NEW 2023 Edition of

Structuring Venture Capital, Private Equity, and Entrepreneurial Transactions

We are proud to enclose the updated 2023 edition of **Structuring Venture Capital, Private Equity, and Entrepreneurial Transactions** by co-authors Jack S. Levin and Donald E. Rocap, senior partners in the international law firm of Kirkland & Ellis LLP.

Here is a summary, written by the authors, of major developments reflected in the new edition.

Highlights of the New Edition

- **SEC issues for PE/VC funds and their portfolio companies.**
  - **Amendments to SEC Rule 10b-5 regarding material non-public information about 1934 Act reporting portfolio company.** SEC Rule 10b-5 prohibits a person (an "insider," including a temporary insider) who possesses material non-public information (i.e., information a reasonable investor would consider relevant to an investment decision) about P (a 1934 Act reporting company) from using such information to buy or sell P's securities or to "tip" others who do so.

Most 1934 Act reporting companies adopt a policy statement (an "insider trading policy") prohibiting officers, directors, employees, and agents from (i) buying or selling P securities when in possession of material non-public information or (ii) disclosing such information to any third party not authorized by P to receive it. Most such policy statements prohibit insiders and temporary insiders (i.e., persons possessing such information) from ever buying or selling the 1934 Act reporting company's securities except:

(a) during a specified trading window period, generally beginning 2 business days after such company's quarterly or annual earnings report and ending a specified number of business days (e.g., 14 business days) prior to the end of such company's next fiscal quarter *or*

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(b) pursuant to an SEC Rule 10b5-1 pre-arranged binding contract (e.g., with a buyer or seller) or a written plan (e.g., with a broker) (i) adopted before the insider became aware of material non-public information, (ii) not thereafter altered or deviated from, and (iii) *either* (x) specifying the amount of securities to be purchased or sold and the date for such purchase or sale *or* (y) containing a formula for determining the amount of securities to be purchased or sold and the price and the date for such purchase or sale *or* (z) granting to a third party not possessing material non-public information authority to purchase or sell the securities and not permitting the insider to exercise, after adoption of such contract or plan, any subsequent influence over such purchase or sale.

For a binding 10b5-1 contract or written plan promulgated during a 1934 Act reporting company's trading window period or at another time when 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.

However, in 12/22, SEC amended Rule 10b5-1 by adding a required "cooling-off" period after a Rule 10b5-1 contract or plan's adoption (or modification) and before trading can commence, so that:

(i) *a director or officer* is now subject to such a (no-sale) cooling-off period ending (x) 120 days following plan adoption or (y) if the company's financial results for the fiscal quarter in which the plan was adopted or modified are disclosed in a 1934 Act report sooner than 120 days following plan adoption, (a) 90 days following plan adoption or modification or (b) 2 business days following disclosure of such financial results and

(ii) *any person other than a director or officer* desiring to take advantage of 10b5-1 is now subject to such a 30-day cooling-off period.[1]

Although an insider is generally permitted to amend or revoke such a 10b5-1 contract or plan, SEC views an amendment of a 10b5-1 contract or plan as the adoption of a *new* contract or plan so that the insider must not be in possession of material non-public information at the time of such an amendment.

Such an amendment of a 10b5-1 contract or plan also triggers the new 12/22 cooling-off period (discussed above) as if the plan were being newly adopted. While SEC views revocation of a 10b5-1 contract or plan when in possession of material non-public

[1]Prior to these amendments, most insider trading policies had already required some minimum cooling-off period, although a cooling-off period shorter than 90 days was common for directors and officers.

information as not violating Rule 10b-5, a Rule 10b5-1 contract or plan must be entered into in 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 (i) adopting a contract or plan, (ii) then revoking when in possession of material non-public information, and (iii) then adopting another. The 12/22 amendments to Item 408 of Regulation S-K also require a 1934 Act reporting company to disclose when a director or officer has terminated a Rule 10b5-1 plan, presumably so regulators and the public may draw inferences about the timing of such termination. See discussion at ¶901.14.

- **Amendments to SEC crowdfunding rules for a portfolio company.** 1933 Securities Act §4(a)(6) allows certain privately held U.S. entities (including a PE/VC fund or a portfolio company) to publicly issue up to $5 million of unregistered securities to accredited and non-accredited buyers without 1933 Act SEC registration, but limits the amount of such §4(a)(6) securities any non-accredited investor can buy (in the aggregate) from all §4(a)(6) issuers during any 12-month period. The maximum such amount for a non-accredited investor (i) with annual income or net worth below $124,000 has been increased to the greater of $2,500 or 5% of the greater of the investor's annual income or net worth and (ii) with both annual income and net worth of at least $124,000 has increased to 10% of the greater of the investor's annual income or net worth, subject to a $124,000 maximum. See discussion at ¶207.8.

- **Formation and operation of PE/VC funds.**

  - **Department of Labor rules regarding ESG investing by PE/VC funds.** DOL has long participated in the regulation of PE/VC funds because U.S. pension and profit sharing plans (which are regulated by DOL) are often substantial investors in such funds.

    Although DOL's guidance relating to environmental, social, and governance ("ESG") investing by PE/VC funds has fluctuated over the years, the bedrock has been that plan fiduciaries may not prioritize non-economic factors (including ESG) over risk-return factors, except when choosing between 2 otherwise equivalent investment alternatives (i.e., the tie-breaker scenario). If ESG factors have a direct impact on the risks/returns of a given investment, they have always been allowed to be considered.

    In 11/20 DOL (during the Trump administration) issued a Rule relating to ESG investing (entitled "Financial Factors in Selecting Plan Investments"), focusing on an ERISA fiduciary's obligation to consider only pecuniary factors when making investment decisions. The preamble to the Rule expressed skepticism about the usefulness of ESG in making investment decisions based on risk-return, and required fiduciaries to document their reasons for any such usage.

    However, in 10/21 (during the Biden administration) DOL issued an extremely lengthy proposed Rule (i) clarifying that ERISA fiduciaries may be required to consider

ESG factors in evaluating an investment's risks/returns analysis and (ii) granting more leeway to consider ESG factors in tie-breaker scenarios. In 12/22 (also during the Biden administration) DOL issued a final Rule (which became effective in 1/23, hereinafter referred to as the 12/22 final Rule) relating to ESG investing (entitled "Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights") requiring ERISA fiduciaries to make investments based on risk-return factors and "not subordinate the interests of plan participants and beneficiaries (such as by sacrificing investment returns or taking on additional investment risk) to objectives unrelated to the provision of benefits under the plan." However, such risk and return factors may (but are not required to) include, as determined by the plan fiduciary, ESG related considerations, such as the economic effects of climate change. In addition, similar to the 10/21 proposed Rule, the 12/22 final Rule also provides that plan fiduciaries may consider ESG factors in tie-breaker scenarios.

This 12/22 final Rule has been challenged in 2 lawsuits. The first lawsuit—filed in the 5th Circuit in 1/23 by 25 states, a public company (which sponsored a defined contribution plan), and an ERISA plan participant—made claims under the Administrative Procedure Act, alleging that the 12/22 final Rule (i) undermines key protections for 152 million workers' retirement saving in the name of promoting ESG factors in investing, (ii) oversteps DOL's statutory ERISA authority, and (iii) is arbitrary and egregious. A 9/23 court order granted DOL's motion for summary judgment to dismiss the lawsuit, stating that the 12/22 final Rule does not require ERISA fiduciaries to prioritize ESG factors over financial considerations and noting that the 2022 final Rule "provides that where a fiduciary reasonably determines that an investment strategy will maximize risk-adjusted returns, a fiduciary may pursue the strategy, whether pro-ESG, anti-ESG, or entirely unrelated to ESG." The court further found that the 12/22 final Rule was not "arbitrary and capricious," noting that "while the Court is not unsympathetic to Plaintiffs' concerns over ESG investing trends, it need not condone ESG investing generally or ultimately agree with the [12/22 final] Rule to reach this conclusion."

The second lawsuit—filed in the 7th Circuit on 2/21/23 by 2 401(k) plan participants—notes that ERISA explicitly requires retirement savings to be invested "solely in the interest of the participants and beneficiaries and for the exclusive purpose of providing benefits to participants and their beneficiaries," and accordingly alleges that the 12/22 final Rule "which permits and encourages plan administrators to consider [ESG] . . . factors when making investments on behalf of plan beneficiaries . . . violates ERISA and exceeds the authority granted to the Secretary." As of 9/23 the plaintiffs' motion for preliminary injunction remains pending.

Although the House and Senate each voted to overturn the 12/22 final Rule under the purview of the Congressional Review Act, President Biden vetoed the resolution, and a Congressional effort to override such veto failed. See discussion at ¶1007.2.2.

- **Increasing usage of PE/VC continuation funds.** Rather than selling an existing successful PE/VC investment, PE/VC funds are frequently forming a "continuation fund" to hold such an appreciated investment which still has strong prospects for future appreciation. A PE/VC fund may be reluctant to forgo the opportunity to achieve further appreciation while many of the fund's LPs may wish to achieve earlier liquidity, particularly for a Target which has already appreciated substantially in value.

  Many PE/VC funds have recently addressed this tension by forming a "continuation fund" as part of a transaction that both (a) allows each of PE/VC fund's LPs to elect whether to sell or to retain such LP's interest in Target and (b) allows the fund's GP to (x) "crystalize" its carried interest based on Target's current FV and (y) obtain a new carried interest in Target's future appreciation.

  Although there are numerous structuring variations, such a transaction commonly involves the following steps:

  (i) PE/VC Fund contributes all of its interest in Target to new Continuation Fund partnership,

  (ii) PE/VC Fund then distributes all of its capital interests in Continuation Fund to PE/VC Fund's LPs and GP in the same proportions as proceeds from a cash sale of Target would have been distributed to the partners (resulting in "crystallization" of GP's carried interest with respect to such Target investment),

  (iii) In connection with such distribution, each PE/VC Fund LP elects whether to (a) sell (as described in (iv) below) some or all of the Continuation Fund interest being distributed to such LP or (b) retain all of such LP's Continuation Fund interest,

  (iv) Prior to such distribution, a new group of investors commits to contribute cash to Continuation Fund (thereby purchasing an indirect interest in Target), with Continuation Fund using such cash to redeem Continuation Fund interests owned by PE/VC Fund's LPs electing to sell some or all of their Continuation Fund interest,

  (v) After redemption of the selling LPs, all Continuation Fund interests are held by (a) those PE/VC Fund LPs who elected to continue to hold an interest in Target through Continuation Fund, (b) Continuation Fund's new group of investors, and (c) Continuation Fund's GP (with Continuation Fund's GP receiving a new carried interest in future Target appreciation while Target is held by Continuation Fund).

  While the above described transaction form is common, there are numerous possible variations, including:

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(i) PE/VC fund contributes multiple portfolio companies to Continuation Fund,

(ii) multiple affiliated (or even unaffiliated) PE/VC funds also contribute 1 or more portfolio companies to Continuation Fund,

(iii) the new group of investors and the electing rollover LPs make additional commitments to Continuation Fund to provide a source of new capital for add-on investments,

(iv) each PE/VC fund LP is given the right (a "status quo option") to elect to simply retain its preexisting interest in Target through PE/VC fund with unchanged carried interest and management fee terms,

(v) PE/VC fund's GP partners (and not merely PE/VC fund's LPs) are permitted to elect to sell a significant portion of their indirect interest in Target, and/or

(vi) the transaction is effectuated through PE/VC fund's cash sale of Target to Continuation Fund, with PE/VC fund's partners receiving an option to retain an interest in Target by using after-tax proceeds from their share of such cash sale to invest in Continuation Fund. See discussion at ¶105.5.

- **Formation, acquisition, and operation of PE/VC funds' portfolio companies.**
  - **New alternative federal income tax on portfolio company which is a large C corp.** In addition to the normal 21% federal corporate income tax (on OI and LTCG), there is a new 15% alternative minimum tax on a C corp with average "adjusted financial statement income" (over a rolling 3-year period) greater than $1 billion, with such tax based on such C corp's "adjusted financial statement income" for the taxable year, effective for taxable years beginning after 12/31/22. In calculating whether the $1 billion test is met, a corporation's adjusted financial statement income includes the adjusted financial statement income of all entities treated as a single employer with such corporation under Code §52(a) or (b). See discussion at ¶107.
  - **SEC rules requiring clawback of erroneous incentive-based compensation paid by a portfolio company.** In 10/22 SEC adopted rules implementing 1933 Securities Act §10D which requires that NYSE and Nasdaq adopt listing standards requiring a 1934 Act reporting company (with limited exceptions) to (i) develop and implement a policy for retrieving incentive-based compensation (i.e., compensation tied to achievement of financial measures) erroneously paid to an executive, (ii) file the clawback policy as an exhibit to its annual report on Form 10-K or 20-F, and (iii) include disclosures in its 1934 Act filings if recovery is triggered under such clawback policy.

    Both exchanges have submitted proposed listing standards which would require such clawback policy to become effective by 12/1/23. Failure to comply with such

standards could result in the non-compliant 1934 Act reporting company being de-listed from NYSE or Nasdaq.

The clawback policy must provide for recovery of incentive-based compensation erroneously received by an executive officer during the 3 fiscal years preceding an accounting restatement. Such compensation is deemed erroneously received if the amount received by the executive exceeds the amount that would have been paid based on the restated amount. Such erroneously paid compensation is required to be repaid by the executive on a pre-tax basis, so that an executive subject to clawback could have paid non-refundable taxes on compensation the executive ultimately repays. See discussion at ¶901.14.

- **HSR filing when PE/VC fund or its portfolio company acquires an existing business.** A Hart-Scott-Rodino ("HSR") filing with FTC/DOJ is required if the size of a PE/VC fund's (or its portfolio company's) acquisition of or its investment in another business entity exceeds specified numerical tests.

  - **Annual inflation adjustment.** The authors have updated the HSR discussion to reflect the 2/23 annual inflation adjustment of all relevant HSR numerical tests, thresholds, and filing fees. While the filing fee for the year ending 2/23 ranged from $45,000 to $280,000 depending on transaction value, the post-2/23 filing fee for a small transaction has been reduced, now beginning at $30,000, while the range of fees for larger transactions has been substantially increased, now ranging as high as $2.25 million.

  - **Non-compliance penalty.** A party failing to comply with HSR reporting and waiting period requirements is subject to a civil penalty which (effective 1/23) increased to a maximum of $50,120 per day during any non-compliance period. See discussion at ¶501.3.3.

- **Forming PE or VC fund as an SBIC which then invests in small businesses.**

  - **Advantages and disadvantages of forming an SBIC.** There are numerous advantages of forming a PE or VC fund as an SBIC, including (a) access to government guaranteed financing (at favorable rates) and (b) ability of a BHC or national bank to invest in such SBIC. However, there are also disadvantages, including (i) limitations on the size of each business in which the SBIC can invest and (ii) complexities in obtaining an SBIC license (the procedures and timing for which changed as of 8/17/23).

    Each portfolio company in which an SBIC invests must either (i) have tangible net worth not exceeding $24 million (recently increased from $19.5 million) and average net income for the past 2 years not exceeding $8 million (recently increased from $6.5 million) or (ii) fall within employee or revenue standards published by the Small Business Administration (the "SBA") for the industry in which the portfolio company is engaged.

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In determining whether the portfolio company meets these size standards, the portfolio company is measured together with all of its ‘‘affiliates,’’ including each entity which the portfolio entity controls, each entity which controls the portfolio company, and each entity which is under common control with the portfolio company.

However, SBA’s regulations state that certain types of investment funds which have invested in the portfolio company will not (in determining whether the portfolio company qualifies as a ‘‘small business’’) be viewed as affiliated with the portfolio company (i.e., such an investment fund will be treated as an ‘‘excluded entity’’), including:

(i) a VCOC,[2]

(ii) an investment company registered under the ICA,[3] and

(iii) a ‘‘traditional investment company’’ as recently clarified by SBA, i.e., ‘‘a professionally managed firm organized exclusively to pool capital from more than 1 source for the purpose of investing in a diversified pool of businesses expected to generate substantial returns to the firm’s investors’’ or any private fund exempt from registration under ICA §3(c)(1) or §3(c)(7).[4] See discussion at ¶209.1(1) and ¶209.2.1.2.

- **There are now 2 forms of SBA government guaranteed financing available to an SBIC:**

(i) the long-standing *Debentures program* (with fixed rate interest, currently 5.688% payable semi-annually) and

(ii) the new *Accrual Debentures program* (pursuant to 8/17/23 regulations intended to attract venture capital, growth equity, and buyout strategy firms to the SBIC program), with no current interest payable and all principal and interest (at rates not yet set) generally due 10 years after the debentures are drawn.

Subject to an overall ceiling discussed in (iv) below,

(i) the maximum amount of SBA *regular Debenture* leverage available to an SBIC is 3 times the SBIC’s regulatory capital,

(ii) the maximum amount of SBA *Accrual Debenture* leverage available to an SBIC is 1.25 times the SBIC’s regulatory capital,

[2]See ¶1007.1.2(2) for discussion of VCOCs.
[3]See ¶1008 for discussion of registered investment companies.
[4]Prior to 8/22/23 it had long been unclear whether a §3(c)(7) fund would be viewed as an excluded entity for SBIC purposes.

(iii) which (in either case) the SBIC may draw down from SBA as the SBIC calls its investor commitments,

(iv) but for either regular Debentures or Accrual Debentures is subject to (x) an overall ceiling of $175 million (including for an Accrual Debenture SBIC the accrued interest reserve) and (y) a further $350 million restriction in the aggregate for 2 or more commonly controlled SBICs. See discussion at ¶1013.

- **Tax court's expansive interpretation of Code §83 and Rev Proc 93-27 as applied to service provider's profits interest in partnership (or LLC), such as a PE/VC fund or portfolio company formed as a partnership or LLC.** Rev. Proc. 93-27 provides that, with limited exceptions, where "a person receives a [partnership] profits interest in exchange for providing services to (or for the benefit of) a partnership in a partner capacity (or in anticipation of being a partner), [IRS] will not treat the receipt of such an interest as a taxable event." The 2023 Tax Court's decision in *ES NPA Holding, LLC v. Commissioner* supports a broad, rather than constrained, application of service provider favorable Rev. Proc. 93-27. In particular, the court interpreted Rev. Proc. 93-27's reference to "services to (or for the benefit of) the partnership (or in anticipation of becoming a partner)" as applying where (i) a service provider renders services to a *partner* of an underlying partnership, (ii) such services relate to the underlying partnership, and (iii) the service provider receives a profits interest in the underlying partnership from that other partner, rather than receiving the interest from the underlying partnership itself.

In the simplified facts of *ES NPA Holding* (as portrayed in the diagram below):

(1) Target corp sought to sell a portion of its assets with the assistance of a business broker, i.e., a service provider ("SP"), with SP agreeing to provide "strategic advice [to Target corp] for the purpose of enhancing the performance of [Target corp's] business and to assemble a new investor group that would purchase" a portion of Target's corp business.

(2) After SP assembled the investor group, Target corp contributed its assets to a partnership ("Operating Partnership").

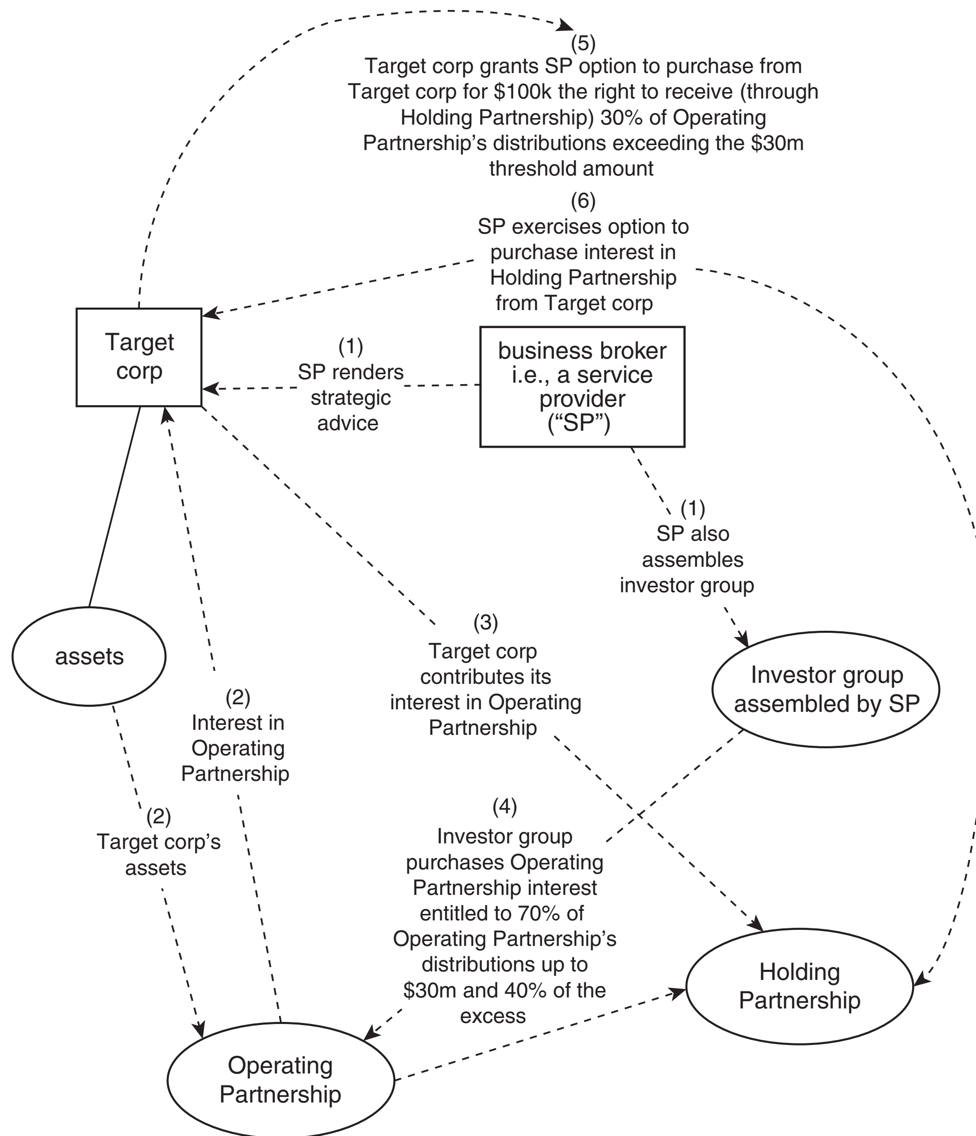
(3) Target corp then contributed interests in Operating Partnership to another partnership ("Holding Partnership").

(4) The investor group then purchased Operating Partnership interests entitled to (i) a 70% share of Operating Partnership distributions up to a $30 million threshold amount and (ii) a 40% share of Operating Partnership distributions exceeding the threshold amount.

(5) For SP's services, Target corp granted SP an option to purchase from Target corp for $100,000 Holding Partnership interests entitling SP to receive (through Holding

Partnership) 30% of Operating Partnership's distributions exceeding the $30 million threshold amount.

(6) SP exercised such option on the transaction closing date and treated the purchase of the Holding Partnership interest from Target as a non-taxable receipt of a partnership profits interest.



IRS asserted that (i) Rev. Proc. 93-27 did not apply because SP provided services to Target corp, not to Holding Partnership and (ii) Rev. Proc. 93-27 should be viewed as a "safe harbor" with limited application. The Tax Court stated that "[w]e do not view Revenue Procedure 93-27 in such a restricted manner, but rather view it as administrative guidance on the treatment of the receipt of a partnership profits interest for services." As to the specific facts, the court found that SP "provided services to or for the benefit of the partnership [i.e., Holding Partnership] in a partner capacity or in anticipation of being a partner. It is undisputed that the material assets of this partnership [i.e., Holding

Partnership] were held in [Operating Partnership], and the activities [SP] performed [presumably referring to SP's services in arranging the new investor group] were to and for the benefit of the future partnership.'' See discussion at ¶1006.3(2).

- **and much, much more.**

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