC safe harbor (1) allowing anyone (whether or not a Portfolio Company affiliate) to resell Portfolio Company restricted securities (as described

in this ¶903) and (2) allowing a Portfolio Company affiliate to resell Portfolio Company unrestricted securities (as described in ¶905).[1]

¶903.1 *Public Information*

To qualify under Rule 144's safe harbor, Portfolio Company must have been a 1934 Act reporting company (see ¶207.3.2(2)), for at least 90 days prior to the sale and have filed with SEC all reports required to be filed by the 1934 Act during the preceding 12 months (or such shorter period as Portfolio Company was required to file such reports), although Portfolio Company need not have made such SEC filings timely.[2]

However, if the selling shareholder is not (and has not at any time during the 3 months preceding the sale been) a Portfolio Company affiliate (i.e., not a member of Portfolio Company's control group, generally meaning each person who is not a board member, officer, or large shareholder with the power to influence company policy), this current public information requirement ceases to apply once the non-affiliate has a 1-year holding period for stock being sold (measured as described in ¶903.4).

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¶903.2 *Volume Limitation*

No volume limitation applies to a selling shareholder who is not (and has not at any time during the 3 months preceding the sale been) a Portfolio Company affiliate and who is selling after the 6-month no-sale period for a 1934 Act reporting company or the 1-year no-sale period for a non-reporting company (as discussed in ¶903.4).

For a selling shareholder who is (or at any time during the 3 months preceding the sale was) a Portfolio Company affiliate and who is selling after the 6-month no-sale period for a 1934 Act reporting company or the 1-year no-sale period for a non-reporting company (as discussed in ¶903.4), such Portfolio Company affiliate may sell only a limited amount of Portfolio Company stock (including both restricted and unrestricted stock—see ¶905) in any 3-month period under Rule 144, generally the *greater* of 1% of the class outstanding *or* the average reported weekly trading volume over the 4-week period prior to filing the Rule 144 notice with SEC (as described in ¶903.5). SEC staff takes the position that such reported

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¶903 [1] If such a person were to publicly resell such securities (i.e., if a Portfolio Company affiliate were to resell any Portfolio Company securities or a Portfolio Company non-affiliate were to resell Portfolio Company restricted securities) without Rule 144 compliance, such selling shareholder would have the burden of establishing status as a non-underwriter of the securities (i.e., demonstrating that such selling shareholder did not acquire the securities with a view to publicly reselling them).

[2] Alternatively, an extensive amount of information about Portfolio Company specified in SEC rules must be publicly available. With one exception, a company not reporting under the 1934 Act is not likely to satisfy this alternative prong of the public information requirement, so we generally do not further mention the alternative prong and generally hereafter refer to the public information requirement as simply that Portfolio Company must be a 1934 Act reporting company. The one exception is a Portfolio Company that was briefly (but ceased to be) a 1934 Act reporting company, because it had issued registered high-yield bonds to fewer than 300 purchasers, but was thereafter required by its bond indenture to become a "voluntary filer" (i.e., a company required by its indenture to file 1934 Act reports with SEC but not required to do so by law), as discussed at ¶501.5.4.3.

trading volume must be reduced by any shares sold by the selling shareholder during the 4-week measurement period.

Under certain circumstances public sales by more than one person are aggregated for purposes of this Rule 144 volume limitation, e.g., all persons acting in concert in the sale of Portfolio Company securities, a donor and a donee, and a deceased person and his or her estate. SEC staff takes the position that the reported trading volume must be reduced by any shares sold by any aggregated person during the 4-week measurement period.

Securities sold pursuant to an effective 1933 Act registration statement *or* under Reg. A *or* in a §4(a)(2) private placement *or* in a Reg. S "offshore transaction" (with sales solely to persons who are not U.S. residents, no "directed selling efforts" into the U.S. market with respect to such securities, and the securities restricted from resale to a U.S. resident for a specified period [one year in the case of Newco equity securities and 40 days for Newco debt securities]) do not count against the volume limitation.

¶903.3 Manner of Sale

A sale of stock by a selling shareholder who is (or at any time during the 3 months preceding the sale was) a Portfolio Company affiliate (who is selling after the 6-month no-sale period for a 1934 Act reporting company or the 1-year no-sale period for a non-reporting company as discussed in ¶903.4) may be made only in certain types of transactions to or through a broker or market maker that involve no solicitation of buyers (referred to as transactions directly with a market maker *or* brokers' transactions *or* riskless principal transactions).

No such requirement applies to a selling shareholder who is not (and has not at any time during the 3 months preceding the sale been) a Portfolio Company affiliate.

¶903.4 6-Month or 1-Year Rule 144 Holding Period

No sales of restricted stock are permitted before the selling shareholder has a 6-month Rule 144 holding period (measured as described below) where Portfolio Company is a 1934 Act reporting company also satisfying ¶903.1 *or* a 1-year holding period (measured as described below) where Portfolio Company is not such a 1934 Act reporting company.

Where Portfolio Company is a 1934 Act reporting company also satisfying ¶903.1 and the selling shareholder has a *6-month* Rule 144 holding period for the restricted stock being sold:

- If the selling shareholder is not (and has not at any time during the 3 months preceding the sale been) a Portfolio Company affiliate (i.e., not a member of Portfolio Company's control group, generally meaning a person who is not a board member, officer, or large shareholder with the power to influence company policy), then once the 6-month holding period has been met for the restricted stock being sold, such a non-affiliate may sell restricted stock of a 1934 Act reporting company also satisfying ¶903.1 without regard to any of the conditions described in ¶903.2 (volume limitation), ¶903.3 (manner of sale), and ¶903.5 (SEC notification).

- If the selling shareholder is (or at any time during the 3 months preceding the sale was) a Portfolio Company affiliate, then once the 6-month holding period has been met, such an affiliate may sell restricted stock of a 1934 Act reporting company also satisfying ¶903.1 only if the sale satisfies all the conditions described in ¶903.2 (volume limitation), ¶903.3 (manner of sale), and ¶903.5 (SEC notification).

Where Portfolio Company is not a 1934 Act reporting company also satisfying ¶903.1 and the selling shareholder has a *1-year* Rule 144 holding period for the restricted stock being sold:

- If the selling shareholder is not (and has not at any time during the 3 months preceding the sale been) a Portfolio Company affiliate (i.e., not a member of Portfolio Company's control group, generally meaning a person who is not a board member, officer, or large shareholder with the power to influence company policy), then once the 1-year Rule 144 holding period has been met for the restricted stock being sold, such a non-affiliate may sell such restricted stock without regard to any of the conditions described in ¶903.1 (public information), ¶903.2 (volume limitation), ¶903.3 (manner of sale), and ¶903.5 (SEC notification).
- If the selling shareholder is (or at any time during the 3 months preceding the sale was) a Portfolio Company affiliate, then once the 1-year Rule 144 holding period has been met for the restricted stock being sold, such an affiliate may sell such restricted stock only if the sale satisfies all the conditions described in ¶903.1 (public information), ¶903.2 (volume limitation), ¶903.3 (manner of sale), and ¶903.5 (SEC notification),
  - so that with respect to ¶903.1's current public information requirement, since Portfolio Company is not a 1934 Act reporting company, Portfolio Company must satisfy the alternative prong by making publicly available the extensive amount of information specified in SEC rules, which Portfolio Company is generally unlikely to do (as discussed in the footnote to ¶903.1).

No 6-month or 1-year holding period is required, however, if the selling shareholder is the estate of a deceased shareholder (or a beneficiary thereof) unless the estate (or beneficiary) is itself a Portfolio Company affiliate.

Although a person who is (or at any time during the 3 months preceding the sale was) a Portfolio Company affiliate must meet certain Rule 144 requirements when selling *unrestricted* (i.e., registered) Portfolio Company stock (see ¶905), the holding period rules described in this ¶903.4 do not apply to such sales by an affiliate of *unrestricted* stock.

¶903.4.1 Commencement of Holding Period

If the selling shareholder previously purchased the restricted securities from Portfolio Company or from a Portfolio Company affiliate (i.e., a member of Portfolio Company's control group, generally meaning each person who is a board member, officer, or large shareholder with the power to influence company policy), the Rule 144

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holding period generally begins when the purchaser has paid the full purchase price, although a full recourse note from the purchaser, secured by assets (other than the Portfolio Company securities being purchased) with an FV at least equal to the note, starts the holding period, so long as such note is paid before resale of the securities.

¶903.4.2 Purchase from Person Other Than Portfolio Company or Portfolio Company Affiliate

Where the selling shareholder purchased the restricted stock from a person who was not a Portfolio Company affiliate (i.e., did not purchase the stock from Portfolio Company or from a Portfolio Company affiliate), the selling shareholder inherits the accumulated holding period of his or her seller and all previous holders (i.e., the holding period tacks), except that if any prior holder was Portfolio Company or a Portfolio Company affiliate, the holding period of Portfolio Company or such Portfolio Company affiliate and prior holders does not tack.

¶903.4.3 Exchange or Conversion

Where the selling shareholder held Portfolio Company convertible debt or convertible preferred stock, the Rule 144 holding period for the Portfolio Company debt or preferred stock tacks to the Portfolio Company common stock into which the debt or preferred stock is converted, so long as the holder makes no payment in connection with such conversion (other than surrendering Portfolio Company securities).

Even where a Portfolio Company debt or preferred stock was not by its terms convertible into Portfolio Company common stock, but is nonetheless exchanged for Portfolio Company common stock, the holding period for the surrendered security tacks to the new Portfolio Company common stock, so long as the holder makes (or made) no payment (other than surrendering a Portfolio Company security) for the privilege of exchanging or as consideration for amending the security to permit such exchange.

- See ¶501.5.2.3 for discussion of the similar IRS tacking rule for such a convertible instrument (used in determining whether a holder has satisfied the more-than-1-year tax holding period necessary for LTCG).

¶903.4.4 Warrant

Where the selling shareholder held a Portfolio Company warrant, a new Rule 144 holding period generally starts at warrant exercise.

However, in two circumstances tacking is permitted in connection with a warrant exercise: First, if the warrant exercise price is paid solely by surrender of other securities of the same company (e.g., Portfolio Company debt, preferred stock, or common stock) (i.e., a gross cashless exercise), the holding period of the surrendered Portfolio Company securities tacks to the new Portfolio Company common stock.

Second, if the Portfolio Company warrant is instead surrendered for Portfolio Company common stock with an FV equal to the warrant spread (i.e., a net

cashless exercise with no payment of the warrant exercise price), the warrant's holding period tacks to the new common.

These two warrant tacking rules apply even if the warrant terms did not provide for such a gross or net cashless exercise, so long as the holder makes no payment in connection with amending the warrant to allow such an exercise or in connection with the exercise (other than surrendering Portfolio Company securities).

These tacking rules do not, however, apply to an employee option (where the holder had no investment risk before exercise). For such an option, the holding period does not start until exercise (or later if the full option price is not paid [or adequately secured] at exercise).

Where the selling shareholder sold a business to Portfolio Company (or to Portfolio Company's affiliate)—either a sale of a business' assets or equity securities—and subsequently receives from Portfolio Company a contractually required contingent payment of Portfolio Company securities as additional purchase price for such business, the Rule 144 holding period for such contingent Portfolio Company securities begins when the selling shareholder sold such business to Portfolio Company (or its affiliate). However, this rule does not cover Portfolio Company securities issued as compensation for the selling shareholder's employment with, or non-compete covenant to, Portfolio Company (or with its affiliate).

- See ¶501.5.2.2 for discussion of the complex IRS tacking rules for a warrant (used in determining whether a non-corporate holder has satisfied the more-than-1-year tax holding period necessary for LTCG).

¶903.4.5 Other Tacking Rules

There are also tacking rules for a stock dividend, stock split, recapitalization, holding company formation, pledge, gift, or transfer to or from a trust or estate.

¶903.4.6 Unvested Securities

When a Portfolio Company executive receives restricted Portfolio Company stock subject to vesting, SEC's rules do not indicate whether the executive's Rule 144 holding period begins when the Portfolio Company restricted stock is issued to him or her or only when the stock ultimately vests.

In 1979, SEC published its position that where restricted securities are issued pursuant to "an employee benefit plan which requires the plan participants to remain as employees for a specified period of time before the securities . . . vest . . . [, the Rule 144] holding period . . . will commence when the securities are allocated to the account of an individual plan participant [and the] fact that the securities may not vest until some later date does not alter the result." It has long been widely believed that this salutary rule applies to all securities granted or sold to employees pursuant to a formal or informal plan.

However, the SEC staff created uncertainty in an early 1994 no-action letter where Portfolio Company granted stock to a number of executives pursuant to substantially similar individual contracts approved by the board (under which

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the stock would vest pro rata over 5 years, based on continued employment). The staff stated that "if the restricted securities are not issued pursuant to an employee benefit plan, the holding period does not begin to run until the date of vesting," and the staff then declined to determine whether the contracts constituted an employee benefit plan.

SEC rules define "employee benefit plan" extremely broadly, as including a "contract, authorization or arrangement, whether or not set forth in any formal documents, . . . [even if] applicable to one person." Hence, there is no rational reason for SEC to distinguish between a formal employee benefit plan and one or a set of individual contracts intended to incent one or more employees.

Discussions with SEC staff indicate that this early 1994 no-action letter was meant merely to restate SEC's long-standing policy that it would not comment on whether a particular employment agreement constitutes an employee benefit plan and such determination must be made by the issuer and its counsel based on the facts and circumstances of each case. Hence, it appears that SEC meant no inference in the no-action letter that the situation then presented fell short of constituting an employee benefit plan.

If Portfolio Company's original issuance of the stock to the executives qualified under SEC Rule 701, the stock can be sold free of most Rule 144 restrictions once Portfolio Company has been a 1934 Act reporting company (as defined at ¶207.3.2(2)) for at least 90 days. Hence, when Rule 701 covered Portfolio Company's original issuance of the executive's stock and Portfolio Company has been a reporting company for at least 90 days, the Rule 144 issue as to when the executive's 6-month/1-year Rule 144 holding period commences is not relevant. See ¶903.7.

¶903.4.7 Incorporation of Partnership or LLC

If Portfolio Company was originally formed as a partnership or LLC (e.g., in order to obtain flow-through tax treatment) and was later transformed into a corporation (e.g., in anticipation of an IPO), SEC takes the illogical position that:

(1) the holders' Rule 144 holding period in the partnership or LLC interests does not tack to the corporate stock received in exchange, because the decision to incorporate is a new investment decision,

(2) *except* that the holders' Rule 144 holding period does tack where (i) at the time of the holder's original investment in the partnership or LLC, a written agreement contemplated that the entity would be transformed into corporate form in connection with an IPO, and (ii) no additional consideration is paid at the time of the transformation, and (iii) the incorporation causes no shift in the holders' economic interests not contemplated by the original documents,

- *but* SEC takes the position that tacking is not permitted for any equity owner of the partnership or LLC who had a veto power or other voting power with respect to Portfolio Company's transformation (e.g., Portfolio Company's general partner), and that even where the decision to incorporate is made by Portfolio Company's board (not by any group of Portfolio Company's equity owners), a Portfolio Company controlling equity owner with power to elect Portfolio Company's board is not permitted to tack.[3]

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¶903.5 *SEC Notification*

If the amount of securities to be sold in reliance on Rule 144 during any 3-month period will exceed 5,000 shares or $50,000, the selling shareholder must file a Form 144 with SEC and give notice to the principal exchange on which the security is listed. For such notice to be valid (i.e., to establish the time for measuring trading volume as described in ¶903.2), the selling shareholder filing the notice must have "a bona fide intention to sell the securities" covered by the notice within "a reasonable time after the filing of such notice."

No such requirement applies to a selling shareholder who is not (and has not at any time during the 3 months preceding the sale been) a Portfolio Company affiliate (i.e., not a member of Portfolio Company's control group, generally meaning a person who is not a board member, officer, or large shareholder with the power to influence company policy).

¶903.6 *Partnership Fund Distribution in Kind*

If a closely held PE/VC Fund (or other entity) distributes Portfolio Company restricted securities in kind to PE/VC Fund's equity owners pro rata, each PE/VC Fund equity owner tacks PE/VC Fund's Rule 144 holding period for the restricted Portfolio Company securities even if PE/VC Fund was a Portfolio Company affiliate (e.g., owned a very large percentage of Portfolio Company's stock and/or furnished a director of Portfolio Company), notwithstanding that the normal holding-period measurement rules (discussed in ¶903.4) would not allow PE/VC Fund's transferee to tack PE/VC Fund's holding period (because PE/VC Fund is a Portfolio Company affiliate).[4]

Thus, once the tacked holding period for restricted securities distributed in-kind reaches 6 months (for a 1934 Act reporting company also satisfying ¶903.1) or 1 year (for a non-reporting company), PE/VC Fund's distributees are treated as satisfying the holding period requirement discussed at ¶903.4.

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[3]If Portfolio Company partnership or LLC has an IPO (see Code §7704) or checks the box for corporate tax treatment (see ¶302.4.2), Newco is thereafter (although still a partnership or LLC for state law purposes) treated as a corporation for federal tax purposes, but no new Rule 144 holding period begins, because there has been no non-tax change in Portfolio Company's form of organization (i.e., Portfolio Company is still a partnership/LLC for all non-tax purposes). However, this technique does not transform Portfolio Company into a state law corporation (a transformation generally desirable for IPO purposes).

[4]Rule 144's literal language, as amended in 1990, permits tacking after a transfer of restricted securities except where the transferor is an affiliate of the restricted securities' issuer. However, a line of SEC no-action letters (commencing before the 1990 amendment to Rule 144 and continuing since) concludes that where an entity which is "closely held," and thus has an "identity of interests" with its equity owners, makes a pro rata distribution of an issuer's restricted securities to the entity's equity owners without receiving consideration, the distributee equity owners are entitled to tack the entity's holding period regardless of whether the entity is an affiliate of the issuer of the restricted securities.

CHAPTER 3

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Chapter 3. Structuring Newco as Flow-Through Entity

E and VC have reached agreement on the economic and certain of the structuring terms of the Newco start-up discussed in Chapter 2. However, they are now exploring whether Newco should be formed as a regular C corp subject to double tax under the U.S. federal income tax system (as Newco was structured throughout Chapter 2) or whether it might be more advantageous to form Newco as a tax flow-through entity, i.e., an S corp, a partnership, or an LLC.

As discussed throughout this Chapter 3, there are (a) many tax and legal differences between a C corp on the one hand and a flow-through entity on the other and (b) many tax and legal differences between the several types of flow-through entities. Three of the principal differences are:

(1) From a federal income tax standpoint, a flow-through entity (unlike a C corp) is generally not subject to entity-level income tax. Rather a flow-through entity's earnings are taxed to its equity owners (with the entity's OI, LTCG, QDI, etc. retaining its entity-level character on the equity owners' federal tax returns). And, unlike a C corp, no additional (or second) federal income tax is imposed when a flow-through entity distributes earnings to its equity owners. An equity owner's tax basis in a flow-through entity is flexible, *increasing* by the amount of the entity's income (which flows through to and is taxed to the equity owners), *decreasing* by the amount of the entity's losses (which flow through to and are generally deductible by the equity owners), and *decreasing* by the amount of the entity's distributions to the equity owners (again unlike a C corp where an equity owner's basis in the entity is generally a frozen amount equal to the equity owner's capital contributions to [or cost of purchasing the equity interest in] the C corp entity).

(2) Some types of entities are disqualified from flow-through federal income tax treatment by arbitrary rules—e.g., an S corp is generally disqualified and treated as a C corp if it has more than one class of stock (ignoring voting power distinctions) or has a shareholder who is a corporation, partnership, LLC,[1] or individual not a U.S. citizen or resident or has more than 100 shareholders, while a partnership or LLC is generally disqualified and treated as a C corp if it has any publicly traded equity interests.

(3) Whether some or all of a flow-through entity's equity owners are liable for the entity's unpaid liabilities—or whether all the equity owners enjoy limited liability, i.e., are generally insulated from such unpaid entity-level liabilities (as with a C corp)—turns on the type of flow-through entity employed. An LLC or an S corp is most likely to shield all the equity owners, and a carefully structured partnership generally can achieve a similar result.

[1]Except that an S corp may have as a shareholder a single member (and thus disregarded) LLC owned by a U.S. individual or other person qualified to be an S corp shareholder.

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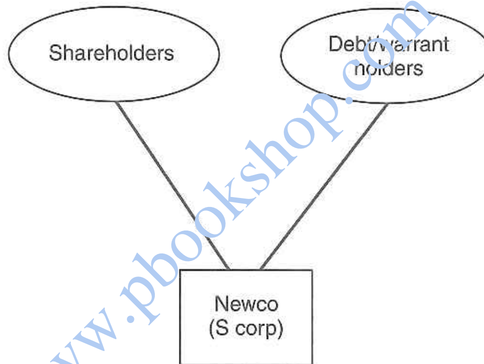
> Discussion of individual tax rates throughout this treatise, unless otherwise specifically stated, takes into account only regular income taxes and does not take into account (a) the uncapped Medicare tax on compensation and self-employment income, (b) the uncapped Medicare tax on passive income, (c) the 3%-of-AGI itemized deduction disallowance, or (d) the personal exemption phase-out, all of which increase the effective tax rate as discussed at ¶107(4).
>
> Unless otherwise stated, when this treatise discusses the LTCG tax rate for an individual taxpayer, we are referring to the regular LTCG rate, not to the reduced §1202 rate.

¶301 NEWCO AS S CORP



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¶301.1 Limited Liability and General Characteristics

¶301.1.1 General

An S corp is a corporation incorporated in the normal manner (by filing appropriate incorporation papers with a state agency, generally the secretary of state of a U.S. state) which then elects (by a filing with IRS) to be taxed pursuant to subchapter S of the Code, in which case the S corp is taxed as a flow-through entity for federal income tax purposes, although the S corp flow-through rules are not identical to the partnership or LLC flow-through rules discussed in ¶302 and ¶303.

¶301.1.2 Limited Liability

An insolvent S corp's shareholders have the same limited liability protection from corporate unpaid creditors as the shareholders of a regular C corp.[1] Thus, neither S nor C shareholders are personally liable for the corporation's debts, absent invocation

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¶301 [1]See, e.g., Del. Gen. Corp. Law §102(b)(6) making no distinction between a C and an S corp.

of the veil-piercing doctrine or a statutory-liability doctrine or shareholder participation in a negligent or wrongful act, which exceptions to corporate limited liability apply equally whether Newco is a C or an S corp.

¶301.1.2.1 *Veil Piercing*

Under the traditional common law doctrine of piercing the limited liability veil, there is a slight risk that one or more Newco shareholders may be held responsible for Newco's liabilities, although the veil-piercing standards for an S corp do not appear to differ from those for a C corp. Some of the significant factors that could lead to such a finding of responsibility are:

- Undercapitalization of Newco.
- Newco's failure to observe corporate formalities (such as regular board and shareholder meetings, maintenance of corporate records, etc.).
- Commingling of the shareholder's and Newco's funds or other assets.
- Failure to maintain an arms-length relationship between Newco and the shareholder (or the shareholder's other businesses).
- Common business enterprise between Newco and the shareholder, i.e., both engaged in portions or segments of an integrated business activity.
- The shareholder's fraudulent intent to avoid liability.

In a well-structured VC transaction, there should be little risk of veil-piercing liability.

¶301.1.2.2 *Environmental Cleanup*

Under CERCLA (the principal federal environmental cleanup statute), each person who is an "owner or operator" of a contaminated facility is liable for cleaning up the facility.

Addressing a long-running dispute whether Newco's CERCLA liability may reach a Newco control shareholder otherwise protected by Newco's corporate shield, the Supreme Court in 1998 held it could, but only in limited circumstances where the Newco shareholder is involved in Newco's pollution-related operations (i.e., the shareholder exercises control over Newco's operations involving leakage or disposal of hazardous waste or over decisions about Newco's compliance with environmental regulations) and takes actions outside the norms of corporate behavior or beyond those actions consistent with mere investor status. See the discussion of this topic at ¶501.5.3.2.

¶301.1.2.3 *Pension Plan and Other ERISA Liabilities*

Where an entity shareholder owns 80% or more of Newco (as defined below), such entity shareholder (as well as any other entity in such entity shareholder's 80% ERISA control group) is generally liable for (1) Newco's delinquent pension contributions, (2) Newco's liability for a terminated underfunded pension plan, (3) Newco's multiemployer union pension plan withdrawal liability, (4) Newco's

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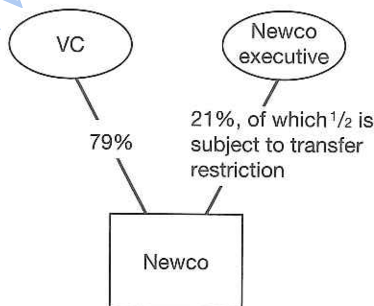
delinquent PBGC premiums, and (5) Newco's continuation medical coverage ("COBRA") obligations, all as described in more detail in ¶501.3.5.2 and ¶501.5.3.1.[2]

In determining whether the entity shareholder owns 80% or more of Newco (or of any other subsidiary), so that Newco or any other lower-tier entity is a member of the entity shareholder's ERISA control group, a lower-tier entity is a member of an upper-tier entity's ERISA control group where the upper-tier entity owns 80% or more of the lower-tier entity's (1) stock by vote or value if the lower-tier entity is a *corporation* or (2) capital or profits if the lower-tier entity is a *partnership or LLC*.

In applying this 80%-or-more test, (1) an upper-tier entity (e.g., VC) is generally treated as owning a pro rata portion of an equity interest owned by a lower-tier entity in which the upper-tier entity has an equity interest, (2) a person is treated as owning an outstanding equity interest owned by a third party where the person has an option to purchase such equity interest, (3) a person is not treated as owning unissued equity interests the person could acquire from the issuer upon exercise of warrants, conversion privileges, or the like, and (4) if an upper-tier entity (e.g., VC) owns 50% or more of a lower-tier entity, certain equity interests in the lower-tier entity owned by third parties are excluded from the denominator (i.e., treated as not outstanding) including, most importantly, (a) a lower-tier entity interest owned, subject to vesting, option, right of first refusal, or other transfer restriction, by an employee of the lower-tier entity and (b) a lower-tier entity interest owned by an officer, director, or 5% owner of the upper-tier entity.

For example, where VC owns 79% of Newco and a Newco executive owns the other 21% of Newco and one-half the executive's 21% equity interest in Newco is subject to vesting, option, right of first refusal, or other transfer restriction, VC is treated as owning approximately 88% of Newco (79 ÷ [100 − 10.5]).



¶301.1.2.4 Shareholder Participation in Negligent or Wrongful Act

The doctrine of corporate limited liability protects a Newco shareholder from Newco's unpaid liabilities merely because he or she is a Newco shareholder (absent invocation of a superseding doctrine such as those discussed above), but does not absolve a Newco shareholder from liability along with Newco where the shareholder (in his or her capacity as a Newco officer, director, employee,

[2]Other ERISA and Code provisions (such as non-discrimination testing requirements for qualified pension benefit plans and certain welfare benefit plans) are also applied to the ERISA control group.

agent, or otherwise) actually participates in Newco's negligent or wrongful act toward a third party, in which case such shareholder would generally be directly liable to the third party.[3] The same is true where a non-shareholder (e.g., a Newco officer, director, employee, agent, or other person who owns no Newco stock) actually participates in Newco's negligent or wrongful act toward a third party.

¶301.2 Federal Income Tax Aspects

¶301.2.1 No Entity-Level Tax

Newco as an S corp is generally *not* subject to federal income tax on its income at the entity level. Rather each of Newco's shareholders reports on his, her, or its tax return a pro rata share of Newco's profits—whether or not distributed—and (subject to numerous qualifications) a pro rata share of Newco's losses. Thus, Newco is not subject to federal corporate tax (at rates up to 35%); instead each Newco shareholder is taxed at the appropriate federal rate—e.g., up to 39.6% for an individual Newco shareholder's flow-through OI (slightly less for business net income from U.S. production activities—see ¶107(6)) and 20% for an individual Newco shareholder's flow-through LTCG and QDI.

Normally a tax-exempt organization (a "TEO") owes no federal income tax on its income. However, a TEO does owe federal income tax on its unrelated business taxable income ("UBTI"). All of a TEO's income from an S corp is automatically treated as UBTI, i.e., S corp income of any type (whether active business or passive investment income) flowing to the TEO as well as the TEO's gain or loss on disposition of the S corp's stock (with certain exceptions for an S corp shareholder which is an ESOP).

A newly formed corporation can make an S election by filing Form 2553 with IRS signed by all of its shareholders (including with respect to a shareholder residing in a community property state, such shareholder's spouse[4]) no later than the fifteenth day of the third month after the corporation's formation (effective from formation), and an existing C corp can make an S election for a taxable year by filing such form with IRS no later than the fifteenth day of the third month of such taxable year.

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¶301.2.2 S Corp Compared to C Corp

(1) The tax on an S corp's taxable income (payable by its shareholders, based on the percentage of stock owned by each, not payable by the corporation) is generally at individual tax rates (with a 39.6% top federal rate for flow-through OI and a 20% top rate for flow-through LTCG and QDI), as opposed to a 35% top federal corporate rate on all of a C corp's income (both OI and CG), although a lower rate [generally 10.5%] applies to a C corp's dividend income.

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[3]For example, Del. Gen. Corp. Law §102(b)(6)'s absolution of a corporation's shareholders from the corporation's debts expressly states "except as [the shareholders] may be liable by reason of their own conduct or acts."

Some states impose even more extensive liability on shareholders of a corporation engaged in one or more specified professional activities, e.g., shareholder liable for legal malpractice committed by shareholder or by person under shareholder's supervision.

[4]Treas. Reg. §1.1362-6(b)(2)(i).

Hence Newco S generally distributes cash to its shareholders equal to 39.6% of its OI plus 20% of its LTCG and QDI (plus an additional amount to cover state income tax). Indeed, a minority S corp shareholder would be well advised to seek a mandatory distribution agreement with the S corp requiring the S corp periodically to make distributions to all shareholders approximately equal to the income tax liabilities attributable to S corp stock ownership (generally at a single uniform rate for all shareholders, because of the S corp one-class-of-stock rule).

(2) While an S corp's losses generally flow through to its shareholders for federal income tax purposes, there are significant restrictions on a shareholder's ability to deduct the flow-through losses, including the basis limitation rule of Code §1366(d), the at-risk rules of Code §465, and the passive activity loss rules of Code §469.

(3) There is generally no double taxation of S corp earnings distributed to shareholders, because S corp dividends are generally treated as a tax-free recovery of the shareholder's basis in his or her stock.

(4) There is also no double taxation when an S corp shareholder realizes on previously taxed accumulated S corp income by selling his or her stock, because undistributed S corp income is added to the shareholder's basis in his or her stock as earned. With a C corp, by contrast, a shareholder's basis in the C corp stock is generally his or her original cost for the stock (plus any subsequent contributions to the C corp), i.e., C corp frozen stock basis. However, with an S corp, a shareholder's tax basis in the S corp stock is flexible, generally consisting of:

- original cost (either the shareholder's initial capital contribution to the S corp where he or she acquired newly issued stock [generally measured by the tax basis of property contributed in kind] or the price the shareholder paid to a third party from whom he or she purchased the S corp's stock),
- *plus* the shareholder's subsequent capital contributions to the S corp (generally measured by the tax basis of property contributed in kind),
- *plus* the S corp's taxable income (and any S corp tax-exempt income) allocable to the shareholder,
- *less* distributions by the S corp to the shareholder,
- *less* the S corp's taxable losses (and non-deductible non-capitalizable expenses) allocable to the shareholder.[5]

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(5) When the S corp's business is ultimately sold, the sellers can deliver asset SUB to the buyer while recognizing only one tax (i.e., S corp status avoids double federal income tax on a sale of the business), unless Code §1374 applies as discussed below. By contrast, when a C corp sells its business in an asset sale designed to deliver asset SUB to the buyer, the sellers generally recognize double tax, i.e., the C corp recognizes gain on the asset sale (equal to sales proceeds less asset basis) and, when the C corp liquidates and distributes its after-tax asset-sale proceeds to its shareholders, the shareholders recognize gain on the disposition of their stock, generally LTCG (equal to liquidation proceeds in excess of basis in the C corp's stock).

[5] With either a C or an S corp, when a shareholder dies, his or her estate or beneficiaries take SUB for the stock although in the case of an S corp there is a basis reduction equal to the decedent's share of any Code §691 income-in-respect-of-a-decedent items held by the S corp. A similar rule applies when the flow-through entity is a partnership or an LLC taxed as a partnership. Code §1367(b)(4), §1014(a), (c).

With an S corp, the sellers can deliver asset SUB to the buyer with only single tax on the sellers using any of four techniques:

(a) sale of S corp's assets to buyer followed by liquidation of S corp and distribution of asset-sale proceeds to the shareholders,
(b) forward taxable merger of S corp into buyer,
(c) sale of S corp's stock to a corporate buyer where both the buying corporation and all of S corp's shareholders (including any non-selling shareholders and, with respect to any shareholder residing in a community property state, such shareholder's spouse) jointly elect under Code §338(h)(10) to treat the stock sale as an asset sale for federal income tax purposes, *or*
(d) sale of S corp's stock to one or more buyers (individual, partnership, LLC, or corporate), where S corp and all of S corp's shareholders (including any non-selling shareholders and, with respect to any shareholder residing in a community property state, such shareholder's spouse) elect under Code §336(e) to treat the stock sale as an asset sale for federal income tax purposes.

This asset-SUB-with-one-tax result is achieved for two reasons:

- *First*, as discussed above, an S corp's taxable income (including its asset-sale gain) is not subject to federal income tax at the S entity level, but only at the shareholder level.
- *Second*, the mechanics of subchapter S—increasing the S corp shareholder's stock basis by his or her share of the S corp's taxable income—protect the shareholders from liquidation gain (as described immediately below).

Under Code §331, a shareholder (of either a C or an S corp) has CG equal to the *excess* of his or her liquidating distributions from the corporation *over* his or her basis in the corporation's stock. A C corp shareholder has frozen stock basis (as described in (4) above, generally the shareholder's cost of acquiring the C corp stock) and thus recognizes CG equal to the C corp's liquidating distribution (generally the asset-sale proceeds after corporate-level tax) less the shareholder's frozen tax basis in his or her stock.

However, an S corp shareholder has flexible stock basis (as described in (4) above), which stock basis increases by his or her share of the S corp's asset-sale gain. Accordingly, when the S corp liquidates and distributes the asset-sale proceeds to its shareholders, they generally do not recognize liquidation gain under Code §331.

(6) For a person who is an S corp shareholder from the corporation's formation and whose percentage ownership remains the same throughout, his or her basis in the S corp's stock is (by virtue of the flexible S corp stock basis rules described above) generally exactly equal to the liquidation proceeds received on the S corp's post-asset-sale liquidation, so that (after taking into account his or her flow-through asset-sale gain or loss) he or she recognizes no further Code §331 liquidation gain or loss. However, in several circumstances there is not congruity between an S corp shareholder's liquidation proceeds and his or her tax basis in the S corp's stock:

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CHAPTER 5

Structuring Buyout

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¶501.2 Three Separate Transactions

A buyout is really 3 separate transactions, each complex and time consuming and all mutually interdependent in their consummation, as described below.

¶501.2.1 Acquisition

The first transaction—Newco's acquisition of Target from Bigco—presents all of the issues inherent in any corporate acquisition:

(1) Negotiating the purchase price for the Target business.
(2) Negotiating representations, warranties, and indemnification provisions, closing conditions, non-compete covenants, transition services agreement, etc. between Newco and Bigco.
(3) Newco's due diligence on the Target business.
(4) Structuring federal income tax aspects of the acquisition transaction, including:

- The pros and cons of structuring the acquisition as an asset purchase, a stock purchase, or a forward or reverse merger.
- Whether the structure selected results in single tax or double tax to the seller.
- Whether the structure selected gives Newco asset SUB or asset COB.

(5) Analyzing other legal aspects of the acquisition transaction, including:

- Liabilities to be inherited by Newco or its subsidiaries, including contingent liabilities.
- Transferability of Target's assets, including contract rights.
- Sales and transfer taxes.
- State income tax issues.

Acquisition issues are discussed further in ¶501.3.

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¶501.2.2 Debt Financing

The second transaction—Newco's $70 million debt financing for the acquisition—includes negotiating the terms of Newco's senior and subordinated/mezz debt, as well as any seller financing, and is critical to consummation of the LBO acquisition.

Debt financing issues are discussed further in ¶501.4.

¶501.2.3 Equity Financing

Newco's equity financing is the third transaction. Negotiating Newco's complex $30 million equity financing arrangements is similar to (but more complex than) negotiating the equity structure of a start-up or growth-equity investment, as discussed in Chapters 2 and 4, including:

- The common stock split among PEs, management, mezz lenders, and possibly the seller.
- Whether management (a) buys common stock to obtain LTCG tax treatment, (b) receives ISOs, with possible LTCG treatment, or (c) is granted NQOs, generally resulting in OI tax treatment.
- Vesting arrangements on management's stock or options, including Code §83(b) tax issues.
- Any FASB 123R accounting issues presented by management's stock purchase or option grants.
- Whether Newco's securities are structured so that PEs are entitled first to receive back their investment plus a fixed yield (through non-convertible debt and/or straight preferred stock) before splitting the residual (common stock) profits with management and the mezz lenders.
- Board control of Newco and veto powers for PEs and/or other Newco equity owners and creditors.
- Right of PEs and/or other Newco equity owners to mandate or veto an ultimate Newco sale or IPO.
- Whether Newco is formed (1) as a regular C corp subject to double tax *or* (2) as a flow-through entity (i.e., an LLC, partnership, or S corp) subject to only single tax, in which case ultimate sale of Newco/Target to BuyerCo can be structured to deliver asset SUB to BuyerCo with single (not double) tax to Newco and its equity owners.

Equity financing issues are discussed further in ¶501.5.

¶501.2.4 Key Issues and Appendix References on Buyouts in General

How does a buyout differ from other mergers or acquisitions?

References:

- Ginsburg Levin and Rocap M&A treatise ¶101 (buyout definition) and ¶102

What does it mean when one layer of invested money (debt or preferred stock) is "subordinated" to another layer? Why would an investor be willing to take an instrument (debt or preferred stock) which is subordinated to other instruments? What are the typical terms of the debt and equity securities issued in a buyout?

References:

- Chapter 6 of this treatise
- ¶108 of this treatise (defining mezz debt and mezz lender)

Why is Newco's capital account bifurcated, with PEs buying both preferred and common stock, while management buys only common stock?

Appendix references:

- See ¶202 of this treatise, discussing the same issue in the context of a start-up transaction

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- See Levin, Perl, and Hirschtritt, Divide and Conquer: Why and How to Bifurcate Your LBO's Equity Structure (Venture Capital Review, Winter-Spring 2004, as subsequently updated to cover developments through publication of this treatise)

Will all of the interest on Newco's debt be deductible for tax purposes? What tax hurdles must be overcome?

References:

- ¶601.1.6 of this book (regarding terms and tax ramifications of subordinated debt) and the precedents cited therein

Was the highly leveraged buyout craze of the late 1980s good for America?
Was the high-tech and Internet start-up craze of the late 1990s thru early 2001 good for America?
Was the over-leveraging binge of the first decade of the 21st century good for America?
Do our current tax laws encourage high leverage?
Should our tax laws be changed?

Appendix references:

- Testimony Before the House Ways & Means Committee of Jack S. Levin, 2/2/89
- American Law Institute, Federal Income Tax Project, Reporter's Study Draft 6/1/89 Subchapter C Supplement Study, by Professor William D. Andrews, pp. 13-37

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¶501.3 Key Acquisition Issues

¶501.3.1 Purchase Price and Related Issues

¶501.3.1.1 Purchase Price

After the parties have agreed on the nominal purchase price, a number of pricing issues still remain to be negotiated, including:

(1) Amount payable in cash.

(2) Amount payable in the form of Newco subordinated debt or preferred stock (i.e., seller paper or seller financing).

(3) Purchase price adjustments to reflect such items as (a) Bigco's retention of Target's cash on hand at closing *or* (b) changes in Target's net book value or net working capital between date of Target's financial statements relied upon in negotiating the purchase agreement and closing.

- Requirement of an audit and right of appeal to (a) an independent CPA firm, (b) arbitration, or (c) court to resolve any disputed purchase price adjustment.

- Reference to GAAP consistently applied or to Target's accounting principles consistently applied to calculate any purchase price adjustment.

Where there is no purchase price adjustment for Target's closing date net book value or net working capital, it may be desirable (although not as effective) for Newco to seek covenants (a) forbidding distributions from Target to Bigco prior to closing and/or (b) obligating Bigco to conduct Target's business prior to closing in the ordinary course and in accordance with past custom and practice, especially with respect to activities the deferral of which would allow Bigco to generate and retain more cash from Target's business, including covenants:

- Requiring normal repairs, maintenance, cleanup.
- Requiring normal purchases of new capital assets.
- Requiring normal purchases of inventory.
- Prohibiting accelerated or discounted inventory sales.
- Prohibiting accelerated or discounted receivable collection.
- Requiring normal trade creditor payments.

If the parties cannot agree on a fixed purchase price, they may want to use a contingent purchase price or earnout based on the future performance of Target's business, although such an approach generally raises complex issues as to (a) whether buyer or seller controls management decisions during the earnout period, (b) whether adjustments to actual earnings will be made for unanticipated events, including strikes or fires, recessions, and increases or decreases in discretionary expenditures such as advertising, (c) whether to include earnings (losses) from subsequent Target add-on acquisitions (and, if not, how to allocate certain expenses between Target's original businesses and any businesses subsequently acquired), and (d) the like.

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¶501.3.1.2 *Representations, Warranties, and Indemnification*

Representations and warranties ("R&W") are a series of statements in the acquisition contract confirming, for example, that (except as set forth in a disclosure schedule to the acquisition agreement prepared by Target's owners—here Bigco) Target has no liabilities, Target's financial statements are accurate, Target's assets are in good condition, etc. (as described in more detail below). There are at least 4 reasons Newco seeks such contractual representations and warranties from Target's owners (here Bigco):

- Disclose information useful to Newco in deciding (a) whether to buy Target, (b) what price to pay for Target, and (c) whether to insert specific contract clauses dealing with specific items.
- Back up Newco's R&W to its lenders who are financing Newco's acquisition of Target.
- Allow Newco to call off the deal after contract signing and prior to closing (where signing and closing are not simultaneous) if the contractual representations and warranties are incorrect.

- Allow Newco to seek money damages from Target's owners (here Bigco), or in an extreme case to rescind the transaction, if the representations and warranties are incorrect.

Some key R&W Newco may seek from Bigco:

(1) There are no Target liabilities (and no facts or status which could give rise to a Target liability) not shown on Target's balance sheet (including known and unknown contingent liabilities), such as:
   - Environmental/pollution violations or cleanup obligations.
   - Employment discrimination claims.
   - Pension underfunding or unfunded retiree medical or insurance benefits.
   - Uninsured or under-insured product liabilities.
   - Product warranties.
   - Patent/copyright/trademark infringements.
   - Antitrust violations.
   - Tax deficiencies.
   - Breach of contract claims.
   - OSHA violations.
   - Guarantees.
   - Other lawsuits, claims, or contingent liabilities.

(2) Target's inventory is good and salable in the ordinary course of business.

(3) Target's receivables are collectible in the ordinary course of business within a specified period.

(4) Target's plants, equipment, and other tangible assets are in good operating condition and without defect.

(5) Target's financial statements are either true and correct or fairly present Target's financial condition and operating results in accordance with GAAP, consistently applied.

(6) Target has good title to its assets and Bigco has good title to Target's stock.

(7) Target has committed no violations of law or governmental regulations (especially important where Target is engaged in a regulated industry).

(8) No governmental or third-party consents are necessary to complete the buyout, except as listed on a schedule.

Each R&W generally contains an exception for matters listed on the disclosure schedule prepared by Target's owners. Thus, when Target and its owners (here Bigco) list an exception in the disclosure schedule, they shift the risk for that matter (e.g., contingent liability, questionable inventory, doubtful receivable, GAAP variation, violation of law, etc.) to the buyer (here Newco), absent a contractual indemnification clause explicitly shifting the risk back to Bigco.

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Bigco's R&W can be unqualified *or* can be qualified by references (a) to Bigco's knowledge (or to the knowledge of specified Bigco executives) or (b) to a materiality standard *or* (c) to both.

Only if Bigco's R&W survive the closing can Newco make a contractual claim against Bigco for damages, in which case the 3 principal issues are (1) the time period permitted to make claims, (2) the stated basket (*either* a deductible amount *or* a threshold amount which must be reached before a claim can be made for the entire amount), and (3) the maximum claim amount.

Security for Newco claims against Bigco (e.g., escrow portion of purchase price, holdback portion of purchase price, right to set off against seller paper (debt or preferred stock), lien on Bigco assets) is more or less important, depending on Bigco's financial health.

Newco might also seek third-party insurance against a specific Target contingent liability, depending on the premium a third-party insurer would charge for a specified amount of protection and whether the insurer can underwrite and issue the policy in time to meet Newco's acquisition time schedule.

Persons who are interested in the extent of Bigco's R&W, and Newco's rights to recover for breach, include not only Newco and its shareholders, but Newco's lenders as well.

The parties' negotiating positions on these issues are generally as follows:

- **Extent of R&W.** In the typical negotiation, Newco seeks extensive R&W from Bigco regarding Target. Bigco, however, seeks to give Newco far fewer R&W (or possibly none at all—i.e., an "as is" sale) and to qualify them with concepts of materiality and knowledge.
- **Survival.** Newco seeks to have the R&W survive the closing for a lengthy period (possibly forever) and seeks to have Bigco indemnify Newco against any breaches Newco discovers during the survival period. Bigco, however, seeks to have the R&W expire at the closing (i.e., to give Newco no right whatsoever to sue Bigco after the closing for breaches of R&W) or, at least, to have the R&W survive only for breaches discovered by Newco within a short period (e.g., 6 to 12 months after the closing).
- **Deductible and/or ceiling.** Newco seeks indemnification which begins with the first dollar of damages from breach and is unlimited in amount. Bigco, however, seeks to have its indemnification obligation subject to (1) a deductible so that Bigco pays claims only in excess of (e.g.) $1 million (or if Bigco cannot obtain a deductible, at least a substantial minimum threshold which, if exceeded, will result in payment of the full amount), (2) a ceiling so that it pays no more than a specified dollar amount or percentage of Newco's purchase price for Target, and (3) where Target has more than one owner, several, rather than joint and several, liability (so that each owner is liable for only a pro rata share).
- **Escrow or other security.** Newco seeks security for Bigco's indemnification obligation, e.g., a holdback of part of the purchase price, escrow part of the purchase price, set off rights against any seller paper, and/or liens against Bigco assets. Bigco, however, does not desire to provide any such security for its indemnification obligation.

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of the issues such seller paper raises, including subordination to, and maturity after, Newco's other financing.

¶501.3.2 Transferring Target Assets and Contracts

¶501.3.2.1 Hard to Transfer Assets and Contracts

Where Newco is purchasing Target's assets, some properties may present difficulties in effectuating the transfer from Target to Newco, including:

(1) with respect to a Target contract right (e.g., a technology license or real estate leasehold), a prohibition in the contract between Target and the other contracting party (the "OCP") on Target's transfer of the contract without the OCP's consent (in which case the OCP may demand a substantial consent fee where Target's rights under the contract are valuable and are being transferred),

(2) with respect to a governmental license, a prohibition in the license (or in governmental regulations) on Target's transfer of the license without the consent of the governmental agency, and

(3) with respect to real estate, vehicles, aircraft, patents, trademarks, copyrights, and other assets the transfer of which must be registered with a governmental agency, the preparation and filing of papers with (and the payment of fees to) the governmental agency.

Examples of such hard to transfer assets:

- Long-term low-rent leasehold.
- Long-term low-interest borrowing.
- Long-term low-royalty patent or other technology license.
- Governmental license or permit.
- Large number of vehicles or aircraft.
- Large number of real estate parcels.
- Large number of patents, trademarks, or copyrights.

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Where Target is a Bigco subsidiary (rather than a Bigco division), structuring the acquisition as a purchase of Target's stock by Newco or a reverse subsidiary cash merger of a Newco subsidiary into Target (rather than a purchase of Target's assets) generally eases the burdens of transferring such Target assets, unless the contract or license (or governmental regulations regarding a government license) treats a change in Target's control (here from Bigco to Newco) like an asset transfer and hence requires consent of the OCP or governmental entity.

A forward cash merger of Target into Newco or a Newco subsidiary may ease the burdens, depending on the contractual language (or governmental regulations regarding the license) and whether state law applicable to the contract or license treats a conveyance by operation of state merger law as a transfer.

It is necessary to read each contract or license (or governmental regulation regarding a license) to ascertain whether a third-party consent is necessary for a

¶501.3.3 Hart-Scott-Rodino Antitrust Filing for Acquisition

¶501.3.3.1 Filing and Waiting Period

An HSR filing with FTC/DOJ is required if (1) the size of an investment or acquisition as described in ¶501.3.3.2 exceeds $312.6 million *or* (2) the size of an investment or acquisition exceeds $78.2 million and the size-of-person test described in ¶501.3.3.3 (one person with at least $15.6 million and one with at least $156.3 million generally measured by annual net sales or total assets) also is satisfied, unless the transaction qualifies for exemption as described in ¶501.3.3.4.[6]

There generally is a 30-day waiting period (before closing the acquisition) after the parties have made their required HSR filings which period is extended if FTC/DOJ requests additional information.

Newco must pay a filing fee:

Fee	*Transaction value*
$ 45,000	greater than $78.2 million but less than $156.3 million
$125,000	at least $156.3 million but less than $781.5 million
$280,000	$781.5 million or more

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If other HSR reportable events are occurring, additional filing fees may be due.

The parties to an HSR reportable transaction must file a substantial amount of information with FTC/DOJ, including (1) any confidential information memorandum ("CIM") (or other document(s) serving such function if no CIM exists), regardless of whether the CIM discusses market shares or competition-related topics, and (2) each study, survey, analysis, and report prepared by or for an officer or director (or person exercising similar functions for an unincorporated entity) of Bigco, Target, or Newco, including by or for an officer or director of a controlling parent or controlled subsidiary, which was prepared for the purpose of evaluating or analyzing the transaction with respect to either (a) synergies and/or efficiencies or (b) markets, market shares, competition, competitors, or the potential for market expansion (either geographic or with new products), including "pitch books" or "bankers' books" prepared by investment bankers, consultants, or other third-party advisers either during an engagement or for the purpose of seeking an engagement.[7]

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[6]The size of various HSR tests are adjusted annually for inflation, and the amounts set forth in text reflect the 2/25/16 adjustment applicable to any transaction closing on or after such effective date.

[7]FTC/DOJ staff takes the expansive position that (1) an "analysis" includes any interoffice memorandum, handwritten note, correspondence, email message, computer file, slide presentation, or board minutes, if such document contains even a brief evaluation or analysis of the acquisition's competitive advantages, even where such document contains substantial other information not required to be filed, (2) failure to include any such analysis may render the HSR filing deficient, so that the HSR waiting period restarts when the omitted analysis is subsequently submitted (unless FTC staff waives restart),

(footnote continues)

- PE Fund's dividend income from a C corp flows through to PE Fund's individual partners as QDI if all the QDI requirements discussed at ¶107(3) are satisfied, so that such an individual GP or LP owes federal income tax at a 20% top rate on PE Fund's QDI allocable to such individual partner (rather than the normal 39.6% top OI rate).
- A C corp partner in PE Fund (a "corporate partner") is entitled to a 70% or 80% DRD with respect to the corporate partner's allocable share of PE Fund's dividend income from U.S. C corps, so that the corporate partner's federal income tax on such dividend income is reduced to 35% multiplied by either 30% or 20% of the dividend income.

(4) Flow-through taxation of PE Fund's OI.

- A PE Fund individual partner is taxed on his or her allocable share of PE Fund's OI (generally income other than CG or QDI) at a 39.6% top rate, while a PE Fund corporate partner is generally taxed at a 35% top rate.
- PE Fund's losses flow through to its partners, e.g., in the early years when PE Fund's management fee and other expenses exceed PE Fund's income.
- However, Code §67 disallows (under the 2%-of-AGI disallowance rule discussed below) a portion of PE Fund's expenses (including the management fee) to the extent allocable to an individual LP (but not to a corporate LP) where PE Fund is not, for tax purposes, viewed as engaged in a business to which such expenses are allocable (but rather engaged merely in an investment activity). This 2%-of-AGI disallowance (1) does not apply to the extent a fund expense is allocable to a fund business activity, possibly including the fund's indirect interest in a business activity conducted through a non-disregarded partnership, LLC, or other flow-through entity,[1] but (2) does apply to fund-level expense allocable to a business activity indirectly owned by the fund through a C corp (i.e., non-flow-through) entity.

  Under this 2%-of-AGI disallowance rule an individual's aggregate miscellaneous itemized deductions (principally employee business expenses and investment [i.e., non-business] expenses) are reduced by 2% of his or her AGI, so that such individual can deduct miscellaneous itemized deductions (including investment expenses) only to the extent such expenses in the aggregate exceed 2% of his or her AGI, regardless of whether PE Fund operates at a net profit or net loss for the year, unless PE Fund is viewed as engaged in a trade or business to which such expenses are allocable.

¶1001 [1]IRS precedents in analogous situations are inconsistent on this point. Compare Rev. Rul. 2007-42, 2007-2 C.B. 44 (corporation owning one-third of an LLC treated as engaged in the active conduct of a trade or business for purposes of Code §355 spin-off as a result of LLC's business, even though the LLC's employees carried on all management and operational functions with respect to the LLC's business), with Rev. Rul. 2008-39, 2008-31 I.R.B. 252 (upper-tier partnership not treated as engaged in business under Code §162 as a result of owning limited partnership interests in lower-tier partnerships engaged in business activities for purposes of classifying management fees paid by the upper-tier partnership).

(5) PE Fund's partners are entitled to receive tax-free distributions of cash or property from PE Fund.

- A partnership can generally distribute cash or property to its equity owners without triggering income tax to either the partnership or the recipient equity owner, as further described below.
- On a partnership's distribution of cash to an equity owner, the equity owner's tax basis in the equity owner's partnership interest is reduced by the amount of cash distributed but the recipient equity owner recognizes no taxable gain.[2] Only when cash distributed to the equity owner exceeds his or her basis in the partnership interest does the recipient equity owner recognize taxable gain, i.e., the equity owner's basis in the partnership is first reduced (to but not below zero) by the cash distributed, and the excess of the cash distributed over the equity owner's basis in the partnership triggers gain to the equity owner, which generally constitutes CG (LTCG if the equity owner has a more than 1 year holding period for the partnership interest).
- On a partnership's distribution of property (including appreciated property) to an equity owner, neither the partnership nor the equity owner generally recognizes taxable gain. Rather the equity owner's basis in the equity owner's partnership interest is reduced by the partnership's basis in the property distributed (but not below zero) and the equity owner takes a basis in the distributed property equal to the reduction in the equity owner's basis in the partnership interest.
- A partnership's distribution of "marketable securities" (expansively defined) to an equity owner is treated as a distribution of cash in an amount equal to the securities' FV for purposes of applying the above rules (so that the distributee equity owner recognizes gain to the extent the FV of marketable securities received by such equity owner exceeds the equity owner's basis in the partnership). In this case (a) the recipient equity owner's basis in the partnership is first reduced (to but not below zero) by the FV of the marketable securities distributed to the equity owner, (b) the FV of marketable securities in excess of the equity owner's basis in the partnership triggers gain to the recipient equity owner (generally CG), and (c) the marketable securities take a basis in the equity owner's hands equal to FV.

  There are, however, several important legislative limitations and exceptions to this rule that marketable securities are treated as cash for this purpose:

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[2] ¶302.2.2 and ¶301.2.2(4) explain the calculation of an equity owner's basis in his or her partnership interest, i.e., generally the equity owner's original cost for such interest, *plus* the equity owner's subsequent contributions to the partnership, *plus* partnership taxable (or tax-exempt) income allocated to the equity owner, *less* distributions by the partnership to the equity owner (measured by the basis of property distributed or the amount of cash distributed), *less* partnership taxable loss (and non-deductible non-capitalizable expense) allocated to the equity owner, *plus* increases in the equity owner's share of partnership liabilities, *less* reductions in the equity owner's share of partnership liabilities (with such liability reductions treated as a cash distribution for purposes of the equity owner-level gain recognition rule described in text).

- Marketable securities distributed to an equity owner are not treated as cash to the extent that gain would have been allocated to such equity owner if the partnership had sold all the marketable securities of the same class. Hence where marketable securities are distributed pro rata to the equity owners, i.e., in the same ratio as the gain on a sale of such securities would have been allocated if the partnership had sold such securities, only the cost basis of the marketable securities is treated as a cash distribution.
- If the partnership is an "investment partnership," i.e., has never engaged in a business and substantially all its assets have always consisted of money and/or securities, the marketable securities distributed are not treated as cash. Under the regulations, PE Fund would not be disqualified from this investment-partnership exception (i.e., would not be treated as engaged in a business) because of "any activity undertaken [by PE Fund] as an investor ..., including the receipt of commitment fees, director's fees, or similar fees ... customary in and incidental to" PE Fund's investment activities.

  Moreover, where an entity taxed as a partnership (e.g., GP Entity) receives "reasonable and customary fees" for rendering "reasonable and customary management services" to an investment partnership (here PE Fund), such fee income does not disqualify GP Entity from this investment-partnership exception when in turn it distributes marketable securities to its partners.

  However, a partnership otherwise qualifying as an investment partnership (e.g., PE Fund) would generally be disqualified from this investment-partnership exception where PE Fund owns a 20% or greater capital or profits interest in (or actively and substantially participates in the management of) one or more flow-through entities engaged in business (e.g., PE Fund owns an interest in one or more operating portfolio companies formed as partnerships or LLCs), because PE Fund would be treated as engaged in the business of each such flow-through entity.[3]
- Under regulations, marketable securities are not treated as cash if (a) when the partnership acquired the securities, the issuing entity had no outstanding marketable securities, (b) the securities acquired by the partnership remained non-marketable for at least six months after the partnership acquired them, and (c) the partnership distributes the securities within five years after they became marketable.
- Securities that were contributed to the partnership by an equity owner are not treated as cash when distributed back to the same equity owner.

(6) For a PE Fund LP which is a tax-exempt organization (a "TEO"):

- Normally a TEO owes no federal income tax on its income. However, a TEO (other than a pension plan for state or local government employees, which is exempt from the UBTI rules) does owe federal income tax on its

[3] Treas. Reg. §1.731-2(e)(4).

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listed types of income, when received incident to an investment activity, should not constitute an active business for UBTI purposes.

- There are numerous complex UBTI structuring solutions (and partial solutions), depending on the factual situation, including:
  - PE Fund purchases portfolio company convertible debt, or
  - a blocker C corp is interposed between PE Fund and a UBTI-generating portfolio company, or
  - a blocker C corp is interposed between a TEO LP and PE Fund, or
  - a group trust (as described in Rev. Rul. 81-100[5]) is interposed between PE Fund and pension plan and IRA LPs, so that the group trust (rather than the TEOs investing through the group trust) reports and pays the tax on any UBTI, or
  - TEOs buy a derivative security, the value of which is based on PE Fund's LP interests (rather than buying an LP interest).
- It is increasingly common for TEOs to invest in a PE fund which is permitted to make UBTI-generating investments, although in some cases TEOs insist that the portion of such PE fund's capital commitments which can be invested in UBTI-generating investments limited to (e.g.) 25% to 35% of the fund's capital commitments.
- A state government organization, apparently including a state employees pension plan, is not subject to the UBTI tax.

(7) For a PE Fund LP which is a foreign (i.e., non-U.S.) person (an "FP"):

- An FP owes no federal income tax on PE Fund's CG allocable to the FP, so long as (a) the CG is not "effectively connected" with an active U.S. business (as opposed to a mere investment activity) conducted by PE Fund, by a PE Fund portfolio company formed as a partnership or LLC, or by the FP and (b) the PE Fund portfolio company generating the CG does not predominantly own U.S. real estate (generally as determined under a 50%-by-FV-at-anytime-in-the-past-5-years test, but treating as a reduction in the FV of such property any mortgage liability or other debt secured by any property and either (i) "incurred to acquire" or (ii) "incurred in direct connection with" such property). See ¶302.7.
- Dividend and interest income allocable to an FP and not "effectively connected" with an active U.S. business is subject to a 30% withholding tax, unless (1) the normal 30% withholding rate is reduced by an applicable tax treaty or (2) in the case of interest, the interest qualifies for the "portfolio interest" exemption from withholding.
- Where PE Fund's dividend income, interest income, or CG allocable to an FP is "effectively connected" with an active U.S. business (as opposed to a mere investment activity) conducted by PE Fund, by a PE Fund portfolio company formed as a flow-through entity, or by the FP, the FP is subject to regular U.S. tax on such "effectively connected" income.

[5] 1981-1 C.B. 326.

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¶1001.4 Industry Standard Generally Limited Partnership Form

Most PE funds are formed as limited partnerships for the reasons discussed in ¶1001.1 through ¶1001.3.

¶1001.5 Key Tax Issues and Appendix References

Should PE Fund be structured as a limited partnership, an LLC, a C corp, or an S corp?

- See precedents cited in Chapters 2 through 8 regarding taxation of these three types of entities.

How is an equity owner that is a TEO or FP taxed?

- See precedents cited in Chapter 3.

¶1002 PROFIT AND LOSS ALLOCATIONS BETWEEN GP AND LPs

¶1002.1 Profit Allocation

Industry standard #1—no LP preferential return: 20% of net profits allocated to GP as carried interest and remaining 80% of net profits allocated according to contributed capital.

Industry standard #2—disappearing LP preferential return: 100% of net profits allocated according to contributed capital until PE Fund achieves specified IRR (e.g., 8%), and thereafter 100% (or less frequently 80% or even less frequently 50%) of net profits exceeding such IRR allocated to GP as carried interest until GP catches up (i.e., until GP is allocated an amount equal to a full 20% carried interest in all net profits), and thereafter 20% carried interest in net profits allocated to GP and remaining 80% of net profits allocated according to contributed capital.

Alternative approach—permanent LP preferential return: Far less commonly, 100% of net profits allocated according to contributed capital (with no carried interest for the GP) until PE Fund achieves specified IRR, with 20% of residual net profits allocated to GP as carried interest and remaining 80% of net profits allocated according to contributed capital (with no carried interest catchup).

¶1002.2 Loss Allocation

Industry standard: Net losses (including net losses attributable to fund expenses, such as management fees paid to GP) allocated same as net profits

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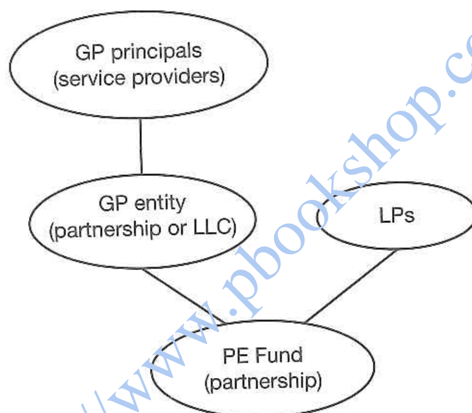
¶1006.4 *Taxation of PE Principal on Partnership's Flow-Through Income and on Gain from Sale of GP Entity: Carried Interest Taxation*

(1) Partnership character-flow-through rules. When a service provider (e.g., a PE principal) (a) holds an equity interest in the GP entity formed as a partnership or LLC (either a capital interest or a carried interest[9]), (b) such equity interest is fully vested or the PE principal made (or was deemed to make) a §83(b) election with respect to such equity interest, and (c) the GP entity, either directly or through a GP or LP interest in PE Fund, subsequently recognizes profit or loss from the GP entity's or PE Fund's operations or asset sales, the PE principal is (under long-standing federal income tax rules) allocated his or her share of such item and the tax character of the item in the partnership's hands (e.g., OI, OL, QDI, LTCG, STCG, LTCL, or STCL) passes through to the PE principal, i.e., the equity interest holder.[10]



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Thus, a capital interest or a carried interest share of LTCG is treated as LTCG; a capital interest or a carried interest share of QDI is treated as QDI; and a capital interest or a carried interest share of interest or other OI is treated as OI.

However, when a service provider holds a partnership (or LLC) interest subject to vesting without making an actual or deemed §83(b) election, the service provider is not viewed as a partner for tax purposes (and hence has no partnership allocations with respect to such unvested partnership interest) until after vesting. Rather, the share of income tax items that would have been allocated to the unvested service partner is allocated for tax purposes among the other partners

[9]To the extent a partner's interest in the partnership's future profits is proportionally larger than his share of the partnership's capital, it is generally called a "carried interest" or "profits interest." Such an interest is frequently offered to the partnership's key service providers.

[10]See Code §702; Wheeler v. Commissioner, 37 T.C.M. 883 (1978); IRS TAM 9219002 (1/27/92).

- as compensation OI for 2013 and subsequent years 75% of the amounts described in (1) through (3) above.

A very similar (but not identical) 2010 Senate bill (not passed by the Senate) would have taxed as compensation OI for 2011 and all subsequent years 75% of the type of income covered by the House-passed 5/10 bill (as described in (1) through (3) above), except that the 2010 Senate bill's OI portion would have been only 50% (for 2011 and all subsequent years) for certain types of income attributable to specified types of assets held at least 5 years (e.g., portfolio companies and Code §197 intangibles [generally GP entity's goodwill], as further described below).[12]

The 25% or 50% portion of income not converted by §710 to compensation OI would, under the 2010 bills, have continued to receive character-flow-through treatment.

This carried interest legislation was not enacted in 2010 or 2011, but may well reappear in the future.

Investment services partnership interest. If either the 2010 House or Senate bill had been enacted in its most recent version, proposed Code §710 would have treated a partnership/LLC interest as an "investment services partnership interest" if it is reasonably expected at the time the partner acquires the interest that the partner (or any "related . . . person"[13]) will provide (directly or indirectly) a substantial quantity of any of the following types of services (herein called "investment management services")[14] with respect to the partnership assets:

"(A) Advising as to the advisability of investing in, purchasing, or selling any specified asset.
"(B) Managing, acquiring, or disposing of any specified asset.
"(C) Arranging financing with respect to acquiring specified assets.
"(D) Any activity in support of [such services]."

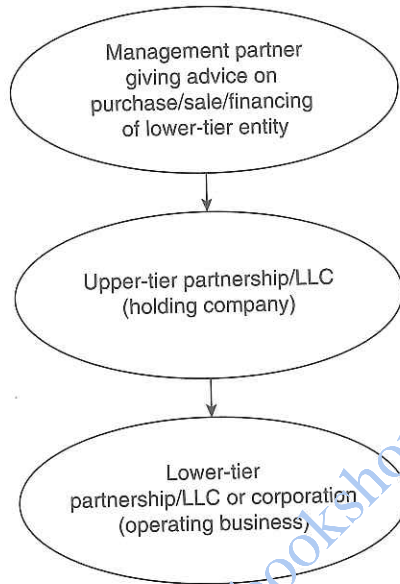
"Specified asset" was defined as (a) corporate stock, (b) interests in partnerships or LLCs (but not an interest in a partnership or LLC 100% owned by a single individual or entity and thus constituting a tax-disregarded entity, as discussed at ¶303.2), (c) debt instruments, (d) notional principal contracts, (e) real estate held for rental or investment, (f) commodities, and (g) certain options, derivatives, and

[12] We do not here explore the wisdom of changing the long-standing carried interest tax rules to the detriment of investment and real estate partnerships, although one of the authors has testified against the proposed legislation. See Carried Interest Taxation: Hearing Before H. Comm. on Ways and Means, 2007 Leg., 110th Congress, 1st Session Serial 110-58 (statement of Jack S. Levin).

[13] Related generally means a family member or a more-than-50%-owned entity.

[14] If a partner receiving a partnership interest (and his related persons) are not expected at the outset to provide substantial such services but there is a subsequent change in the services, see "Change in services" below.

carried interest (extremely broadly defined) is reasonably expected to (1) advise regarding the upper-tier entity's purchase, sale, or financing of the lower-tier entity's equity (or debt) *or* (2) manage the upper-tier entity's equity (or debt) investment in the lower-tier entity.



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In such case, although the upper-tier and lower-tier entities viewed as a whole are not in the investment or real estate business, such management partner might be viewed as covered by §710 because the upper-tier entity's interest in the lower-tier entity is literally a specified asset owned by the upper-tier entity.

Second, with respect to the nature of the service provider's services: even where a partnership owns specified assets, a partner's interest is an "investment services partnership interest" only if the partner (or a related person) is reasonably expected to perform (directly or indirectly) a "substantial quantity" of investment management services *with respect to such specified assets*. Application of this exception should generally be clear where the partner performs no investment management services—for example, where the partner is engaged solely in marketing, production, or R&D activities in connection with the partnership's operating business.[15]

Application of this exception where the partner (in addition to his/her operational activities) performs some investment management services with respect to specified assets is not entirely clear, because the bill does not define "substantial quantity." Nonetheless, the exception should generally apply where a partner's investment management services with respect to specified assets are only an

[15]See the examples contained in Joint Committee on Taxation, Technical Explanation of the Revenue Provisions Contained in "American Jobs and Closing Tax Loopholes Act of 2010," for Consideration on the Floor of the House of Representatives, p.269 (5/28/10).