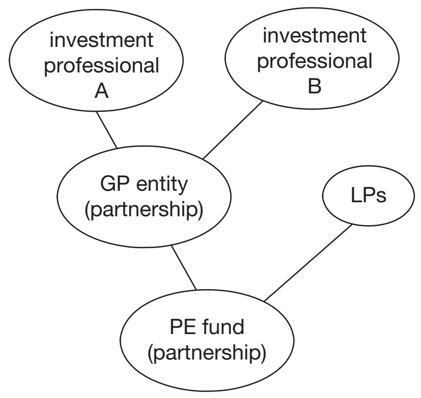
NEW 2020 Edition of
Structuring Venture Capital, Private Equity, and Entrepreneurial Transactions

We are proud to enclose the updated 2020 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

- **Formation and operation of PE/VC fund.**
  - **Post-2017 3-year holding period requirement for PE/VC fund GPs to qualify for LTCG tax rate on carried interest CG.** An individual investment professional (including a member of PE/VC fund's GP entity) holding a "carried interest" in an investment partnership (i.e., a share of partnership profits disproportionate to contributed capital) has long been entitled to the LTCG tax rate (which is lower than the OI rate) for his or her allocable share of carried interest CG on assets held by the fund for more than 1 year. Code §1061, effective for taxable years beginning after 12/31/17, imposes a special 3-year holding period requirement in order for such an investment professional's carried interest gain to achieve LTCG status.



Specifically, if an "applicable partnership interest" (API) is held (directly or indirectly) by an individual (e.g., investment professional A or B), LTCG that would otherwise be recognized by the individual with respect to that interest is recharacterized as STCG (and hence is taxable at the higher OI rate) to the extent such net LTCG exceeds the net LTCG that would have been recognized if the LTCG holding period was more than 3 years, rather than more than 1 year.

An API is any partnership interest "which, directly or indirectly, is transferred to (or held by) the [individual] taxpayer in connection with the performance of substantial services by the taxpayer, or any related person, in any applicable trade or business." An "applicable trade or business" is an activity conducted through one or more entities that "consists, in whole or in part of . . . (A) raising or returning capital and (B) either (i) investing in (or disposing of) specified assets (or identifying specified assets for such investing or disposition), or (ii) developing specified assets." "Specified assets" include corporate stock, debt instruments, equity interests in widely held partnerships, and real estate held for rental or investment.[1]

The API definition is aimed at a partnership interest held by an investment professional of a PE, VC, debt, or hedge fund who:

(a) shares in fund carried interest or incentive allocation through partnership interests in the fund's GP entity,

(b) acquires or holds such GP interest in connection with performance of substantial services for the GP entity or for an affiliated management company entity, and

(c) performs activities (through a GP or management company entity) which includes raising and/or returning capital as well as investing in, disposing of, identifying, and/or developing "specified assets" for the fund.

7/20 proposed regulations (which would generally apply to taxable years beginning on or after the date final regulations are issued) adopt an expansive interpretation of the API definition. In particular, the proposed regulations provide that:

(i) activities in the "raising or returning capital" and the "investing or developing" action prongs of the applicable trade or business test need not occur in the same year,

[1]Due to the absence of specified assets, carried interest in a fund partnership should not be an API if the fund invests only in portfolio companies each of which: (i) is treated for federal income tax purposes as a partnership (or LLC), (ii) is not widely held, and (iii) is engaged in a business not involving ownership of specified assets (such as corporate stock, equity in a widely held or publicly traded partnership or trust, debt, etc.).

(ii) activities by taxpayers or related persons through different entities are aggregated, and

(iii) actions taken by an agent or delegate of a principal (e.g., a PE fund management company that is delegated authority to perform investment management services by the PE fund's GP) are attributed to the principal.

The statutory API definition does not appear to pick up a partnership interest in a GP entity held by a *passive* investor (not related to an investment professional) who purchased such interest in the GP entity, because such investor does not appear to be a "taxpayer" acquiring such interest "in connection with the performance of substantial services by the taxpayer, or any other related person." Nevertheless, 7/20 proposed regulations would expand the statutory API definition to create an entity-level API taint extending to equity owner(s) who neither provide services to the entity nor are related to a person who does so.

The 2020 proposed regulations acknowledge that Code §1061 makes the API characterization at the level of the person who is reporting partnership income on an income tax return and refer to such a person as an "Owner Taxpayer." However, the proposed regulations would broaden the statute's scope by adding the new concept of a "Passthrough Taxpayer" (e.g., a partnership) that the regulations would "treat . . . as a taxpayer for the purpose of determining the existence of an API." As a result of such treatment, a partnership interest (in, e.g., a PE fund) acquired by such a Passthrough Taxpayer (e.g., the partnership entity which acts as PE fund's GP) in connection with the performance of substantial services by such GP entity (including agents or delegates of the entity) or a related person in an applicable trade or business would be an API in the hands of a Passthrough Taxpayer. Under the proposed regulations, not-more-than-3-year-gains flowing through such a Passthrough Taxpayer would retain their §1061 taint (subject to a limited exception discussed below) even if allocated (directly or through 1 or more intermediate flow-through entities) to a *passive investor.*

The statute provides 3 specific §1061 exceptions and there are 2 additional potential regulatory exceptions.

The first statutory exception is Code §1061(c)(4)(A), which excepts "any interest in a partnership directly or indirectly held by a corporation." This exception appears broader than likely intended. It is sensible to except a C corp from Code §1061 because C corps do not benefit from a reduced tax rate on LTCG. However, an S corp does pass through the character of LTCG. Thus Treasury/IRS quickly announced in Notice 2018-18 its intention to issue regulations (retroactive to 1/1/18) providing that this statutory exemption for partnership interests held by a "corporation" does not apply to a partnership interest held by an S corp. The 7/20 proposed regulations take the position

MORE ➤

that the corporate holder exception does not apply to an S corp (effective for taxable years beginning after 12/31/17) or to a passive foreign investment corporation with respect to which a qualified electing fund election has been made (effective for taxable years beginning after 8/14/20). Although legal authority for this regulation is questionable, it reaches a sensible result, hence we doubt many taxpayers will feel comfortable taking a contrary position.

The second statutory exception is Code §1061(c)(4)(B), which excepts any capital interest in the partnership which provides the taxpayer with "a right to share in partnership capital commensurate with . . . the amount of capital contributed," which should apply where an investment professional invests capital in the fund (directly or through the GP entity) at the same time, and in exchange for the same interest in partnership capital, as passive fund investors.

The 7/20 proposed regulations contain an excessively narrow interpretation of this exception. As drafted, many or most allocations with respect to the invested capital of PE professionals may fail to qualify for the qualified capital interest exception. Under the regulations, qualified capital interest allocations must be made both to an API holder and to the fund's unrelated non-service providers "based on their respective capital account balances." In most private equity funds, income allocations with respect to an investment are based on the partners' respective capital contributions which funded the applicable investment or based on the partners' respective aggregate capital commitment to the fund, and hence are not "based on . . . capital account balances."

In addition, the proposed regulations require that the allocations be made in the "same manner" to an API holder and to the fund's unrelated non-service partners, subject to a qualification that "an allocation to an API Holder will not fail to qualify because it is not reduced by the cost of services provided by the API Holder or a Related Person to the partnership." In many PE funds, the invested capital of a PE professional is not subject to GP carried interest. It is not clear whether, for purposes of the qualified capital interest exception, the carried interest is a "cost of services" that an investment professional's capital is permitted not to bear.

The proposed regulations' preamble "request[s] comments on other allocation arrangements that . . . could be treated as" eligible for the exception, suggesting the final regulations may broaden this exception.

Also, under the proposed regulations, in applying the qualified capital interest exception, a capital account would not include "the contribution of amounts directly or indirectly attributable to any loan or other advance made or guaranteed, directly or indirectly, by any other partner or the partnership." PE firms often provide financing for the capital commitments of junior investment professionals or provide credit support for such financing provided by unrelated lenders. Under the proposed regulations, such financing would prevent the capital interest of such junior investment professionals from meeting the qualified capital interest exception. This proposed limitation is in no way suggested by Code §1061's statutory language, but rather appears to reflect an IRS desire to impose a limitation that was included in pre-2017 proposed carried interest legislation but not included in §1061.

Code §1061(b) contemplates a regulatory exception "To the extent provided by the Secretary, . . . [for] income or gain attributable to any asset not held for portfolio investment on behalf of third party investors." This exception appears intended to exempt from §1061 recharacterization gains attributable to a PE fund's enterprise value (as distinct from value attributable to carried interest in assets held by the PE fund), although the benefit of this exception may be limited if it requires effectuating Treasury regulations, and the 7/20 proposed regulations provide no guidance on implementation of this exception.

The 7/20 proposed regulations would, however, add a new regulatory exception. As described earlier (in our discussion of the API definition), the proposed regulations would extend the scope of §1061 to cover a passive investor in a "Passthrough [Entity] Taxpayer" that holds an API (such as a passive investor in a GP partnership that in turn holds a carried interest in a PE fund). That is, the Passthrough Taxpayer's service activities would generally cause the passive investor's interest in a Passthrough Taxpayer to be treated as an API. However, as a partial limitation on this extension of §1061's scope, such an API taint would not apply to a person who:

(i) purchases a Passthrough Taxpayer interest for FV in a taxable transaction,

(ii) has not provided services and is not anticipated to provide future services for the Passthrough Taxpayer or any lower-tier partnership, and

(iii) is not related to any person who provides services for the Passthrough Taxpayer or any lower-tier partnership.

The proposed regulations' preamble makes clear that this exception would not, however, apply to a passive investor who acquires an interest in a Passthrough Taxpayer in exchange for a capital contribution to the Passthrough Taxpayer, as opposed to acquiring the interest through a taxable purchase of the interest from another partner. We fail to discern a good reason preventing such a passive investor from qualifying for this potential exception and hope IRS will rethink this point in drafting the final regulations.

As described above, under a plain reading of §1061, in the case of a sale of a partnership interest, the seller's holding period in the partnership interest (i.e., whether or not more than 3 years) controls, not the partnership's holding period in its underlying assets. However, the 7/20 proposed regulations would override this statutory language in 2 fact patterns.

Under the first override (the "indirect-not-more-than-3-year-API-equity look-through rule"), if an individual recognizes CG from sale of an interest in a pass-through entity (e.g., a partnership or S corp) in which the individual has a more-than-3-year holding period, but the assets of the pass-through entity include a direct or indirect API in which the pass-through entity has a holding period of 3 years or less, the portion of the individual's gain attributable to such underlying API with a holding period of 3 years or less would be treated as §1061 STCG.

Under the second override (the "substantially-all-not-more-than-3-year-assets look-through rule"), if an individual recognizes CG from a direct or indirect sale of an API with a more-than-3-year holding period, a look-through rule would apply if 80% or more of the API partnership's assets (excluding cash, cash equivalents, unrealized receivables, and inventory) consist of assets (i) the sale of which would produce CG or CL (excluding assets, such as §1231 assets which are not subject to Code §1061 recharacterization) and (ii) which have a holding period of 3 years or less. Under this look-through rule, a portion of the individual's LTCG from the direct or indirect API sale would be treated as §1061 STCG corresponding to the portion of LTCG that would have been subject to §1061 recharacterization had the API partnership sold all of its assets.

- **Technique #1 to maximize satisfaction of §1061's 3-year holding period.** Where PE fund makes multiple investments in a single portfolio company (for example, to fund an add-on acquisition or other business expansion), PE fund will have different holding periods for each of its investments in such portfolio company, so that §1061's 3-year requirement may be satisfied with respect to the fund's first investment but not its subsequent investment(s).

  PE fund should (where possible) structure follow-on investments in such portfolio company to minimize risks of creating §1061 STCG. For example, where portfolio company is a corporation, all of its shareholders could contribute capital to the corporate portfolio company in proportion to their existing shareholdings without acquiring any new shares of stock. Under current law, the new investment should merely increase the tax basis of the existing stock, not start a new holding period.

  However, a 2020 Chief Counsel Memorandum takes the position that a sole shareholder's contribution of cash or property to a corporation, with no additional shares received in exchange, creates a split basis and holding period in the shares previously held by the sole shareholder (partially reflecting the basis and holding period of the original shares and partially reflecting the basis and holding period of the newly contributed cash or property). The CCM's theory is that the failure to issue additional shares in this fact pattern is a "meaningless gesture" so that IRS may impute an issuance of additional shares. We do not, however, believe that the CCM reflects the law as it currently exists.

The general rule of federal income taxation is that tax consequences are based on the transaction that is done, not on an alternative form of transaction that could have been done and, if done, would have produced different tax consequences that IRS prefers. IRS has no general authority to invent transaction steps—in this fact pattern, a deemed issuance of shares to the contributor followed by a deemed recapitalization of the contributor's previously held and deemed newly issued shares—to alter transaction tax consequences.

- **Technique #2 to maximize satisfaction of §1061's 3-year holding period.** Where a PE fund recognizes carried interest gain from sale of an investment with a less-than-3-year holding period, the fund's partnership agreement often permits GP to waive its right to carried interest distributions and allocations from such sale and instead to receive subsequent distributions and allocations—in an amount equal to the waived carried interest gain—from PE fund's future gain on the sale of a different PE fund investment that has met Code §1061's 3-year holding period.

  Where properly structured and permitted by PE fund's partnership agreement, such a waiver should (a) prevent GP from being allocated carried interest gain on PE fund's sale of the investment that has not met Code §1061's 3-year holding period (so no gain is recharacterized under §1061) and (b) allow GP instead to take an increased carried interest gain allocation on a future sale of an investment that has met Code §1061's 3-year holding period.

  While the 7/20 proposed regulations do not address such carry waiver/catch-up arrangements, the preamble to the proposed regulations states that Treasury and IRS "are aware that taxpayers may seek to circumvent section 1061(a) by waiving their right to gains generated from the disposition of a partnership's capital assets held for three years or less and substituting for these amounts gains generated from capital assets held for more than three years. . . . Taxpayers should be aware that these and similar arrangements may not be respected and may be challenged under section 707(a)(2)(A), §1.701-2 and §1.704-1(b)(2)(iii), and/or the substance over form or economic substance doctrines." Although these bases for possible IRS challenge should be considered in structuring a carry waiver/catch-up arrangement, we expect that such arrangements will continue to be commonly used. See discussion at ¶1006.4.2.

- **Department of Labor recent pronouncements affecting PE/VC funds.** DOL participates in the regulation of PE/VC funds because U.S. pension and profit sharing

MORE ➤

plans regulated by DOL are often substantial investors in such funds. In the past DOL has raised issues with such plans investing in PE/VC funds.

- **Certain DOL regulated plans can invest in vehicle with PE/VC component.** In 6/20 DOL issued an Information Letter concluding that the fiduciary of a 401(k) or other defined contribution retirement plan can prudently offer plan participants the opportunity to invest in a vehicle with a PE/VC component. The DOL Information Letter suggests several factors for a plan fiduciary to consider when evaluating such an investment with PE/VC exposure. The Information Letter addresses a multi-asset class vehicle that included, among its investments, a PE/VC component holding investments in numerous underlying PE/VC funds and co-investments. The Information Letter does not, however, address a 401(k) plan's investment directly in 1 or more PE/VC funds.

  Although the DOL Information Letter does not reflect a change in applicable law, it is likely to make more plan fiduciaries comfortable with evaluating whether to include an investment with PE/VC exposure as part of the menu of available alternatives for plan participants and accordingly may present an increased source of capital for PE/VC funds.

- **DOL's proposed rule regarding ESG investing.** Although DOL's guidance relating to environmental, social, and governance ("ESG") responsible-impact-themed investing has fluctuated over the years, the bedrock of its guidance has been that plan fiduciaries may not prioritize non-economic factors (including ESG) over obtaining the best economic results, except when (i) choosing between 2 otherwise equivalent investment alternatives (i.e., the "tie breaker" scenario) or (ii) the ESG factors have a direct impact on the returns/risks of a given investment.

  In 6/20 DOL issued a Proposed Rule generally tracking this prior guidance but also imposing additional documentation and prudence requirements on a plan fiduciary selecting an investment that incorporates ESG factors. The Proposed Rule (if adopted) may not impact the operation of a PE/VC fund that is viewed as not holding plan assets, but may impact the PE/VC fund's interactions with existing and potential LPs. For example, benefit plan investors (e.g., in deciding whether to make an investment in a PE/VC fund) may ask the PE/VC fund to explain what type of ESG factors the PE/VC fund will consider, how these ESG factors will be weighted, and how the consideration of ESG factors may impact the PE/VC fund's income and expenses. Any written or oral ESG statements from the PE/VC fund must, of course, accurately reflect the fund's actual operational practices in order to avoid SEC penalty under the Investment Advisers Act as well as liability to LPs. See discussion at ¶1007.2.

- **U.S. withholding tax imposed on person purchasing partnership/LLC interest from non-U.S. seller.** If a PE fund formed as a partnership or LLC is treated as engaged in a U.S. trade or business (either because of PE fund's own U.S. activities or because PE fund owns an equity interest in 1 or more partnership or LLC portfolio companies which are engaged in a U.S. trade or business), a non-U.S. partner (including an LP) who sells a partnership interest in such PE fund is treated as receiving income effectively connected with a U.S. trade or business ("ECI"), triggering a U.S. tax obligation, if and to the extent that the non-U.S. LP would have been allocated ECI if the PE fund (or the flow-through portfolio company) had sold its assets at FV.

  Beginning in 2018, if a non-U.S. LP sells an interest in a partnership or LLC (e.g., a PE fund) that holds ECI assets directly, or indirectly through flow-through entities, the buyer of such LP interest is generally required to withhold (from the purchase price the buyer of such LP interest is paying to the non-U.S. seller) and pay over to IRS an amount equal to 10% of the gross amount realized by the selling non-U.S. LP (as a payment against the selling LP's U.S. tax obligations). This arbitrary 10%-of-proceeds withholding tax obligation may substantially exceed any U.S. income tax the seller would owe (e.g., where only a small portion of the partnership's assets are ECI assets) and may even exceed the entire sale proceeds (because the "amount realized" from sale of a partnership interest includes not only the proceeds received by the seller but also the selling LP's proportionate share of partnership-level liabilities).

  If the buyer fails to pay such required withholding to IRS, the partnership is itself obligated to withhold the required amounts (plus interest) from distributions that would thereafter have been made to the buyer. However, 2020 regulations delay implementation of the partnership's secondary withholding obligation, so that it applies only to a transfer occurring after 12/31/21.

  The 2020 regulations exempt the buyer of the partnership interest from the withholding obligation described above if the buyer receives a certification:

  (a) from the seller of the partnership interest that the seller is a U.S. person, or

  (b) from the seller that the seller is not recognizing any gain (or any OI under Code §751 rules) from the transfer, or

  (c) from the partnership that:

    (i) the seller has been a partner in the partnership for the seller's 3 taxable years preceding the transfer year, and

    (ii) the seller was allocated gross income from the partnership in each such year, and

    (iii) the amount of gross ECI allocated to the seller in each such year was less than $1 million, and

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(iv) any such gross ECI allocated to the seller was less than 10% of the seller's gross income from the partnership in each such year, and

(v) the seller reported any such gross ECI on a timely filed federal income tax return, or

(d) from the partnership that, if the partnership were to sell its assets at FV, less than 10% of the gain realized on such asset sale would be ECI, or

(e) from the seller that it is not required to recognize any gain from the transfer as a result of application of a non-recognition provision or tax treaty.

The 2020 regulations also:

▲ allow a seller which is a non-U.S. partnership owned in whole or in part by U.S. persons to certify the portion of the amount realized that is attributable to its U.S. partners, which portion would be exempt from withholding, and

▲ place a cap on the buyer's withholding obligation equal to (x) 100% of the amount realized by the seller from the sale (which amount realized generally includes the seller's share of partnership-level liabilities) minus (y) the portion of such amount realized that is attributable to the seller's share of partnership-level liabilities. Where this cap applies, the buyer is obligated to withhold 100% of the consideration payable to the seller. The cap is designed to protect the buyer from having to withhold more than 100% of the consideration it is paying for the partnership interest in a fact pattern where (a) the buyer neither knows nor receives certification from the seller or the partnership with respect to the liability reduction amount or (b) the buyer is paying a relatively low price to purchase an interest in a partnership that has very large partnership-level liabilities.

For a post-2017 sale of an LP interest, both the PE fund's GP and the LP-interest buyer should ensure that appropriate certifications, representations, and indemnities are obtained to protect the LP interest buyer and the PE fund from risk of liability for failure to comply with this required tax withholding obligation. See discussion at ¶1015.7.

- **Necessity for finder working with PE fund to register with SEC as broker-dealer if soliciting potential LPs for such fund.** When a PE fund in formation retains a finder to identify and solicit LP investors, paying compensation therefor, there is ambiguity as to whether (and under what circumstances) such finder must register with SEC as a broker-dealer.

  However, SEC has recently issued a proposed order that, if adopted, would create a new broader broker-dealer exemption for unregistered individuals acting as finders for private funds who receive a contingent or other fee in connection with identifying potential LP investors for the private fund, so long as:

- ▲ no general advertising or solicitation is used in connection with the securities offering,
- ▲ the finder has a reasonable basis to believe each identified LP is an accredited investor,
- ▲ the finder is not licensed with a broker-dealer entity and has a clean regulatory history, and
- ▲ the finder's activities are limited to those permitted under the order and certain disclosures are made to any LP solicited by the finder.

At this time, it remains unclear whether and to what extent a PE/VC fund is permitted to utilize 1 or more individuals who are not registered-broker-dealers to identify and solicit potential LPs and to compensate them for such service. See discussion at ¶1011(2) and ¶1012.2.

- **LBOs and other Portfolio Company acquisitions.**

  - **Limitation on deduction for business interest.** When a PE fund's Portfolio Company makes an LBO or other acquisition of a Target business, the PE fund generally makes a substantial equity investment in Newco and Newco borrows the remainder of the amount necessary to effectuate the Target acquisition. Thereafter Portfolio Company obtains significant tax benefits from deducting its interest expense on the borrowed leverage.

    However, the 2017 Tax Act imposed a formulistic ceiling on the amount of interest expense Portfolio Company could deduct each year, generally 30% of Portfolio Company's EBITDA, but then subject to an even more restrictive EBIT formula beginning in 2022, with any excess interest expense carried forward to future years, also subject to such annual formula limitation.

    The 2020 CARES Act liberalized Code §163(j)'s business interest deduction *for a C corp* by (a) increasing the C corporation's 30%-of-adjusted-taxable-income limitation on such business interest deduction to 50% for its taxable years beginning in 2019 and 2020 and (b) permitting such C corporation to elect to calculate the §163(j) limitation for its 2020 taxable year based on its 2019 (rather than 2020) adjusted taxable income.

    The 2020 CARES Act also amends Code §163(j)'s business interest deduction *for a partnership (or LLC taxed as a partnership)* by:

    (a) increasing the partnership's 30%-of-adjusted-taxable-income limitation on such business interest deduction to 50% for its taxable year beginning in 2020,

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(b) permitting the partnership to elect to calculate the partnership-level §163(j) limitation for its taxable year beginning in 2020 based on the partnership's 2019 (rather than 2020) adjusted taxable income,

(c) increasing an individual's 30%-of-adjusted-taxable-income limitation on such business interest deduction to 50% for the individual's taxable years beginning in 2019 and 2020,

(d) permitting an individual to elect to calculate the individual-level §163(j) limitation on such business interest deduction for the individual's 2020 taxable year based on the individual's 2019 (rather than 2020) adjusted taxable income, and

(e) treating, absent a contrary election by the applicable partner, 50% of the partnership's "excess business interest" for the partnership's taxable year beginning in 2019 and allocated to such partner (apparently including from an upper-tier partnership) as (i) paid or incurred by the partner in the partner's 2020 taxable year (notwithstanding an otherwise-limiting "silo" rule) and (ii) deductible by the partner in the partner's 2020 taxable year without regard to the §163(j) limitation.

As applied to *an S corp*, it appears that the 2020 CARES Act amendments to Code §163(j) (described above with respect to a partnership) should be interpreted as (a) increasing the S corp's 30%-of-adjusted-taxable-income limitation to 50% for a taxable year beginning in 2020 (i.e., the same as the rule applicable to a partnership) and (b) permitting the S corp to elect to calculate the §163(j) limitation for the 2020 taxable year based on the S corp's 2019 adjusted taxable income. See discussion at ¶601.1.6.4.

- **Dissenters' rights of appraisal in acquisition of Target Corp.** Because Delaware (i) typically updates each year its business-entity-formation-and-operation statutes (i.e., its corporate, partnership, and LLC codes) and (ii) has specialized courts focusing on business-entity litigation, a large percentage of U.S. business entities have been and are being formed in Delaware (whether or not the entity plans to have substantial business operations in Delaware). For this reason Delaware entity law plays an outsize role in disputes involving mergers and acquisitions.

  At least 1 aspect of Delaware law is unusually complicated: the right of Target Corp's shareholders to dissent from a proposed merger and instead seek appraisal rights, when Target Corp is being acquired by another business entity.

  Delaware's complex corporate law grants appraisal rights in a Target merger unless at least 1 of the following 2 fairly broad exceptions apply:

  (1) Such class or series of target shares are listed on a national securities exchange *and* also only a "small" number of such Target shares seek appraisal (with "small" meaning that such Target shares seeking appraisal do not exceed 1% of Target's

outstanding shares of such class or series eligible for appraisal *and* also that the aggregate merger consideration for such Target shares seeking appraisal does not exceed $1 million) *or*

(2) Such class or series of Target shares are:

(a) either listed on a national securities exchange or held of record by more than 2,000 shareholders *and*

(b) 100% of the merger consideration (other than cash for fractional Target shares) consists of:

(i) stock of the surviving corporation (whether or not publicly listed or widely held) and/or

(ii) stock of another corporation which is either listed on a national securities exchange or held of record by more than 2,000 holders.

However, neither exception (1) nor (2) applies (so that appraisal rights *are* available) if there is no Target shareholder vote with respect to the merger because of Delaware Corporation Law §253 (i.e., acquiring entity owns at least 90% of Target's stock before the merger).

However, a Delaware corporation may in its charter provide additional appraisal rights not otherwise required by law. See discussion at ¶502.3.1.

- **HSR filing.** A Hart-Scott-Rodino ("HSR") filing with FTC/DOJ is required if the size of an acquisition or investment (and, in certain cases, the size of the parties to the transaction) exceeds specified numerical tests.
  - **Annual inflation adjustment.** The authors have updated the HSR discussion to reflect the 2/20 annual inflation adjustment of all relevant HSR numerical tests, thresholds, and filing fees.
  - **Non-compliance penalty.** A party failing to comply with HSR reporting and waiting period requirements is subject to a civil penalty which (effective 1/20) increased to a maximum of $43,280 per day during any non-compliance period.
  - **Measuring size of acquiring entity for HSR purposes.** When Newco is controlled by a PE fund (i.e., by PE fund #1), Newco's size is generally measured at the PE fund #1 level by taking into account the assets and sales of PE fund #1 and its controlled portfolio companies. But Newco's size (for HSR purposes) generally does not take into account the assets and sales of PE fund #2 (generally with a name similar to PE fund #1 but formed perhaps 4 or 5 years after PE fund #1 by some or all of the same individuals who owned PE fund #1's GP) nor the portfolio companies controlled by PE fund #2, although there is substantial overlap in the individuals owning PE fund #1's and #2's GP.

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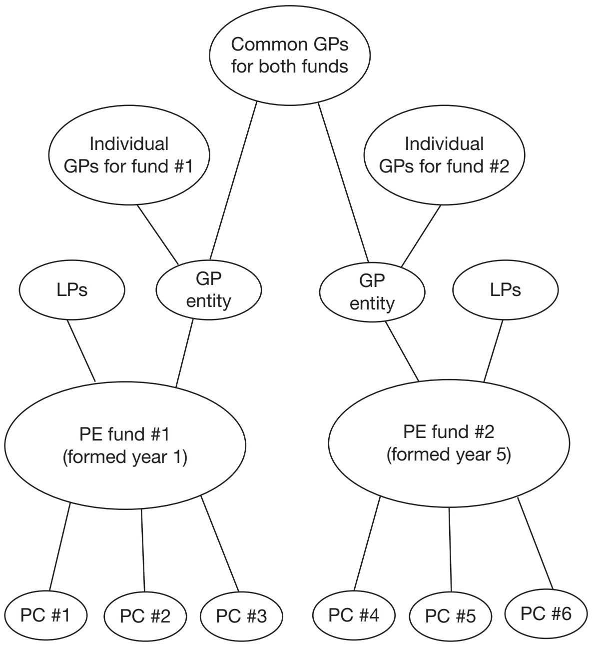

This is so because a PE fund is generally a partnership without any GP entity or LP entity having "control," i.e., the right to 50% or more of the partnership's profits or assets (after payment of its debt) on dissolution of such fund, which is the HSR test for determining the assets and sales to be taken into account.

However, in 9/20 FTC proposed an HSR rule change under which many such funds would be required to aggregate the holdings of investment managers and funds under common investment management for purposes of the HSR size-of-person and size-of-transaction tests. If adopted, this rule would likely result in more transactions being subject to HSR notification with significantly more information required to be analyzed and reported in the HSR filing.

▲ **Proposed additional HSR exemption.** In 9/20 FTC proposed to add a new exemption that would cover an acquisition of up to 10% of Target corporation's voting securities provided the acquiring person does not have a "competitively significant relationship" with Target corporation (but this exemption would not apply where Target is a partnership/LLC). This exemption would be available even if the acquisition is not solely for the purpose of investment and even if interaction with management is anticipated. However, the exemption incorporates a broad definition of "competitor" that is likely to limit its application.

See discussion at ¶501.3.3.

- **PE/VC investment in operating portfolio company made by Bank Holding Company ("BHC") affiliate.** Although a BHC affiliate is generally prohibited by the

BHC Act from investing in operating companies, a BHC is permitted to invest (through a non-banking subsidiary) in an operating portfolio company so long as the securities it acquires do not give the BHC any of the following:

- ▲ 5% or more of the portfolio company's voting securities,
- ▲ 25% or more of the portfolio company's total equity by value, or
- ▲ "a controlling influence" over the portfolio company.

The Fed has recently clarified application of these 3 tests. See discussion at ¶209.2.1.1.

- **Compensation for Portfolio Company executives.**

  - **Significant expansion of Code §162(m)'s $1 million ceiling (with no annual inflation adjustment) on compensation deduction for each of a public corporation's top executives.** Extensive 12/19 proposed regulations (implementing 2017 anti-taxpayer legislation) substantially expanded Code §162(m)'s scope, so that it covers (i) a corporation or any other entity treated as a corporation for tax purposes if publicly held on the last day of its taxable year (ii) with respect to all types of compensation, including cash, property, and the spread in an equity-based award (e.g., an option or SAR).

A corporation (or other entity so treated for tax purposes) is publicly held if it (i) has any class of securities (e.g., common stock, preferred stock, or debt) required to be registered under 1934 Act §12(b), or (ii) has any class of equity securities required to be registered under 1934 Act §12(g), or (iii) is required to file SEC reports under 1934 Act §15(d).

The 2017 legislation and the proposed regulations also substantially expand §162(m)'s previous scope by:

(a) expanding the category of "covered employees" subject to §162(m)'s $1 million limitation and

(b) eliminating prior exceptions (i) for compensation paid under a plan or agreement existing before the corporation became publicly held, (ii) for performance-based compensation, and (iii) for compensation not paid for services as an employee.

This 2017 Tax Act expansion of Code §162(m) applies to a publicly held corporation's taxable year beginning on or after 1/1/18 (i.e., 2018 for a calendar-year corporation), except that these changes do not apply to post-2017 compensation covered by the 11/2/17 §162(m) grandfather rule, i.e., compensation pursuant to a written binding contract in effect on 11/2/17 and not modified in any material respect on or after such date.

The proposed regulations:

(a) Treat an S corp as publicly held and subject to §162(m) if the entity issues debt securities registered under 1933 Act §15(d).

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(b) Treat the corporate parent of a disregarded entity (e.g., a single-member LLC or qualified subchapter S subsidiary) as publicly held if the disregarded entity is obligated to file reports under 1934 Act §15(d).

(c) Provide detailed rules for applying the §162(m) deduction limitation where 1 or more members of an affiliated group of corporations is publicly held and an individual who is a covered employee of a publicly held group member receives compensation from 1 or more of the other group members.

(d) Take the position that an individual who was a covered employee of a publicly held corporation (or a predecessor publicly held corporation) after 2016 is forever treated as a "covered employee" of such publicly held corporation, even after such individual ceases to have the status of an employee.

(e) Provide guidance on the meaning of a "predecessor" publicly held corporation for purposes of applying the once-covered-post-2016-always-covered rule.

(f) Eliminate the prior exception from §162(m) for compensation paid under a plan or agreement that existed before the corporation became publicly held.

(g) Take the position that where a publicly held corporation is a partner in a partnership (or an LLC taxed as a partnership), Code §162(m) applies to the corporation's distributive share of the partnership's deduction for compensation paid to a covered employee of the publicly held corporation. See discussion at ¶909.

- **Analysis of tax and economic pros and cons of 6 alternative approaches to stock-based executive compensation.** The authors have added a series of 6 examples illustrating the tax and economic aspects of 6 alternative methods for compensating an executive with portfolio company stock or NQOs, with and without SRF, with and without §83(b) election, with and without using multiple classes of stock (e.g., common stock, junior common stock, senior common stock, non-convertible preferred stock, and convertible preferred stock). See ¶408.2.

- **Exit scenarios: alternative methods for a PE/VC fund and/or Portfolio Company's management to sell their SEC-restricted Portfolio Company stock in an IPO.** PE/VC fund and Portfolio Company management both generally acquire their Portfolio Company stock (from Portfolio Company) in private placements (Reg. D for PE/VC fund and Rule 701 for management), so they both hold SEC-restricted stock which they cannot resell to the public without SEC 1933 Act registration (or an exemption from registration). One method for reselling their Portfolio Company stock to the public (after Portfolio Company is successful and their stock's FV has substantially appreciated) is in an initial public offering (an "IPO").

The authors describe a number of alternative approaches to an IPO (each with its own advantages and disadvantages), including:

(i) 1933 Act-registered primary offering, secondary offering, or part primary/part secondary offering, generally using form S-1,

(ii) for each of these types of public offering, the pros and cons of using underwriters vs. effectuating a "direct listing" (without using underwriters),

(iii) whether to list Portfolio Company's shares on a national stock exchange or simply allow them to be traded in the over-the-counter market, and

(iv) utilizing a merger of Portfolio Company with a publicly traded SPAC (i.e., a "Special Purpose Acquisition Company") to create a public market for the shares held by Portfolio Company's old shareholders post-merger. See discussion at ¶901.2 through ¶901.7.

- **Bankrupt and troubled Portfolio Companies.**
  - ■ **NOLs.** The 2020 CARES Act expanded LossCo's ability to utilize NOLs generated in taxable years beginning after 12/31/17 and before 1/1/21 by carrying such NOLs back for 5 years and forward for an unlimited period. However, NOLs generated in taxable years beginning after 12/31/20 cannot be carried back at all.

    LossCo's NOLs generated in taxable years beginning after 12/31/17 can be carried forward for an unlimited period, but if used in a taxable year beginning after 12/31/20 cannot offset more than 80% of such LossCo carryforward year's taxable income. See discussion at ¶804.1, ¶804.2, and ¶809.2.
  - ■ **Where Newco (financed by PE fund) acquires Target in a highly leveraged LBO and Newco/Target goes bankrupt reasonably soon thereafter, Bankruptcy Code §546(e) may protect Target shareholders' LBO proceeds from a fraudulent conveyance claim.**
    - ▲ **Application of fraudulent conveyance doctrine to failed LBO.** Where PE-financed Newco acquires Target in an LBO, the transaction structure generally prejudices Target's old unsecured creditors because (i) the proceeds from Newco's substantial acquisition borrowings are paid out to Target's old shareholders (as the purchase price for Target), (ii) while the acquisition lenders acquire a claim against Target's old assets which (if secured by the Newco/Target assets) is superior to the claim of Target's old unsecured creditors or (if not so secured) is pari passu with the claim of Target's old unsecured creditors.

      If the Newco-Target enterprise then goes bankrupt reasonably soon after the LBO (e.g., because of an unanticipated business downturn combined with Newco's substantial LBO acquisition debt), Target's old trade and general

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creditors (and in some circumstances Target/Newco's new trade and general creditors) often assert a fraudulent conveyance claim against:

(a) the LBO acquisition lenders,

(b) Target's old shareholders (to the extent of each shareholder's proceeds from Target's sale to Newco), and

(c) the LBO's private equity sponsor(s).

The validity of such a fraudulent conveyance claim generally turns on the highly subjective issues of whether Newco/Target, immediately after the LBO, either:

(1) was insolvent (debts greater than asset FV), or

(2) was inadequately capitalized, or

(3) did not reasonably expect to be able to pay its obligations as they mature in the ordinary course of business.

In the context of a complex LBO with many participants (e.g., Target shareholders, acquisition lenders, PE/VC sponsors, Target directors), there is very little law on how the aggregate damages to creditors harmed by the fraudulent conveyance are allocated among those LBO participants ultimately determined to be liable for the fraudulent conveyance. Hence, it is unclear:

(i) whether a court would permit a contribution claim—after fraudulent conveyance liability has been established and damages paid—by 1 LBO participant against another participant and

(ii) if so, how the relative fraudulent conveyance liability amount allocated to each participant would be computed.

Indeed, federal case law seems to suggest that no such contribution right is available.

▲ **U.S. Supreme Court 2018 decision rejects Bankruptcy Code §546(e) protection where Target shareholder's bank acts as mere conduit.** Where a Target shareholder is, or receives payment for Target stock through, a "stockbroker," a "financial institution" (which includes a bank, S&L, or trust company), or a "financial participant" (which includes an entity with at least $1 billion of securities contracts),[2] confusing and poorly worded Bankruptcy

[2]All of which persons are herein collectively referred to as a "protected person" (a term not used in the Bankruptcy Code).

Code §546(e) had long been interpreted by several federal courts of appeals as exempting from fraudulent conveyance attack the Target sale proceeds received by a Target shareholder through a protected person.

However, the U.S. Supreme Court's 2018 *Merit Management* decision held that §546(e) does not protect a fraudulent transfer in which the protected person (e.g., the bank) served as a mere *conduit* for a Target shareholder to receive its Target stock sale proceeds. Rather, the court must "look to the transfer that the [bankruptcy] trustee seeks to avoid," i.e., the cash transfer from Newco to the old Target shareholder, which did not actually involve a protected person as a substantive participant.

▲ **Remaining routes to §546(e) protection.** ***First*****,** the Supreme Court's *Merit* opinion did not discuss the circumstances under which a stockbroker, bank, or other financial institution (i.e., a protected person), although acting on behalf of a Target shareholder (and not on behalf of itself) in receiving the proceeds from Newco, could be viewed as playing a sufficiently substantive role as to invoke §546(e) on behalf of the Target shareholder.

Second, there are 2 favorable post-*Merit* lower court decisions regarding a financial institution acting as Newco's (not Target's or a Target shareholder's) agent/custodian in delivering proceeds to Target shareholder. In a 4/19 federal district court decision (*In re Tribune Company* fraudulent conveyance litigation), Newco (which was acquiring Target) retained a financial institution to act as *Newco's* (not as Target shareholders') "agent" in distributing the LBO proceeds to Target's shareholders, so that such financial institution acted not as Target shareholders' agent but rather as *Newco's* "agent . . . tasked with making payments on [Newco's] . . . behalf to [each of Target's] Shareholders upon the tender [to the financial institution agent] of their [Target] stock certificates" as part of a "securities contract."

Thus the federal district court concluded that Newco "itself was a financial institution" (although Newco was in the newspaper and broadcasting business, rather than a financial business) based on the following reasoning:

(i) Newco had retained a financial institution to serve as Newco's "agent or custodian" "in connection with the LBO transaction," by distributing the LBO proceeds to Target's shareholders (in exchange for their Target stock), so that Newco was the financial institution's "customer."

(ii) §546(e) states that "when [a financial institution as defined in §546(e)] is acting as agent or custodian for a customer [here Newco] . . . in connection with a securities contract . . . *such customer*" is a financial institution and hence a §546(e) protected person (emphasis added).

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(iii) Because Target's shareholders received a settlement payment for the Target stock from a financial institution (i.e., from Newco), Target's shareholders are protected by §546(e).

And in 6/20 a Bankruptcy Court (*In re Boston Generating LLC*) followed the *Tribune* decision's reasoning in holding that §546(e) applies to distributions made by a financial institution as "agent" for its "customer" (which was purchasing its own securities in a tender offer). See discussion at ¶501.4.3.9(5).

- **SEC regulation of securities issuances.**

  - **SEC expands Reg. D definition of "accredited investors."** When a PE/VC fund or a portfolio company issues securities (e.g., LP interests in a PE/VC fund or stock in a portfolio company), such issuance must (unless a 1933 Act exemption is available), be registered as a public offering under the 1933 Act (which is costly and burdensome and, in the case of a PE/VC fund issuing LP interests in the fund, would destroy the fund's ICA exemption). One of the principal such exemptions is SEC Reg. D, which is easier to satisfy if all or most of the purchasers are "accredited investors" ("AIs").

    SEC has broadened the AI definition to include (a) certain individual's holding professional certifications, (b) knowledgeable employees, and (c) certain entities and individuals which are investment advisers, broker-dealers, and family offices. See ¶207.3.2(1).

  - **Crowdfunding.** 2012 crowdfunding legislation allows a U.S. company not registered with SEC under the 1934 Act to publicly issue up to $1 million of securities (including stock) in any 12-month period without the complexity of registering such securities under the 1933 Act and without complying with 1933 Act Reg. D, so long as the company complies with SEC Reg. Crowdfunding (including conducting such securities issuance through an SEC-registered independent intermediary's internet portal).

    By virtue of the 2012 legislation's periodic inflation mechanism, the amount of securities which can qualify for Reg. Crowdfunding in any 12-month period has risen to $1,070,000. See discussion at ¶207.8.

- **Federal income tax rates for 2020 and thereafter (subject to possible future legislative change depending on outcome of 11/20 election).**

  - **C corp income tax rate.** The federal *C corp* income tax rate for 2020 (on both OI and LTCG) is 21%.

  - **Individual income tax rates.** The top federal *individual* income tax rates for 2020 (which also applies to partnership, LLC, or S corp income flowing through to an individual equity owner) are as follows:

- For **OI**, the top rate is 37%,
  - with possible reduction of the top rate (perhaps to as low as 29.6%) for U.S. "business" OI flowing through a partnership, LLC, proprietorship, or S corp to a "qualified" individual equity owner.
- For **normal LTCG**, the top rate is 20%.
- For **STCG**, the top rate is 37%.
- For **QDI** (qualified dividend income), the top rate is 20% (i.e., the same as the normal LTCG top rate).
- For **Code §1202 LTCG** (from sale of "qualified small business stock" held more than 5 years), the top rate is:
  - 0% for such stock acquired after 9/27/10,
  - 7% for stock acquired between 2/18/09 and 9/27/10, and
  - 14% for stock acquired between 8/11/93 and 2/17/09.

■ **Individual income-based Medicare tax** (in addition to regular income tax discussed above):

- On **compensation and self-employment income**, the rate is 3.8%, with (a) 2.9% imposed half on an employer and half on an employee or 100% on a self-employed person plus (b) an additional 0.9% on such income exceeding a threshold amount ($250,000 for a joint-return individual) imposed 100% on an employee or self-employed person.
- On **investment income, i.e., passive income (including OI, QDI, and CG) from investments and businesses as to which an individual is not active**, the rate is 3.8%, to the extent the individual's AGI exceeds a threshold amount ($250,000 for a joint-return individual).

See discussion at ¶107.

• **. . . and much, much more . . .**