NEW 2017 Edition of

Structuring Venture Capital, Private Equity, and Entrepreneurial Transactions

We are proud to enclose the 2017 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, in conjunction with special editors Russell S. Light of Kirkland & Ellis LLP and the late Martin D. Ginsburg of Georgetown University Law Center.

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

Highlights of the New Edition

- **Changes in federal securities law.**

  - **SEC substantially broadened Reg. D's exemption from 1933 Act registration for issuance of new securities.** Effective in early 2017, SEC substantially rearranged Reg. D's several exemptive provisions, which allow a company (whether a corporation, partnership, or LLC) to issue its securities to PE/VC and other investors without 1933 Act registration. Because 1933 Act registration for a company's securities is a lengthy, expensive, and public process, the company frequently prefers to issue its securities in an unregistered private placement.

    In the past, Rule 504 (which imposed the fewest hurdles to an unregistered securities issuance) covered a securities issuance up to $1 million, Rule 505 (which imposed more hurdles than did Rule 504) covered a securities issuance up to $5 million, and Rule 506 (which imposed the most hurdles) covered an unlimited securities issuance.

    SEC's recent Reg. D amendments (1) increased the amount permitted in a Rule 504 issuance from $1 million to $5 million, (2) completely eliminated Rule 505, and (3) made no change to Rule 506, all as more fully described below.

    - **SEC expands Rule 504 exemption.** A company (so long as neither a 1934 Act reporting company nor an investment company) can (after SEC's recent

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amendments) issue up to $5 million of unregistered securities under Rule 504 to an unlimited number of accredited investors and an unlimited number of non-accredited investors (who need not meet any sophistication requirement), with no private offering memorandum or other specific disclosure requirement.

The company cannot, however, employ general solicitation or advertising for potential purchasers under Rule 504 (except for the 3 specific circumstances described below), meaning that the company cannot offer its securities through:

- a publication (including a newspaper or magazine advertisement or article), broadcast, or other use of mass media mentioning the offering,
- a seminar or meeting with one or more potential purchasers invited by general solicitation or advertising,
- a statement on a public website,
- a face-to-face discussion, phone call, letter, or other oral or written communication about the offering to anyone with whom the company or its sponsor or financial adviser/placement agent (or their employees or agents) does not have a "pre-existing substantive relationship"—i.e., a relationship that allows the company to reasonably conclude that each person being solicited is an accredited investor.

  "Accredited investor" generally means:

  - a human being with at least $1 million net worth (or joint net worth with spouse), excluding primary residence and mortgage debt thereon, or more than $200,000 income (or $300,000 joint income with spouse) or a director or executive officer of the company, or
  - an entity (not formed for the purpose of acquiring the securities) with total assets exceeding $5 million.

The company (issuing securities without SEC registration pursuant to Rule 504) must, however, comply with any applicable state securities rules applicable to each state in which the company is issuing such securities.

Securities the company issues under Rule 504 (except for the 3 specific circumstances described below) constitute restricted securities for SEC purposes and hence cannot be publicly resold without SEC registration or an exemption (e.g., SEC Rule 144).

- ▲ **Rule 504(b)(1) sales of securities do qualify for general solicitation or advertising and, after issuance, constitute unrestricted securities for SEC purposes.** In 3 specific circumstances (involving compliance with state

securities laws) SEC Rule 504(b)(1) permits a company to use general solicitation or advertising in issuing its securities without 1933 Act registration, in which case such securities do not, after issuance, constitute SEC-restricted securities and hence can be publicly resold without SEC registration or an exemption therefrom (e.g., SEC Rule 144).

The first such circumstance covers sales of securities in one or more states which provide for state registration of the securities, along with delivery of a substantive disclosure document to each purchaser.[1]

The second circumstance covers sales of securities in one or more states that do not provide for state registration of the securities, but where the company registers and offers its securities in at least one state that does allow for such registration (along with delivery of a substantive disclosure document) and delivers the registration state's disclosure document to each purchaser in the non-registration states.[2]

The third circumstance covers sales in one or more states that allow general solicitation and advertising for sales of securities to accredited investors.[3]

Securities issued by a company under any of these 3 circumstances (so that general solicitation and advertising is allowed) do not constitute restricted securities and hence can be publicly resold without SEC registration.

- **Rule 505 repealed.** SEC completely repealed Rule 505.
- **Rule 506(b) unchanged.** SEC did not change Rule 506(b) and hence a company can still issue (under Rule 506(b)) an unlimited amount of securities without SEC registration to an unlimited number of accredited investors plus up to 35 non-accredited investors who are sophisticated (alone or in conjunction with a sophisticated purchaser representative), with a private offering memorandum delivered to each non-accredited investor, but with no general solicitation or advertising allowed.

Under federal preemption rules, a Rule 506(b) issuance is generally exempt from state regulation other than form filing and a fee.

Securities issued under Rule 506(b) constitute restricted securities and hence cannot be publicly resold without SEC registration or an exemption therefrom (e.g., SEC Rule 144).

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[1] Most states have such a provision.
[2] A few states have no provision for registration and hence this (ii) procedure can be used in such states.
[3] Many states have such an exemption.

- ▲ **Rule 506(c) unchanged.** SEC did not change Rule 506(c) and hence a company can still elect to issue (under Rule 506(c)) an unlimited amount of securities without SEC registration to an unlimited number of accredited investors with no private offering memorandum or other specific disclosure, using general solicitation and advertising, so long as there are no sales of such securities to any non-accredited investor and the company engages in enhanced verification of each investor's accredited investor status (rather than less invasive self-certification).

  Under federal preemption rules, a Rule 506(c) issuance is generally exempt from state regulation other than form filing and a fee.

  Securities issued under Rule 506(c) constitute restricted securities and hence cannot be publicly resold without SEC registration or an exemption therefrom (e.g., SEC Rule 144).

- ■ **SEC Rule 701,** allowing a company to sell unregistered (but restricted) securities to its service providers, did not change. See discussion at ¶207.3, ¶207.7, and ¶208.

- **Delaware court decisions severely limit board's fiduciary duty owed to preferred stockholders.**

  - ■ **Two Delaware court decisions.** Where preferred stock terms require a corporation to redeem its outstanding preferred stock (e.g., at face plus accrued but unpaid cumulative dividends) at a specified date (or dates), but the corporation's directors conclude that, while such redemption would be in the *preferred* stockholders' best interests, such redemption would not be in the *common* stockholders' best interests, how should the directors resolve such conflict?

    The Delaware Chancery Court concluded in a 2017 case that while the board owes full fiduciary duties to common stockholders, "preferred stockholders are owed fiduciary duties only when they do not invoke their special contractual rights and rely on a right shared equally with the common stock," i.e., that preferred stockholders' rights are merely "contractual in nature," so the "board does not owe fiduciary duties to preferred stockholders when considering whether or not to take corporate action that might trigger or circumvent the preferred stockholders' contractual rights." Rather "the board has a duty to prefer the common's interests, as pure equity holders," by "maximiz[ing] the value of the corporation over the long-term for the benefit of presumptively permanent equity capital" (i.e., common stock).

    Accordingly the court refused to dismiss common stockholders' claim that the board breached its fiduciary duty to the common stockholders when the board sold part of the corporation's business in order to fund a mandatory preferred stock

redemption obligation, because selling part of the corporation's business impaired the corporation's ability to generate long-term value for the common stockholders.

The court stated that the board had a fiduciary duty to determine whether it was in the common stockholders' best interest to breach the preferred stock redemption obligation (even if the corporation would then be subject to a contractual damage claim from the preferred holders), rather than to sell assets and thereby diminish the corporation's long-term business potential.

Similarly, in a 2013 Delaware Chancery Court decision, where the board sold the entire business—which was treading water—for a price that left no proceeds for the common stock after payment of the preferred obligations, the court concluded that the board should have determined whether the sale was in the common stockholders' best interest even if rejecting the sale and continuing the struggle to improve the corporation's business would have made it less likely the preferred would ultimately be paid off.

- **Possible solution: automatic self-effectuating penalties.** Because of these cases denying preferred fiduciary duty, the preferred holders (at least for a Delaware corporation) may want the preferred stock terms to include specific and automatic self-effectuating economic penalties to the common stock (and in favor of the preferred stock) upon non-payment of any preferred redemption or preferred dividend obligation, e.g.:
  - an increase in the preferred's (accruing) dividend rate,
  - a reduction in the preferred's conversion price (if the preferred is convertible into common stock) or a springing conversion right (if the preferred is not otherwise convertible), perhaps with subsequent periodic conversion price reductions so long as non-payment continues, and
  - periodic issuance to the preferred holders of penalty warrants to buy common stock at a low price.

The existence in the preferred terms of such economic penalties on the common stock increases the likelihood that the board would comply with the preferred terms (in order to avoid such economic penalties to the common) or, if the board did not comply with the preferred's terms, such penalties on the common would at least increase the economics for the preferred holders.

Similarly, a contractual drag-along provision in the articles of incorporation and/or in contractual agreements between the common and preferred holders—allowing the preferred holders to sell all of the corporation's stock to the best bidder under specified circumstances (e.g., failure to redeem the preferred on a specified schedule), with sale proceeds shared in accordance with the preferred and common stock's liquidation

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priorities and with all of the common stockholders obligated to cooperate and sign appropriate documentation—would put additional pressure on the common stockholders to cooperate with the preferred stockholders in selling the corporation. See discussion at ¶601.2.4.

- **Executive compensation.**

  - **Calculation of service provider's OI on receipt of equity interest in corporation versus partnership/LLC.** Where a company's service provider ("SP") receives an equity interest in the company in connection with the SP's performance of services for the company, SP's income tax ramifications vary significantly depending on whether the company (1) is formed as a corporation (so that Code §83 applies without modification) or (2) is formed (and taxed) as a partnership or LLC (so that Rev. Proc. 93-27's more-service-provider-favorable tax rules apply).

    Where Rev. Proc. 93-27 applies (i.e., the company is formed as a partnership or LLC), SP's OI is governed by Rev. Proc. 93-27's liquidation value ("LV") approach (which frequently produces a zero LV at the time of issuance), with a deemed §83(b) election, rather than (where the company is formed as a corporation) by Code §83's fair value ("FV") approach, with no deemed §83(b) election.

    SP generally should be able to obtain the same Rev. Proc. 93-27 tax advantages (LV approach with deemed §83(b) election) even though the company is formed as a corporation where the company's equity owners (including SP) own the company's stock through a partnership or LLC. See discussion at ¶202.3.5.1 and ¶302.5.1 (including Example 3).

  - **Revised GAAP accounting rules for executive stock-based or option-based compensation can increase employer's GAAP net income.** Under revised 3/16 GAAP rules, in the case of a *stock sale or award* to an executive, the company's GAAP *compensation expense* (which reduces the company's GAAP net income) is equal to:

    (1) the stock FV at the time of the sale or award,

    (2) *less* the price (if any) paid by the executive,

    while the company's GAAP *tax expense* (which also reduces the company's GAAP net income) is reduced (thus increasing the company's GAAP net income) by the company's tax saving (calculated over the life of the award) resulting from its tax deduction on account of the stock sale or award.

    Under the 3/16 revised GAAP rules, in the case of a *stock option grant* to an executive, the company's GAAP compensation expense (which reduces the company's GAAP net income) is equal to:

- the option's FV at grant date, taking into account both (a) the spread (if any) at grant plus (b) the FV of the option privilege, i.e., the value to the executive from deferring the stock purchase decision and payment of the option price (generally approximately 30% of the option price for an option granted at the money),

while the company's GAAP tax expense (which also reduces the company's GAAP net income) is reduced (thus increasing the company's GAAP net income) by the company's tax saving (calculated over the life of the award) resulting from its tax deduction on account of the stock option grant and exercise.

For both a stock sale or award and a stock option, the revised GAAP rules measure GAAP compensation expense at *grant date*, but (through post-grant adjustments) measure tax consequences at *tax recognition date* based on the company's actual ultimate tax results. Thus, if stock FV rises between grant date and tax recognition date (which *for a stock grant or sale* is generally immediately upon grant or sale if there is no SRF or there is an SRF plus a §83(b) election, or at vesting where there is an SRF with no §83(b) election, and *for an option* is generally at exercise if there is no post-exercise SRF or if there is a §83(b) election at exercise), the company would recognize an increase in tax benefits and hence in its GAAP income.

Thus, under the 3/16 revised GAAP rules a substantial increase in the company's stock price between grant date and tax recognition date generally results in a substantial decrease in the company's taxes and hence a substantial increase in the company's GAAP net income. Indeed, after adoption of the 3/16 GAAP rules, several high-tech companies reported large increases to their GAAP net income attributable to tax benefits flowing from the exercise of employee stock options.

These same GAAP rules apply whether the company is a corporation or a partnership/LLC. See discussion at ¶409.1 (which contains numerical examples based on several alternative grant and vesting/exercise scenarios).

- **PE/VC fund formation—new U.S. Department of Labor rules may prohibit a PE/VC fund from accepting a commitment from a smaller pension plan or IRA.** Hotly debated DOL rules (issued during the Obama administration) became effective 6/9/17 (although the Trump DOL announced it continues to analyze the rules) apparently prohibiting a PE/VC fund sponsor from communicating with a U.S. non-governmental benefit plan investor (e.g., a U.S. pension plan or IRA) in a manner viewed as a "recommendation" that the benefit plan invest in the fund unless the benefit plan investor utilizes a large independent institutional investment adviser in deciding whether to make such investment in the fund.

  If a fund sponsor markets an LP interest to a benefit plan which does not have such a large independent fiduciary (generally a smaller pension plan or IRA), the fund sponsor could be

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viewed as a fiduciary making a "recommendation" to the benefit plan and thus as violating the DOL conflict of interest rules, although it can be argued that a fund sponsor which simply provides a private offering memorandum to a benefit plan investor without any further communication from the fund to the benefit plan has not become a fiduciary making a prohibited "recommendation."

Shortly before the rules' 6/9/17 effective date the Trump DOL somewhat ambiguously announced that it "will not pursue claims against fiduciaries who are working diligently and in good faith to comply . . . or treat those fiduciaries as being in violation. . . ." See discussion at ¶1007.2.

- **Exit scenarios—reduced tax rates for shareholder's gain on sale of Code §1202 "qualified small business stock."** Code §1202 grants a reduced LTCG tax rate and a reduced Medicare tax rate for an individual's gain from sale of a C corp's stock which the individual has held more than 5 years and which meets a number of other statutory requirements. The extent of the tax rate reduction (from the normal 20% LTCG and 3.8% Medicare tax rates) turns on when the individual acquired the stock:

Date stock acquired	*Reduced LTCG tax rate*	*Portion of LTCG subject to 3.8% Medicare tax*
9/28/10 and thereafter	0%	0%
2/18/09 through 9/27/10	7%	25%
8/11/93 through 2/17/09	14%	50%

Stock-sale gain is eligible for Code §1202's reduced tax rates only if the transaction meets a number of (overly complex and in some places overly vague) requirements, including:

- ▲ The corporate issuer must be a U.S. C corp.
- ▲ The gain must be taxable to an individual (directly or through a flow-through entity).
- ▲ The individual (or flow-through entity) must have acquired the stock from the corporation at original issuance, not from a third party, with exceptions for gifts and bequests.
- ▲ The stock must have been held longer than 5 years, with tacking for gifts, bequests, and certain §351 (incorporation) and §368 (reorganization) events.
- ▲ The stock must have been acquired for cash, property (other than stock), services, or (under certain circumstances) in a Code §351 incorporation or §368 reorganization in exchange for §1202 stock of a predecessor corporation.

- ▲ The corporation must have had no more than $50 million of aggregate gross assets (generally measured by tax basis) ‘‘immediately after’’ the shareholder acquired the stock.
- ▲ The corporation must have used at least 80% of its assets (by value) in conducting an active business (or businesses) during ‘‘substantially all’’ of the shareholder’s holding period for the stock.
- ▲ The corporation must not have made certain types of stock redemptions.
- ▲ The shareholder must not have engaged in certain types of short sales with respect to the corporation’s stock.
- ▲ The maximum amount of an individual’s LTCG from sale of a single corporation’s stock eligible for the reduced rate in any tax year is the greater of: (1) an **aggregate limitation** of $10 million (taking into account the individual’s gain during such year and all prior years) **or** (2) an **annual limitation** of 10 times the individual’s aggregate basis in such stock sold by the individual during such year. See discussion at ¶907.1.

- **§1202 as applied to Portfolio Company stock owned by PE/VC fund partnership.** Where PE/VC fund buys, holds for more than 5 years, and then sells Portfolio Company stock which meets §1202’s requirements, the fund’s LTCG should qualify for §1202 treatment to the extent allocable to an individual LP or an individual GP.

  This should include GP’s 20% carried interest in fund’s Portfolio Company stock gain, so long as GP’s percentage interest in such gain has not increased from the date on which fund purchased the Portfolio Company stock to the sale date. It is not relevant for §1202 qualification that GP’s share of fund’s profit on Portfolio Company’s stock exceeds GP’s share of fund’s capital invested in Portfolio Company, i.e., that GP supplied (e.g.) 1% of fund’s capital invested in Portfolio Company stock but is entitled (by virtue of GP’s carried interest) to a larger share of fund’s profit on Portfolio Company stock, so long as GP’s percentage share of fund profit from Portfolio Company stock did not increase between fund’s purchase of the Portfolio Company stock and fund’s sale of such stock. See discussion at ¶907.1(1) (Example 1).

- **Additional issues.** The authors have also added discussion of a number of other Code §1202 subrules, including:
  - ▲ In applying the $50 million asset test when a shareholder purchases Portfolio Company stock, when are Portfolio Company’s assets measured by tax basis and when by FV? Where tax basis is the correct measure and Portfolio Company owns equity in a subsidiary, is the test applied to the equity interest’s tax basis or the underlying assets’ tax basis, and does the answer vary depending on whether the subsidiary is a corporation or a partnership/LLC?

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- Where corp #1 (the stock of which qualified for §1202 before the acquisition) is acquired by corp #2 in a tax-free §368 reorganization in exchange for corp #2 stock, are corp #1's assets added to corp #2's assets in determining whether corp #2 meets the not-more-than-$50 million asset test at the time of the acquisition, so that future appreciation in corp #2's stock held by corp #1's old shareholders qualifies for §1202, and, if so, does corp #2 count corp #1's assets at their old basis in corp #1's hands or at FV?

- Does the step-transaction doctrine apply in determining if Portfolio Company has exceeded the $50 million asset test, e.g., where Portfolio Company issues new stock to A while planning to issue additional new stock to B, is the consideration to be paid by B in the near future viewed (in applying the $50 million assets test to A's stock purchase) as if already received by Portfolio Company?

- In applying the active business test (i.e., in determining if 80% of Portfolio Company assets by FV have been used in conducting an active business) during "substantially all" of a shareholder's stock holding period, (i) under what circumstances does Portfolio Company's working capital count as an active business asset and (ii) do Portfolio Company's R&D activities constitute active business? See discussion at ¶907.1.

• **Exit scenarios—minority shareholder protective devices when TargetCorp is being sold.** When TargetCorp is being sold (to BuyerCo) and some of TargetCorp's shareholders object to the terms of such sale, state corporation law often grants TargetCorp's shareholders one or more protective devices, which can include:

(a) dissenters' rights of appraisal,

(b) shareholder vote, and

(c) minority shareholder class action suit asserting that TargetCorp's board of directors in selling TargetCorp did not satisfy the "business judgment rule," as supplemented (at least for a Delaware corporation) by (i) the *Revlon* "enhanced scrutiny" standard requiring the board to obtain the highest price reasonably attainable for TargetCorp's shares in a sale of TargetCorp's control where cash is all or a substantial portion of the consideration or (ii) the "entire fairness" standard for a controlling shareholder "conflicted transaction,"

all as further described below.

- **Dissenters' rights of appraisal.**

  - **Sale of TargetCorp assets.** If BuyerCo is acquiring substantially all of TargetCorp's assets, the laws of many jurisdictions permit a dissenting TargetCorp shareholder to receive from Buyer in cash the appraised FV of

his or her TargetCorp stock as determined by a court. Delaware and some other states, however, deny appraisal rights to a TargetCorp shareholder when TargetCorp sells all or substantially all its assets unless TargetCorp's charter otherwise provides.

- ▲ **Sale of TargetCorp by merger.** If BuyerCo is acquiring TargetCorp by merger, the laws of most jurisdictions allow a dissenting TargetCorp shareholder to receive from BuyerCo in cash the appraised FV of his or her shares, as determined by a court, although various state laws contain exceptions.

  Delaware, for example, denies appraisal rights to a TargetCorp shareholder—whether BuyerCo's acquisition of TargetCorp is accomplished by (1) two-party forward merger (TargetCorp into BuyerCo) or (2) three-party forward merger (TargetCorp into BuyerCo's subsidiary) or (3) three-party reverse subsidiary merger (BuyerCo's subsidiary into TargetCorp)—if 100% of the consideration to TargetCorp's shareholders (other than cash for fractional TargetCorp shares) is comprised of BuyerCo stock listed on a national securities exchange or held by more than 2,000 holders.

  Nevertheless, even where the above rules would grant appraisal rights to a TargetCorp shareholder, a 2016 Delaware statutory amendment denies such appraisal rights if the TargetCorp shares seeking appraisal are listed on a national securities exchange and either:

  (a) the total number of TargetCorp shares seeking appraisal does not exceed 1% of TargetCorp's outstanding shares of such class eligible for appraisal rights or

  (b) the FV of the consideration (provided in the merger agreement) for all the Target shares seeking appraisal does not exceed $1 million,

  but nonetheless does allow appraisal rights (notwithstanding (a) and (b) above) if the merger is a short-form merger, i.e., a merger not requiring TargetCorp shareholder approval because BuyerCo already owns at least 90% of TargetCorp's shares at the time of the Target-into-Buyer merger. See discussion at ¶502.3.1.

- ■ **Shareholder vote.**

  - ▲ **Sale of TargetCorp assets.** If BuyerCo acquires all or substantially all of TargetCorp's assets, state law generally requires TargetCorp shareholder approval, with the necessary percentage for approval varying according to the law of TargetCorp's jurisdiction of incorporation and the specific provisions of TargetCorp's charter (which may require a higher percentage than applicable state law).

In Delaware, for example, a sale of all or substantially all of TargetCorp's assets requires approval of a majority of TargetCorp's outstanding voting stock, unless TargetCorp's charter calls for a higher percentage. Many other states require more than a majority (frequently two-thirds) for approval.

States differ in their interpretation of "substantially all" of a corporation's assets, with some judicial opinions indicating that over 50% may be "substantially all," or in some cases even less than 50%.

- **Sale of TargetCorp by merger.** A merger generally requires approval from TargetCorp's shareholders with the required percentage varying from state to state, subject to increase by a corporation's charter.

  In Delaware, for example, a merger requires approval from a majority of TargetCorp's outstanding voting stock, unless TargetCorp's charter calls for a higher percentage. Many other states require more than a majority (frequently two-thirds) for approval.

  However, where BuyerCo has first purchased a portion of TargetCorp's stock—in a tender offer and/or one or more negotiated purchases—and BuyerCo then desires to squeeze out TargetCorp's remaining (minority) shareholders by merger, a vote of TargetCorp's shareholders can be avoided in two circumstances:

  First, most state laws contain an exemption allowing a short-form merger—without any TargetCorp shareholder vote—between BuyerCo and one of its subsidiaries (here TargetCorp)—with TargetCorp's minority shareholders receiving BuyerCo stock, cash, or other consideration as specified in the short-form merger agreement. The percentage ownership that BuyerCo must already have in TargetCorp in order to utilize this short-form merger procedure (without a TargetCorp shareholder vote) varies from state to state (90% being the necessary percentage in Delaware).

  Where the acquisition is friendly and TargetCorp has adequate authorized but unissued stock, TargetCorp might grant BuyerCo a top-up option to purchase from TargetCorp (typically for a BuyerCo note) such number of previously unissued TargetCorp shares as are necessary (after BuyerCo's tender offer or open-market purchases) to meet the state law threshold for a short-form merger.

  Second, a 2013 addition to Delaware law (as further amended in 2016) allows a vote of TargetCorp's shareholders on a merger between TargetCorp and BuyerCo to be avoided where:

(a) TargetCorp has more than 2,000 shareholders or is listed on a national securities exchange immediately prior to executing the merger agreement, and

(b) BuyerCo or its subsidiary ("AcquiringCorp") makes a first-step offer for any and all TargetCorp stock, and

(c) immediately following consummation of the offer, the TargetCorp stock purchased by AcquiringCorp pursuant to such offer, together with the TargetCorp stock otherwise owned by AcquiringCorp and any "rollover stock" (as defined below), is sufficient to approve the second-step squeeze-out merger (under Delaware law and TargetCorp's charter), generally more than 50%, and

(d) all non-tendered TargetCorp stock (other than rollover stock) is exchanged in the second-step squeeze-out merger for the same amount and kind of consideration per share as was received by the tendering TargetCorp shareholders in the tender offer (i.e., cash in the same amount per share as in the tender offer where the tender offer consideration was cash), and

(e) TargetCorp is incorporated in Delaware.

"Rollover stock" means TargetCorp shares covered by a written agreement requiring the shareholder to transfer such shares to AcquiringCorp in exchange for AcquiringCorp stock, so long as such TargetCorp shares are actually transferred to AcquiringCorp no later than immediately prior to the time the merger becomes effective.

Before the 2016 Delaware statutory amendment, *all* non-tendering TargetCorp shareholders were required to receive (in the squeeze-out merger) the same type and amount of consideration per share for their TargetCorp stock as the tendering TargetCorp shareholders (i.e., requirement (d) above but without the parenthetical exception for rollover stock, which was added by the 2016 amendment). However, after the 2016 amendment, AcquiringCorp can now acquire TargetCorp shares owned by one or more TargetCorp shareholders (including TargetCorp executives) in exchange for AcquiringCorp stock, even though all of TargetCorp's other shareholders receive cash for their TargetCorp shares (both in the tender offer and in the squeeze-out merger).

While the 2016 statutory amendment allows TargetCorp stock owned by *any* TargetCorp shareholder (not merely by a TargetCorp executive) to be treated as rollover stock, i.e., acquired by AcquiringCorp in exchange for AcquiringCorp stock, the provision is likely to be used most often in practice to roll one or more key TargetCorp executives' TargetCorp stock into AcquiringCorp stock.

Especially where BuyerCo is a new entity (formed by a PE fund to acquire Target in an LBO), BuyerCo may (after the 2016 amendment) offer TargetCorp executives (who will become post-merger BuyerCo key executives) an opportunity to exchange their TargetCorp shares for BuyerCo shares tax-free (as part of BuyerCo's Code §351 formation and buyout of TargetCorp), thus allowing such TargetCorp executives to exchange their low tax basis TargetCorp stock without CG recognition for higher FV BuyerCo stock (which takes a post-merger low carryover tax basis from their old TargetCorp stock). See discussion at ¶503.3.2.7.

- **Exit scenarios—Target board's fiduciary duty.**

(1) Business judgment rule. Under state corporation law, business judgments reached by TargetCorp's directors are generally respected and accorded deference if the board acted on an informed basis, in good faith, and in the honest belief that the action was taken in the best interests of the corporation and its shareholders. In order for the board to claim the benefit of this judicial ''business judgment rule,'' the board must be able to demonstrate that it acted with due care after thorough study and conscientious deliberation.[4]

(2) *Revlon* enhanced scrutiny. However, under Delaware law, when TargetCorp's board is considering a transaction in which TargetCorp's shareholders give up TargetCorp's control—i.e., (i) a sale of TargetCorp where cash is all or a substantial portion of the consideration (e.g., PE fund sponsors Newco's LBO acquisition of TargetCorp or BuyerCo acquires TargetCorp with cash comprising all or a substantial portion of the consideration) or (ii) a combination of TargetCorp and BuyerCo with TargetCorp's shareholders receiving BuyerCo stock but with the combined BuyerCo-TargetCorp enterprise thereafter controlled by one BuyerCo shareholder (or by a group of BuyerCo shareholders acting in concert)—TargetCorp's directors have a duty more rigorous than required by the business judgment rule to protect the interests of TargetCorp's shareholders and obtain the highest price for their shares reasonably attainable (the so-called *Revlon* duty), so courts typically subject the directors' conduct to ''enhanced scrutiny'' to ensure that they have acted reasonably to achieve these goals.

Enhanced scrutiny involves a judicial determination as to (i) the adequacy of the decision-making process employed by TargetCorp's directors, including the information on which they based their decision to pursue the transaction, (ii) the reasonableness of TargetCorp directors' actions in light of the circumstances then existing, and (iii) the ability of TargetCorp's board to accept higher offers even after a definitive agreement for the transaction has been signed. There is no one path to satisfying TargetCorp directors' *Revlon* duty and, depending on circumstances, courts have been satisfied with:

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[4]While Delaware law is clear on the board's fiduciary duty issues discussed in text and some other states' laws are less clear, most states are likely to agree on the principles herein enunciated, subject to the ''other-constituency'' statutes enacted by some states, as discussed in (5) below.

(a) a full "market check" where TargetCorp or its financial advisers solicit interest from a wide array of potential bidders for TargetCorp before signing a merger agreement with BuyerCo (that includes a Target "no-shop" provision), or

(b) a limited market check where TargetCorp or its financial advisers (confident that they can identify virtually all likely bidders) solicit interest from a small number of likely competing bidders (again, before signing a merger agreement with a "no-shop" provision), or

(c) either some or perhaps even no pre-signing market check by TargetCorp, so long as the signed BuyerCo-TargetCorp acquisition agreement allows competing bidders for TargetCorp to submit unsolicited alternative offers (even after the BuyerCo-TargetCorp acquisition agreement has been signed but before the TargetCorp shareholder approval) and also allows TargetCorp directors to terminate the BuyerCo-TargetCorp acquisition after paying BuyerCo a reasonable termination fee if TargetCorp's directors believe an unsolicited alternative offer is superior to the terms offered by BuyerCo, or

(d) no pre-signing market check by TargetCorp, so long as the signed BuyerCo-TargetCorp acquisition agreement allows TargetCorp and its financial advisers to actively solicit offers from select alternative bidders for a short post-signing period (a "go-shop") and allows TargetCorp directors to terminate the BuyerCo-TargetCorp acquisition agreement, after paying BuyerCo a reasonable termination fee (typically smaller than the fee described in (c)) if TargetCorp's directors believe such an alternative offer is superior.

When some board members have an interest in the transaction different from the interest of TargetCorp's shareholders generally—e.g., in an LBO where Newco or its PE fund sponsor offers TargetCorp's management the opportunity to continue as post-acquisition Newco/Target executives, perhaps with increased compensation, and/or to invest in Newco by buying, or receiving options to buy, Newco common stock—it is advisable to form a committee of TargetCorp independent directors (who have no interest in the acquirer) to foster an arm's length negotiation between the acquirer and TargetCorp, and often to engage in an auction process or limited market check with the assistance of an independent investment banker.

Where the enhanced scrutiny standard is not met and a Delaware court concludes that TargetCorp's disinterested directors did not thoroughly review the proposed sale of TargetCorp (and alternative opportunities) and take reasonable steps necessary to maximize TargetCorp shareholders' sale proceeds, Delaware courts have enjoined BuyerCo's acquisition of TargetCorp, or if the acquisition has already been consummated, have held TargetCorp directors personally liable for breaching their fiduciary duty by selling TargetCorp for too low a price.

(3) Exception to enhanced scrutiny, allowing business judgment rule to apply. Delaware courts have, however, held that the enhanced scrutiny standard does not apply to a transaction otherwise falling within the parameters for enhanced scrutiny (as described in (2) above) where:

(i) the transaction has been approved by a fully informed, uncoerced majority vote of disinterested TargetCorp shareholders (or by such a majority of TargetCorp's fully informed, uncoerced, disinterested shareholders tendering their TargetCorp stock to BuyerCo, which is viewed as the equivalent of a majority shareholder vote), and

(ii) the BuyerCo-TargetCorp transaction has already been consummated so the issue before the court is damages (not an injunction), and

(iii) the transaction is not covered by the more rigorous "entire fairness" standard applicable where TargetCorp is engaging in a "conflicted transaction" with its controlling shareholder (as discussed in (4) below).

(4) Controlling shareholder conflicted transaction. Where TargetCorp has a controlling shareholder (the "TargetCorp controller") and BuyerCo's acquisition of TargetCorp is a "conflicted transaction," Delaware courts have adopted an "entire fairness" standard of review (which is even more rigorous than the "enhanced scrutiny" standard described in (2) above).

One type of conflicted transaction is where the TargetCorp controller seeks to acquire the remaining TargetCorp shares not previously held by the TargetCorp controller. In such case Delaware courts apply an "entire fairness" standard, requiring proof that *both price and process* have been fair (almost always requiring a full trial if a minority shareholder sues), unless the following six-part test is satisfied:

(a) from the outset the TargetCorp controller conditioned the transaction on non-waivable approval by both (i) a TargetCorp board independent committee and (ii) a majority-of-the-minority shareholders,

(b) the independent committee is independent of the TargetCorp controller,

(c) the independent committee is empowered to freely select its own legal and financial advisers and to definitively reject the TargetCorp controller's offer,

(d) the independent committee meets its duty of care in negotiating a fair price for the minority shareholders,

(e) the minority shareholders are fully informed, and

(f) the minority shareholder approval is uncoerced.

This Delaware six-part test is also employed in a second type of conflicted transaction where the TargetCorp controller is selling TargetCorp to an independent third party (BuyerCo), but the TargetCorp controller receives some benefit that the TargetCorp minority shareholders do not receive (a "differential transaction"), which could include:

(A) a higher price per TargetCorp share than the TargetCorp minority shareholders are receiving, or

(B) BuyerCo shares in exchange for part or all of the TargetCorp controller's shares while the TargetCorp minority shares are receiving only cash, or

(C) satisfaction of an extreme liquidity need on the part of the TargetCorp controller (not shared by the TargetCorp minority shareholders).

In such a differential transaction, the TargetCorp controller is permitted to receive such a benefit without requiring entire fairness, i.e., that both price and process have been fair, so long as the six-part test discussed above is satisfied.

Entire fairness is not implicated solely because TargetCorp has a controlling shareholder, but only where TargetCorp has a controlling shareholder *and* BuyerCo's acquisition of TargetCorp is a conflicted transaction (as described above). Thus, where the TargetCorp controller sells its entire stake in TargetCorp, receiving identical consideration per share to the minority shareholders, the business judgment rule (not the entire fairness standard) applies (supplemented by enhanced scrutiny in a sale of TargetCorp's control where cash is all or a substantial portion of the consideration or the combined BuyerCo-TargetCorp enterprise is controlled by one BuyerCo shareholder or a group of BuyerCo shareholders acting in concert), unless the controller forced an inappropriate TargetCorp fire sale in order to solve the controller's personal liquidity crisis.

(5) Other constituency statutes. Approximately 30 states (but not Delaware) have enacted various versions of "other-constituency" statutes, permitting (or in a few cases requiring) TargetCorp's board of directors, in acting on BuyerCo's proposed acquisition of TargetCorp, to consider interests other than those of TargetCorp's shareholders. Various of these statutes permit or require the board to consider the interests of:

- TargetCorp's employees,
- TargetCorp's customers,
- TargetCorp's creditors,
- TargetCorp's suppliers,
- communities served by TargetCorp,
- TargetCorp's long-term interests,

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- the local and national economy,
- BuyerCo's reputation, ability, and potential conduct,
- other factors TargetCorp's board deems pertinent, and
- the possibility that TargetCorp's continued independence may best serve TargetCorp's long-term interests.

Some of these other-constituency state statutes apply to any acquisition of TargetCorp, while some apply only to certain forms of acquisition, e.g., a sale of all or substantially all TargetCorp's assets.

There is little precedent on the extent to which a court may hold that such a permissive or mandatory other-constituency statute exonerates TargetCorp's board from liability (or injunction) where TargetCorp's board has not engaged in the activities which would have been required to satisfy the board's fiduciary duty had an other-constituency statute not been in effect, i.e., because TargetCorp's board accepted an acquisition proposal that did not provide TargetCorp's shareholders with the highest price reasonably attainable for TargetCorp's shares. See discussion at ¶503.3.3.1 to ¶503.3.3.5.

- **Delaware fiduciary duty rules for a partnership or LLC's GP/managing member.**
  - **Fiduciary duty.** Delaware partnership and LLC law grants a partnership or LLC substantial leeway to contract or expand (by clear provisions in the entity's basic agreement) the extent of a GP's or managing member's fiduciary duty.

    A 2013 Delaware Supreme Court decision (dealing with an LP's claim that the publicly traded partnership's GP had breached its fiduciary duty when the GP approved a conflicted transaction between the partnership and the GP) held that the GP is presumed to have acted in good faith so long as the GP followed the procedures set forth in the partnership agreement, even if, by all appearances, the transaction was unfair to the LPs. However, four years later a 2017 Delaware Supreme Court decision reversed course and required the GP to comply with each of the conflict procedures set forth in the partnership agreement, as described below.

    Both of these decisions involved the same publicly traded limited partnership (the "Partnership"), and in both cases, the same LP alleged that the same GP had breached the partnership agreement by unfairly favoring the GP to the detriment of the LPs.

    In the 2013 decision, the Partnership (composed of the GP and a large number of LPs whose interests were publicly traded) entered into a joint venture with the GP on terms proposed by the GP, with the GP receiving 75% of the joint venture profits and the Partnership receiving only 25%. The GP appointed a special committee comprised of independent directors, which approved the transaction. The court found that (i) with

one exception neither the special committee nor the financial adviser sought better terms from the GP, (ii) the financial adviser did not use common valuation metrics, and (iii) the financial adviser's opinion regarding the transaction suggested that the GP's proposal was based on an EBITDA multiple for the LPs substantially below the multiple reported on the financial adviser's website for other similar transactions.

The court nevertheless concluded that the complaint did not plead facts sufficient to show that the GP's decision to approve the related party transaction was "so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any ground other than bad faith," basing its decision on an interpretation of four provisions in the partnership agreement:

(1) "Any standard of care and duty . . . under the Delaware Act . . . shall be . . . waived . . . to permit the [GP] to act . . . so long as such action is reasonably believed by the [GP] . . . to be in the best interests of the Partnership" (the "Fiduciary-Duty-Waiver-and-Partnership-Best-Interests" clause).

(2) The GP is allowed to buy property from and sell property to the Partnership in a "fair and reasonable" transaction "no less favorable to the Partnership than those generally . . . available from unrelated third parties" (the "Related-Party-Transaction" clause).

(3) The GP will not be liable for monetary damages so long as the GP "acted in good faith" (the "GP-Exculpation" clause).

(4) Any action taken or omitted by the GP "in reliance upon the opinion [of an investment banker or other consultant or adviser] . . . shall be conclusively presumed to have been done or omitted in good faith" (the "Conclusive-Presumption" clause).

Interpreting these 4 clauses *together* (rather than requiring the conflicted transaction to satisfy each clause separately), the court concluded that (i) the GP would be liable for damages only if the GP acted in bad faith, (ii) the GP's actions, based upon the special committee's determination, which were in turn based on the financial adviser's advice, are "conclusively presumed" to be in good faith, and (iii) this is true "even if the terms of the [joint venture] . . . were not as favorable as a third party transaction or otherwise fair."

In the 2017 decision (involving the GP's repurchase from the same publicly traded Partnership of the 75% interest in the same joint venture), the GP formed a special committee of independent directors which, after receiving a report from its financial adviser, concluded that the purchase price the GP proposed to pay to the partnership was fair.

The Delaware Supreme Court rejected the approach it had taken in the 2013 decision and held that the partnership agreement required the transaction to comply with the

standards in the Related-Party-Transaction clause (fair, reasonable, and no less favorable than available from unrelated third party), regardless of whether the GP reasonably believed the transaction to be in the Partnership's best interests (as required by the Fiduciary-Duty-Waiver-and-Partnership-Best-Interests clause), looking to specific provisions over more general ones.

Turning to the question of good faith and whether the GP-Exculpation clause insulated the GP from monetary damages, the court lowered the pleading standard announced in the 2013 case and required the plaintiff only to "plead facts supporting an inference that [the GP] did not reasonably believe the . . . transaction was in the best interest of the Partnership."

The court also rejected the GP's argument that, under the Conclusive-Presumption clause, the GP was entitled to a presumption of good faith because it relied on the financial adviser's opinion when approving the transaction, reaching this result in part due to alleged flaws in the financial adviser's analysis and in part because the financial terms of the transaction were "fully baked" by the time the adviser "appeared on the scene to render a fairness opinion." See discussion at ¶302.1.4(7).

- **Non-waivable covenant of good faith and fair dealing.** Delaware partnership/LLC law prohibits a partnership or LLC agreement from limiting or eliminating the statutory implied contractual covenant of good faith and fair dealing. In a series of cases, including a 2017 decision, the Delaware Supreme Court held that GP's reliance on a conclusive-presumption-of-good-faith clause in a partnership agreement—i.e., a provision stating that GP's reliance on an independent adviser's opinion or an independent committee's decision or some other specified act conclusively demonstrates good faith—does *not* prevent GP's action from breaching Delaware's statutory non-waivable implied duty of good faith and fair dealing.

In the 2017 decision a publicly traded partnership (Target) was acquired by an affiliate of Target's GP ("Purchaser"), with the amount of stock and cash consideration paid by Purchaser to Target's LPs having been approved by:

(i) an allegedly independent conflicts advisory committee and

(ii) a majority vote of Target's independent LPs (i.e., LPs who were not affiliated with Target's GP),

both of which approval methods Target's partnership agreement stated were sufficient to immunize the related-party purchase from LP challenge.

However, proxy material prepared by Target's GP in connection with Target's LP vote failed to disclose that (a) a member of Target's "independent" conflicts advisory committee held a position with an affiliate of Purchaser until four days after his

appointment to Target's independent committee and (b) was then reappointed to such position with the Purchaser affiliate immediately after closing of Purchaser's acquisition of Target.

The court concluded that, although Target's partnership agreement both disclaimed fiduciary duties and extinguished disclosure duties, "once [GP] went beyond the minimal disclosure requirements of the LP Agreement, and issued a 165-page proxy statement to induce the [LPs to cast the] . . . safe harbor [majority-LP vote], implied in the language of the LP Agreement's conflict resolution provision was an obligation not to mislead [the LPs]," i.e., "a requirement that the [GP] . . . not act to undermine the protections afforded [LPs] . . . in the safe-harbor process," notwithstanding that "the express terms of the LP Agreement did not address, one way or another, whether the [GP] . . . could use false or misleading statements to enable it to reach the safe harbors."

Such "terms [i.e., a GP obligation not to mislead the LPs and hence undermine the LP vote protections] are easily implied because the parties must have intended them and have only failed to express them because they are too obvious to need expression. . . ." Also "[i]mplicit in the express terms is that the Special Committee membership be genuinely comprised of qualified members and that deceptive conduct not be used to create [a] . . . false appearance." See discussion at ¶302.1.4.(6).

- **Federal income tax rates for 2017 and thereafter.**
  - **C corp income tax rates.** The top federal *C corp* income tax rate for 2017 and thereafter (on both OI and LTCG) continues at 35% (subject to an approximately 3 percentage point reduction on qualified U.S. production business net income). See discussion at ¶107(5) and (6).
  - **Individual income tax rates.** The top federal *individual* income tax rates for 2017 and thereafter (which also apply to partnership, LLC, or S corp-level income flowing through to an individual equity owner) are:
    - For **OI and STCG,** the top rate continues at 39.6% (subject to an approximately 3 percentage point reduction on qualified U.S. production business net income).
    - For **normal LTCG,** the top rate continues at 20%.
    - For **QDI** (qualified dividend income), the top rate continues at 20% (i.e., the same as LTCG).
    - For **Code §1202 LTCG** (from "qualified small business stock" held more than 5 years), the top rate continues at:
      - 0% for such stock acquired on or after 9/28/10,
      - 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. See discussion at ¶107(1) through (3) and (6).

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

  - On **compensation and self-employment income,** the rate continues at 3.8%, with (a) 2.9% imposed half on employer and half on employee or 100% on a self-employed person plus (b) an additional 0.9% on such income in excess of a threshold amount ($250,000 for a joint-return individual) imposed 100% on the employee or self-employed person.

  - On **passive income from investments and on business income as to which the individual is not active,** the rate continues at 3.8% on the individual's AGI in excess of a threshold amount ($250,000 for a joint-return individual).

- **Individual itemized deduction and personal exemption phase-outs** add to individual federal income taxes:

  - A phase-out of itemized deductions by 3% of AGI in excess of a threshold amount (approximately $300,000 for a joint-return individual), with a maximum such phase-out equal to 80% of itemized deductions.

  - A phase-out of personal exemptions as AGI increases (from approximately $300,000 to $425,000 for a joint-return individual). See discussion at ¶106(3).

- **HSR filing for acquisition.** 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 2/17 annual inflation adjustment of all the relevant HSR tests, thresholds, and filing fees.

  - **Non-compliance penalty.** Effective 1/24/17, the maximum civil penalty for an HSR violation increased to $40,654 per day. See discussion at ¶501.3.3.1.

- **. . . and much, much more . . .**

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