NEW September 2016 Edition of Mergers, Acquisitions, and Buyouts
by Martin D. Ginsburg, Jack S. Levin, and Donald E. Rocap

We are proud to enclose the September 2016 edition of Ginsburg Levin and Rocap Mergers, Acquisitions, and Buyouts.

Here is a summary of major developments reflected in the new edition, written by co-authors Jack S. Levin and Donald E. Rocap, senior partners in the international law firm of Kirkland & Ellis LLP.

Highlights of the New Edition

- **Charitable donation of T stock immediately before P's taxable acquisition of T.** If A, a T shareholder (either minority or even majority controlling shareholder), contributes T stock to charity at approximately the same time as P is acquiring T in a taxable transaction, (1) is A entitled to a charitable deduction for the FV of the donated T stock without also recognizing the gain inherent in her T stock or (2) is A taxed on her inherent gain in the T stock and treated as contributing to charity the proceeds from the stock sale to P?

  Under long-standing precedent, including a revenue ruling, A is not taxed on her inherent gain in the T stock, unless at the time the stock is donated to charity A (the donor) is under, and thus the donee charity takes the T stock subject to, a binding legal obligation (the P-T acquisition agreement) to sell, redeem, or otherwise dispose of the T stock. However, if at donation time A’s stock is already subject to such a binding legal obligation, A is taxed on the inherent gain in the stock (even if P has the right to call off the acquisition should T suffer a material adverse change before consummation).

  Thus, if at the time of the donation A has not yet entered into a binding legal obligation, the tax law does not recharacterize the transaction merely because A
intends (and expects) the donee charity to, and in fact the donee charity does, promptly avail itself of the opportunity to convert the donated stock to cash.

The same principle applies (i.e., A is not taxed on the appreciation in her T stock) if the taxable sale of T to P is not structured as a simple sale of T’s stock to P (as discussed above) but utilizes another transactional format:

- T is being sold to P via a taxable cash merger between P and T (forward or reverse), and A’s charitable contribution of T stock occurs before T’s shareholders have voted on the T-P merger,

- T is being sold to P via a cash tender offer (i.e., P is making a tender offer for T’s stock to be followed by a squeeze-out cash merger of P and T [forward or reverse]), and A’s charitable contribution of T stock occurs before a majority of T’s shares have been tendered into P’s tender offer, or

- T is selling its assets to P and distributing the proceeds to its shareholders in a taxable liquidation and A’s charitable contribution of T stock occurs before a majority of T’s shareholders have ratified the liquidation plan. See discussion at ¶203.8.

• Tax-free spin-offs.

- Unwind of high-vote/low-vote structure. Code §355 dealing with tax-free spin-offs (or split-ups) requires that a distributing corporation (“D”) own and distribute an amount of stock of its controlled subsidiary (“C”) representing C’s “control,” which is defined to mean (a) stock representing 80% or more of the voting power of all C’s outstanding stock and (b) 80% or more of each class of C’s non-voting stock.

  Where D owns (a) less than 80% of C’s total voting power or (b) less than 80% of a class of C non-voting stock, IRS rulings have long permitted D to gain “control” of C before the spin-off by (a) recapitalizing a class of C voting stock into a higher voting class so that D in the aggregate holds more than 80% of C’s voting power and/or (b) recapitalizing a class of C non-voting stock in which D holds less than 80% into a class that holds a low amount of voting power.

  IRS issued several private letter rulings permitting C, following the spin-off, to unwind the high-vote/low-vote structure that had been created to meet the “control” definition as described above. However, in 2013, IRS announced that it would no longer issue letter rulings on such high vote/low vote structures while it studied issues associated with such rulings.

  In 7/16 IRS published a revenue procedure reporting on the results of that study and providing a safe harbor with respect to the potential unwind of these
structures. Specifically, the revenue procedure applies to a series of transactions in which:

1. D owns an amount of C stock not satisfying the “control” requirement,
2. C recapitalizes its shares, as a result of which D acquires “control” of C through the creation of high-vote and low-vote classes of stock (the “Recapitalization”),
3. D distributes C stock in a proposed Code §355 distribution, and
4. thereafter C desires to effectively unwind the dual class structure created in the Recapitalization.

In these cases, IRS will not assert that the Recapitalization lacks substance such that D failed to satisfy the “control” test so long as either:

- no action is taken by C (or its directors, officers, or controlling shareholders) to unwind the Recapitalization at any time prior to 24 months after the distribution or
- the Recapitalization unwind occurs pursuant to a transaction with a third party and there was no agreement, understanding, arrangement, or substantial negotiations or discussions regarding the third-party transaction or a similar transaction during the 24 months ending on the distribution date.

This guidance provides welcome certainty to D considering a dual class Code §355 distribution of C with respect to future ability to rationalize C’s capital structure if warranted by market and business considerations.

The 7/16 Rev. Proc., by its terms, does not appear to apply where D owns historic “control” of C and recapitalizes C’s shares into a high-vote/low-vote structure in order to (i) retain more than 20% (by value) of C’s stock for disposition subsequent to a Code §355 distribution or (ii) issue more than 20% (by value) of C’s stock in an IPO prior to a Code §355 distribution while maintaining such “control.” IRS officials have, however, stated in public forums that the 7/16 Rev. Proc. does extend to such situations.

The authors hope IRS will supplement the Rev. Proc. to confirm this point and, in doing so, consider allowing a less-than-2-year unwind period where D’s control of C is historic. See discussion at ¶1003.1.2.

- **Active trade or business test.** A 2/15 revenue procedure expressed concern regarding spin-offs with small active trades or businesses, stating that they may present evidence of device, lack an adequate business purpose, or violate other Code §355 requirements and/or circumvent the repeal of the General Utilities doctrine.
While it studied these issues, IRS announced that it would not normally issue private letter rulings where the active trade or business of D or C represented less than 5% of the corporation's total gross assets.

In 7/16, IRS issued proposed regulations, which, if finalized in proposed form, would require that the FV of active trade or business gross assets of each of D and C must represent at least 5% of the FV of that entity's total gross assets, calculated by dividing the FV of an entity's “Five-Year-Active-Business Assets” by the FV of the entity's “Total Assets.” An entity's “Five-Year-Active-Business Assets” would be its gross assets used in one or more businesses. This rule would put a premium on having a certain level of good 5-year active trade or business assets. If D or C is engaged in a substantial active trade or business that does not meet the 5-year requirement, such active trade or business assets would fall on the bad side of this calculation.

The test for each of D and C would be measured at the D “separate affiliated group” and C “separate affiliated group” level, and although interests in partnerships generally would not count as business assets, a look-through rule would apply for partnerships through which D or C is considered to be engaged in one or more 5-year active trades or businesses. Active trade or business assets would include reasonable amounts of cash and cash equivalents held as working capital or required to be held (x) for regulatory purposes, (y) by contract, or (z) as prudent reserves. “Total Assets” would be the Five-Year-Active-Business Assets plus all of the corporation’s other assets.

A corporation’s Five-Year-Active-Business Assets and other assets would be determined and categorized as of immediately after the distribution. The asset FV could, however, be measured (i) immediately before the distribution, (ii) on any date within the 60-day period before the distribution, (iii) on the date that an agreement binding on D at all times thereafter regarding the distribution is entered into, or (iv) on the date of a public announcement or filing with SEC with respect to the distribution. If D and C do not calculate and report these values consistently, IRS would determine the values as of immediately prior to the distribution (unless IRS determines that the use of such date is inconsistent with §355’s purposes).

For purposes of Code §355 generally, a five-year active trade or business can include assets acquired less than five years before a distribution where the assets constitute an expansion of a pre-existing business. However, the proposed regulations include a broad anti-abuse rule which would disregard any transaction or series of transactions (e.g., an expansion of an existing business) undertaken with a principal purpose of avoiding the 5%-active-trade-or-business requirement. In addition, the rules would apply separately to each spin-off, with no exception.
for an internal spin-off, where these rules could be problematic even in an otherwise non-abusive situation.

These 7/16 proposed regulations would generally apply to a transaction occurring on or after the date final regulations are issued, but would not apply to a distribution (i) pursuant to a binding agreement, resolution, or other corporate action occurring prior to the date final regulations are issued, (ii) described in a ruling request submitted on or before 7/15/16, or (iii) publicly announced or described in an SEC filing on or before the date final regulations are issued.

Importantly, the preamble to the proposed regulations states that Congress did intend that a greater than de minimis active trade or business is required in order to accomplish a tax-free spin-off. Despite failing to discern that intent over decades of its previous Code §355 interpretations of Congressional intent, IRS appears to be taking the position that a certain level of active trade or business assets has always been required. Given this position, from and after 7/15/16 practitioners should be wary of attempting a Code §355 distribution with an active trade or business that does not meet the 7/16 proposed regulations’ minimum active business threshold requirements. See discussion at ¶1004.1.2.

**Device test.** To qualify as a tax-free spin-off, D’s distribution of C’s stock must not be a “device” for the distribution of D’s or C’s E&P. The device test was designed to prevent shareholders from extracting earnings from D in a CG transaction without significantly reducing their percentage equity interest in D. IRS regulations state that the determination of whether a corporate separation constitutes a device is based on all the facts and circumstances, including the presence of certain enumerated device and non-device factors.

7/16 proposed regulations would impose new device tests where D or C holds substantial non-business assets. The preamble to the proposed regulations expresses IRS’ belief that, where D is publicly traded, taxpayers have been giving undue weight to this fact as a non-device factor and over-emphasizing what IRS views as “weak” business purposes to offset evidence of device resulting from the separation of non-business assets from business assets, even when pressure from public shareholders was a catalyst for the transaction. In addition IRS believes that a transaction is generally a device where either D or C has a large percentage of non-business assets or D’s and C’s respective percentages of such assets differ substantially.

To address these concerns, the 7/16 proposed regulations would add two new “device factors”:

1. Ownership of non-business assets by D or C representing 20% or more of total assets and
(2) A difference in the percentage of total assets represented by non-business assets between D and C (unless the difference is below 10% or, in a split-off scenario, is attributable to the need to equalize C’s and D’s values).

Under the proposed regulations, the term “business assets” would mean gross assets used in one or more active trades or businesses. Helpfully, IRS clarified that “business assets” would include reasonable amounts of cash and cash equivalents held as working capital or required to be held (a) for regulatory purposes, (b) by contract, or (c) as prudent reserves. In addition, the percentage of business assets generally would be measured at the “separate affiliated group” level. Although partnership interests and corporate stock would generally be treated as non-business assets, a look-through rule would apply for (i) a partnership conducting an active trade or business in which D or C is deemed to engage under Code §355(b) and the regulations and (ii) stock of a corporation in which either the C “separate affiliated group” or D “separate affiliated group” owns a 50%-or-greater interest.

An entity’s business and non-business assets would be identified and classified as of immediately after the distribution. The asset FV could, however, be measured (i) immediately before the distribution, (ii) on any date within the 60-day period before the distribution, (iii) on the date that an agreement binding on D at all times thereafter regarding the distribution is entered into, or (iv) on the date of a public announcement or SEC filing with respect to the distribution. If D and C do not calculate and report these values consistently, IRS would determine the values as of immediately prior to the distribution (unless IRS determines that the use of such date is inconsistent with Code §355’s purposes).

Finally, although a strong business purpose would remain a non-device factor, the 7/16 proposed regulations would require that, for a business purpose to overcome evidence of device related to differences between D’s and C’s business/ non-business asset ratios, there must be a strong business purpose relating directly to such difference.

Under the 7/16 proposed regulations, certain purported Code §355 distributions would be a per se device, no matter the strength of the business purpose or other non-device factors. This largely mechanical per se device rule (a) would apply if the non-business assets of either D or C equal or exceed two-thirds of its total assets and (b) then would compare the non-business asset percentages of each of D and C. The test would be measured by reference to three “bands” or ranges of non-business asset percentages of the corporation (D or C) that has the higher percentage of non-business assets. If the non-business asset percentage of the other corporation is less than the specified minimum non-business asset percentage for the applicable band, then the transaction would be a per se device.
### Table

<table>
<thead>
<tr>
<th>Non-business asset percentage of D/C</th>
<th>Band 1</th>
<th>Band 2</th>
<th>Band 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equal to or greater than 66% but less than 80%</td>
<td>30%</td>
<td>40%</td>
<td>50%</td>
</tr>
<tr>
<td>Equal to or greater than 80%, but less than 90%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equal to or greater than 90%</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The rules for determining the requisite percentages of business and non-business assets would be the same as those that apply for purposes of the proposed new device factors, described above.

Proposed adoption of this per se device rule would make application of the device test more rigid and may not take into account all circumstances or good business reasons for certain asset divisions. However, IRS appears to be of the view that the burdens resulting from, and the rigidity of, these mechanical tests are warranted when two-thirds or more of D’s or C’s assets consist of non-business assets.

The proposed regulations provide two important exceptions to this per se device rule that should appropriately free most “cash-rich split-offs” to corporate shareholders (that pass muster under Code §355(g)) from application of such rule. First, the per se device rule would not apply if the distributees in the transaction are domestic (U.S.) corporations that would be eligible for the 80% dividends-received deduction under Code §243(a) or §245(b). Second, the per se device rule ordinarily would not apply to certain transactions with important non-device indicia, described under Reg. §1.355-2(d)(5), such as a transaction in which D and C lack E&P or a split-off transaction in which it is clear that the distribution if taxable would otherwise qualify as a non-pro rata redemption to all D shareholders under Code §302(a). See discussion at ¶1006.1 and ¶1006.4.

- **LossCo (troubled company) debt restructuring—tax ramifications from transferring property to creditor in payment of full-recourse or non-recourse debt.** If LossCo is unable to pay its creditors (or is in bankruptcy), some or all of its debts are typically modified, restructured, or satisfied in a manner that alleviates LossCo’s financial burden, generally involving compromises by LossCo’s creditors and possibly by LossCo’s shareholders.
  - **Full-recourse debt.** Where, as a part of such a debt restructuring, LossCo transfers assets (e.g., real estate) to a creditor in exchange for cancellation of LossCo *full recourse* indebtedness which exceeds in amount the transferred assets’ FV, the
general rule is that LossCo is treated, for tax purposes, as selling the property for an amount equal to the property's FV (not for the larger amount of indebtedness being cancelled). Thus, LossCo recognizes Code §1001 gain (or loss) on disposition of the property equal to the property's FV minus LossCo’s tax basis in the property.

In addition, LossCo also recognizes debt cancellation (“DC”)—which in turn becomes either cancellation of debt income (“CODI”) or attribute reduction (“AR”)—equal to the amount of debt cancelled minus the property’s FV.

- Non-recourse debt. Where, however, LossCo’s debt is non-recourse (i.e., the creditor’s claim is limited to the property securing the debt), LossCo is viewed for tax purposes as selling the asset to the creditor for an amount equal to the debt’s adjusted issue price (i.e., face amount, with adjustments for unamortized OID, unamortized OIP, and unpaid accrued interest), and LossCo does not recognize any DC.

Often LossCo would prefer DC rather than Code §1001 taxable gain because LossCo can often treat DC as AR (which does not constitute immediate taxable income), rather than as gain on disposition of the asset (which does constitute immediate taxable income).

- Non-recourse debt created through organizational structure. The non-recourse nature of debt typically results from limitations in the applicable loan agreement, for example, a provision that, in the event of a default, the creditor’s claim against LossCo is limited to LossCo’s interest in the asset (e.g., real estate) securing the loan.

However, non-recourse debt can also be created through organizational structure. If LossCo has a subsidiary entity that is disregarded for federal income tax purposes (e.g., an LLC 100% of the equity interests of which are owned by LossCo), the disregarded entity’s debt which is not guaranteed by LossCo is generally treated as non-recourse LossCo debt for federal income tax purposes since (1) the subsidiary is disregarded, (2) the debt is viewed for federal tax purposes as LossCo’s debt, and (3) LossCo does not have full recourse liability for the debt. This is true even if the debt is full recourse to the disregarded LLC.

Thus, LossCo recognizes Code §1001 gain (or loss) on disposition of the property equal to the difference between disregarded-LLC’s tax basis in the property and the full amount of LLC’s adjusted issue price for the debt (i.e., the property’s FV is not relevant). Hence none of LossCo’s gain constitutes DC and none qualifies for the AR rules. See discussion at ¶1202.2.2.3 and ¶1202.4.1.4(2).
2016 proposed Code §385 debt-equity regulations. 4/16 complex proposed regulations would mandate equity characterization for certain related party debt instruments, without regard to traditional subjective debt-equity factors (e.g., DER, overlap, projected ability to service the debt, reasonable debt terms, act like creditor). These regulations would apply only in limited circumstances: to debt instruments issued between corporations bearing an 80%-or-greater parent-subsidiary or brother-sister relationship (but not part of a single group filing a U.S. consolidated federal income tax return), referred to as an “expanded group.” These rules would apply where, for example, a U.S. corporation issues a debt instrument to its 80%-or-greater foreign parent corporation or where a partnership owns 80% or more of the stock of two U.S. corporations, one of which issues a debt instrument to its sister corporation.

The proposed regulations would, with limited exceptions (including an exception for debt instruments not exceeding $50 million in the aggregate), automatically treat a debt instrument as equity if issued by one expanded group member to another:

(a) as a dividend or redemption distribution,

(b) in exchange for stock of another group member, or

(c) in exchange for property of another group member in certain types of asset reorganizations.

The same treatment would apply if a debt instrument is issued by one expanded group member to another member for cash or other property, with “a principal purpose” of funding a distribution or acquisition described in (a) through (c). The proposed regulations would treat debt as issued with a principal purpose of funding such a distribution or acquisition if the debt is issued during the period beginning 36 months before, and ending 36 months after, the applicable distribution or acquisition, with a narrow exception for certain debt issued for property in the ordinary course of business. This portion of the regulations would apply to debt instruments issued after 4/3/16.

To facilitate IRS audits, the proposed regulations would also impose new recordkeeping requirements for a debt instrument issued between members of an “expanded group” (as defined above) if (regardless of the type of transaction being financed):

(1) the stock of any group member is publicly traded,

(2) a group financial statement shows total assets exceeding $100 million, or

(3) a group financial statement shows total annual revenue exceeding $50 million.
Such a debt instrument would automatically be treated as equity unless:

(a) documentation is prepared within 30 days of the debt instrument’s issuance evidencing a binding obligation to repay the funds, the creditor’s rights to enforce the terms of the instrument, and a “reasonable expectation” of the borrower’s ability to repay the instrument on its terms and

(b) ongoing documentation is prepared and maintained evidencing a continuing and genuine debtor/creditor relationship, including payments of interest and principal and, if applicable, enforcement actions upon default.

This documentation portion of the regulations would apply to a debt instrument issued after the regulations are finalized. See discussion at ¶1302.3.

- **Reductions in company’s GAAP earnings because of stock grants, sales, or options to executives.**

  - **Stock sale or award.** When a company makes a stock sale or award to an executive, (1) the company’s accounting net income is reduced (over the executive’s service period, generally the vesting period) by the compensation expense, which in turn is equal to the stock’s FV at the time of sale or award less the price (if any) paid by the executive and (2) the company’s accounting net income is increased by its expected tax saving from any tax deduction created by the stock sale or award, so that the company’s accounting net income is reduced by such compensation expense net of the tax benefit.

  - **Stock option.** When a company grants a stock option to an executive, (1) the company’s accounting net income is reduced (over the executive’s service period, generally the vesting period) by the compensation expense, which in turn is equal to the option’s FV at the grant date, taking into account both (a) the spread (if any) at grant between the stock’s FV and the option price and (b) the FV of the option privilege, i.e., the value to an executive from deferring the stock purchase decision and payment of the option price (generally 20% to 40% of the option stock’s grant date FV for an option that is not significantly in-the-money at grant), and (2) the company’s accounting net income is increased by its expected tax saving from any tax deduction created by the option grant and exercise, so that the company’s accounting net income is reduced by such compensation expense net of the tax benefit.

  - **Tax saving calculation.** Under pre-3/16 GAAP rules, the tax savings from any tax deductions in excess of the company’s accounting expense (“excess tax benefits”) have generally been credited directly to net worth as paid in capital and do not flow through the company’s income statement. However, GAAP rules adopted in 3/16 eliminate the concept of “excess tax benefits,” effective 1/17 for a public
company using the calendar year and 1/18 for a private company using the calendar year, with early adoption permitted.

Under the new 3/16 rules, the company is required to adjust its tax benefits (generally calculated pursuant to Code §83, §409A, and §404(a)(5)) from a sale, award, or option grant and exercise as estimated at grant to reflect its actual tax benefits (e.g., because of FV fluctuations between sale/grant and vesting if no §83(b) election was made for a stock sale/award or between grant and exercise/vesting for an option) and such adjustments, whether positive (the company’s actual tax benefits are greater than estimated) or negative (the company’s actual tax benefits are smaller than estimated), flow through the company’s income statement and affect GAAP net income.

- **Vesting rules.** An executive’s stock or option is frequently subject to vesting based on a “service condition” (requiring the executive to provide services to the company) or a “performance condition” (requiring both (i) the executive to provide services to the company and (ii) satisfaction of a performance target relating to the employer’s operations or activities, either during or after the requisite service period).

Stock or option FV is not reduced based on the possibility the executive will not vest in the award and hence will forfeit the compensation; rather, compensation expense is recognized only for an award that ultimately vests. Under GAAP rules adopted in 3/16 (effective 1/17 for a public company and 1/18 for a private company as described above), the company must either (i) estimate the portion of its awards expected to vest based on the provision of services and subsequently adjust such estimate from time to time in light of vesting expectations and ultimately based on actual vesting results or (ii) take into account forfeitures based on failure to provide services as they actually occur.

Prior to the 3/16 rules’ effective date a company must estimate the forfeitures expected to occur based on the failure to provide services and adjust the estimate from time to time based on vesting expectations and actual forfeitures.

- **Paying withholding tax with new shares.** An award may permit the company to withhold shares to “meet the employer’s minimum statutory [tax] withholding requirements” without causing the award to be treated as a liability for accounting purposes (which would invoke harsher accounting rules).

Under pre-3/16 GAAP rules, “if an amount in excess of the minimum statutory requirements is withheld, or may be withheld at the employee’s discretion, the entire award shall be classified . . . as a liability” for accounting purposes.
However, GAAP rules adopted in 3/16 permit shares to be withheld at a rate up to the maximum individual statutory tax rate in the applicable jurisdictions for federal, state, and local income and payroll taxes, without causing the award to be treated as a liability. Subject to this common percentage cap applicable to all employees taxed in a given jurisdiction, the new rules (a) do not require that the employer actually withhold the same percentage amount from each employee and (b) allow an employee some discretion in specifying the amount of withholding with respect to his award. Thus, under these 3/16 GAAP rules, the employer may withhold shares in an amount up to the taxes the employee would owe with respect to the award, determined using the maximum individual statutory tax rate in the applicable jurisdictions, and the award could still be treated as an equity instrument (allowing the more desirable accounting rules described above to be utilized).

However, the new 3/16 rules apply only to an employer that has a statutory tax withholding obligation (e.g., not to a partnership, for an award issued to a partner).

The 3/16 rules are effective 1/17 for a public company using the calendar year and 1/18 for a non-public company using the calendar year, with early adoption permitted. See discussion at ¶1502.3.1.1, ¶1502.3.1.2, ¶1502.3.1.4.

**Proposed IRS regulations attack PE/VC fund management fee reduction in exchange for enhanced LTCG allocation, i.e., waived management fee.**

- **Waived management fee concept.** GPs of some PE/VC funds opt to reduce the management fee payable by the fund to the GP (which is taxable as OI) in exchange for an enhanced allocation of fund profits taxable at lower rates as LTCG and/or QDI.

  This management fee reduction is most commonly structured as a cashless contribution arrangement, under which GP can satisfy a portion of its capital commitment to the fund by making deemed (or “cashless”) contributions to the fund equal to the amount by which the management fee was reduced. GP then receives subsequent fund distributions as if it had actually made the cashless contributions to the fund in cash (i.e., amounts representing a return of the cashless contribution plus or minus the positive or negative investment return on the cashless contribution), conditioned on the fund earning sufficient profits to support characterization of these distributions as an interest in future fund profits (LTCG and QDI).¹

¹Less often, GP receives a capped interest in future fund allocations and distributions equal to only the fee reduction (i.e., cashless contribution) amount.
In some cases the entire GP waiver is made upfront at the time of fund formation, while in other cases GP reserves the right to elect periodically to waive in advance a portion of the management fee in exchange for such an enhanced allocation of fund future appreciation.

As long as there is meaningful economic risk that GP may not receive sufficient allocations of fund profits to make GP whole for the foregone management fee (e.g., when the allocation equal to the foregone management fee is out of annual net profits and may not be taken from appreciation in fund assets existing at the time of the management fee-reduction election, but rather may be taken only from subsequent [i.e., post-management-fee waiver] appreciation), this technique should convert management fee income which would have been taxed as OI into a profits interest in the fund, so that the character of the item of income allocated to GP—generally LTCG and QDI—flows through to GP.

- **7/15 IRS proposed regulations.** 7/15 proposed IRS regulations would treat such a fund management fee reduction arrangement as a “disguised payment for services,” resulting in OI characterization, unless the arrangement meets a high “entrepreneurial risk” standard. The proposed regulations would create a presumption of insufficient entrepreneurial risk where GP’s profit allocation is:
  
  (i) capped in amount,

  (ii) measured by gross income, rather than net income,

  (iii) reasonably determinable in amount, or

  (iv) even if not reasonably determinable in amount, “designed to assure that sufficient net profits are highly likely to be available to make the allocation” to GP.

Under traditional management fee reduction arrangements, GP’s right to receive or retain distributions in respect of waived fees has been conditioned on the fund recognizing sufficient CG or QDI in one or more years in which the fund generates overall net income (ignoring years in which the fund has net losses). Under the proposed regulations, profit allocations would be viewed as “highly likely to be available”—and hence presumed to be disguised payments for services (i.e., OI)—unless profits allocated to GP under the arrangement are limited to the fund’s net profits over an extended period (e.g., the fund’s cumulative net income over the fund’s entire life).

The proposed regulations would apply to arrangements entered into or modified (including by making new fee waivers) after final regulations are issued (expected sometime in late 2016).
For arrangements entered into before issuance of final regulations (and not thereafter modified), the regulatory preamble asserts that the proposed regulations “generally reflect Congressional intent,” although there appears to be little support in pre-existing law for recharacterizing a properly structured cashless contribution arrangement as a disguised payment for services.

- **Future modification of Rev. Proc. 93-27.** The preamble to the 7/15 proposed regulations also announced that IRS intends to modify Rev. Proc. 93-27 (which allows a partnership profits interest issued to a service partner to be valued at its $0 LV, rather than its speculative FV) so that the Rev. Proc. would not apply this taxpayer-favorable rule “to a profits interest issued in conjunction with a partner foregoing payment of an amount that is substantially fixed.”

If the Rev. Proc. is so modified, IRS could assert that a fund GP entering into a fee reduction arrangement must recognize immediate OI equal to the FV of the profits interest received by GP even if this profits interest satisfies the high “entrepreneurial risk” standard of the proposed disguised sale regulations. See discussion at ¶1505.1(6).

- **6/16 IRS liberalization of Code §409A regulations.** Exceedingly complex and lengthy Code §409A regulations mandate immediate OI recognition plus a 20% additional penalty tax (producing a 59.6% maximum tax rate) on many types of OI compensation to a service provider paid on a deferred basis.

6/16 proposed (pro-taxpayer) regulatory amendments (which taxpayers may immediately rely upon) liberalize a few of Code §409A’s many highly technical (and anti-taxpayer) rules, including:

- the unforeseeable event rule,
- permissible distribution triggers,
- the anti-abuse rule,
- severance arrangements, and
- service recipient stock rules.

See discussion at ¶1506.

- **Double-tax penalty on REIT built-in gain extended to 10 years.** A C corp (with appreciated assets) electing to be taxed as a REIT (or an existing REIT acquiring appreciated assets from a C corp with carryover basis [“COB”]), is generally, by virtue of Code §337(d) and the regulations thereunder, subject to Code §1374’s entity-level corporate penalty tax on such built-in gain (“BIG”) to the extent recognized within a
specified period (the “recognition period”) following the C corp’s REIT election (or the REIT’s COB asset acquisition from a C corp).

Prior to 2016, the “recognition period” for a former C corp (with appreciated assets) electing to be taxed as a REIT (or for a REIT acquiring appreciated COB assets from a C corp) tracked the Code §1374 “recognition period” for a C corp electing to be taxed as an S corp (or an S corp acquiring COB appreciated assets from a C corp), i.e., 10 years for such gain recognized before 2009, temporarily reduced to 7 years for such gain recognized in 2009 and 2010, then temporarily reduced to 5 years for such gain recognized in 2011 through 2014, then permanently reduced to 5 years for gain recognized in 2015 and thereafter, as discussed in the S corp context at ¶1103.7.4.

While the length of the S corp “recognition period” (10 years, then 7 years, then 5 years) is established by statute (Code §1374), the length of the REIT recognition period has always been established by regulations which until 6/16 simply incorporated by reference the S corp §1374 statutory recognition period. Indeed, the legislative history of the 12/15 legislation which made permanent the S-corp §1374 5-year recognition period acknowledged that “Under current Treasury regulations, these [Code §1374] rules, including the five-year recognition period, also would apply to REITs” (emphasis added).

However, in 6/16 IRS surprisingly changed course, publishing temporary §337 regulations that, effective for a C corp with appreciated assets which converted to a REIT after 8/7/16 (or a REIT acquiring appreciated COB assets from a C corp after 8/7/16), de-linked the regulatory REIT recognition period from the statutory S corp recognition period, stating in the regulatory preamble that REIT conversions “will no longer be affected by [the shortening of] the length of the [S corp] recognition period from 10 years to 5 years with respect to C corporations that elect to be, or transfer property to, S corporations.” Instead, these temporary regulations adopted a 10-year recognition period for a C corp with appreciated assets which elected to be taxed as a REIT after 8/7/16 (or a REIT which acquired appreciated COB assets from a C corp after 8/7/16).

Application of these Code §1374 principles is mandatory absent an election (made when the C corp with appreciated assets elects REIT status or the REIT acquires appreciated assets from a C corp) to instead recognize the inherent gain in the appreciated assets at such time. See discussion at ¶1607.1.

**2016 court decision expands scope of ERISA group liabilities.** If P acquires the “requisite percentage” of T’s stock, ERISA generally causes P (i.e., T’s new parent) as well as P’s other subsidiaries (i.e., T’s new sister entities) to be joint and severally liable for T’s unpaid ERISA pension obligations, which is very relevant if T should ultimately go bankrupt with underfunded pensions.
Similarly if PE/VC fund acquires the “requisite percentage” of T’s stock (or Newco formed and owned by PE/VC fund acquires the “requisite percentage” of T’s stock), ERISA may cause PE/VC fund as well as its other portfolio companies (i.e., T’s sister portfolio companies) to be joint and severally liable for T’s unpaid ERISA pension obligations.2

The “requisite ownership” is 80% or more (by vote or value where the lower-tier entity is a corporation or by capital or profits where the lower-tier entity is a partnership or LLC), except that in certain circumstances where P (or PE/VC fund) owns 50% or more of the lower-tier entity, certain shareholders (e.g., lower-tier entity’s employees who own stock in lower-tier entity subject to restrictions) are disregarded, so that P’s (or PE/VC fund’s) less-than-80% ownership of the lower-tier entity could constitute requisite ownership.

In a 2016 district court decision, bankrupt T (with underfunded pension liability) was owned 70%-30% by two PE/VC funds (the Sun funds) formed several years apart by the same PE/VC sponsor group (Sun Capital). The two Sun funds did not generally invest in the same portfolio companies, had minimal common LPs, and if the two funds did occasionally invest in the same portfolio company, the investments were not proportionate to each fund’s capital.

### Actual structure

![Diagram of actual structure](image)

2Where the upper-tier entity (P or PE/VC fund) is a partnership or LLC (rather than a corporation) the ERISA group liability rules apply to such upper-tier partnership/LLC entity only if such upper-tier entity is engaged in a “trade or business,” but there is less clarity on whether the upper-tier entity’s other subsidiaries (i.e., T’s sister entities) escape ERISA group liability if the upper-tier entity is not engaged in a trade or business.
Because neither of the two PE/VC funds owned the requisite percentage (here 80%) of bankrupt T, the court (in holding both PE/VC funds liable for bankrupt T’s unpaid pension obligation) created a different path, concluding that both PE/VC funds were liable because, in the district court’s view, they had created a new entity, a “federal” “partnership-in-fact” (owned 70/30 by the two PE/VC funds), to serve as the LLC’s 100% owner (so the imaginary partnership was [under the ERISA rules] liable for the ERISA obligation the LLC had inherited [under the ERISA rules] from bankrupt T). The court then concluded (without discussion) that the partners of the imaginary “federal” partnership (the two PE/VC funds) were liable (i.e., apparently as the imaginary partnership’s general partners) for the imaginary partnership’s ERISA obligation.

The court (relying on the Internal Revenue Code’s broad definition of a partnership for tax purposes) reasoned that the two PE/VC funds’ “smooth coordination [was] indicative of a ‘partnership-in-fact’ sitting atop the LLC: a site of joining together and forming a community of interest.” However, if the court believed the two PE/VC funds needed an entity in order to engage in such joint activity, it is unclear why the LLC actually formed by the two PE/VC funds (which under state law afforded its members protection from the LLC’s unpaid obligations)—rather than an imaginary “federal” “partnership-in-fact” created by the court—wouldn’t serve as the repository for such coordinated activity.
Because there is in fact no federal partnership law (i.e., all partnerships are formed under state, not federal, law), it is not surprising that the court’s “federal” “partnership-in-fact” (unlike the LLC which the two PE/VC funds actually did create) afforded no explicit equity owner-level protection against unpaid “partnership”-level liabilities.

- Possible extension of imaginary partnership approach to investments made in concert by several wholly independent PE/VC funds or by PE/VC fund along with co-investors. If this 2016 district court decision were to stand, there is a possible argument that investments by multiple investors in a bankrupt T (made in concert) should be amalgamated, i.e., treated as made by an imaginary partnership, even if made:
  
  (a) by two or more wholly independent PE/VC funds (or two wholly independent Ps) or

  (b) by a PE/VC fund along with one or more co-investors (e.g., one or more of the fund’s limited partners and/or one or more persons who are not fund limited partners).

  In such case, all of the co-investors who cooperate in making the investment (including even a 1% co-investor) could be viewed as GPs in an imaginary general partnership, with full unlimited liability for bankrupt T’s entire ERISA liability. See discussion at ¶1702.3.5.3 through ¶1702.3.5.7.

- Avoiding T shareholder vote (and SEC proxy rules) on second-step squeeze-out merger of T minority shareholders after P first acquires (generally by tender offer) substantial T stock. Where P (or S) has first acquired a portion of T’s stock and P then desires to squeeze out T’s remaining (minority) shareholders by merger, P generally prefers to avoid a vote of T’s shareholders (e.g., especially where T is a 1934 Act reporting company and hence required to comply with SEC’s proxy rules). There are two circumstances where a vote of T’s shareholders can be avoided:

  - First exception: Delaware §253(a) and similar exceptions in other states. Most state laws contain a long-standing exemption allowing a short-form merger—without any T shareholder vote—between a parent (here P or its subsidiary S, whichever has acquired sufficient ownership of T’s stock) and one of its corporate subsidiaries (here T), with T’s minority shareholders receiving P stock, cash, or other consideration as specified in the short-form-merger agreement.

    The percentage of ownership that P (or S) must have in T in order to utilize the short-form merger procedure (without a T shareholder vote) varies from state to state (90% being the required percentage in Delaware). Thus, once P (or S) has acquired the requisite stock ownership in T by purchasing T stock (e.g., at least
90% in Delaware)—in a tender offer or in one or more negotiated stock purchases—P (or S) can (if such a short-form merger statute is applicable) merge with T without a T shareholder vote.

Where the acquisition is friendly and T has adequate authorized but unissued stock, T might also grant P (or S) a top-up option before P (or S) commences its tender offer for (or negotiated purchase of) T stock, giving P (or S) the right (and perhaps the obligation) to purchase from T (typically for a note) that number of new T shares which, when combined with the T shares acquired by P (or S) in the tender offer or negotiated purchase, will be sufficient to meet the state law threshold for a short-form merger (e.g., 90% in Delaware).

- **Second exception: Delaware §251(h).** Under a 2013 addition to Delaware law (as further amended in 2016), a vote of T’s shareholders (and hence a 1934 Act proxy statement) on a forward or reverse merger of T and P (or P’s subsidiary S) can be avoided where:
  
  (a) T (organized as a corporation) has more than 2,000 shareholders or is listed on a national securities exchange immediately prior to executing the merger agreement,

  (b) P or its corporate subsidiary (“AcquiringCorp”) makes a first-step tender or exchange offer for any and all T stock (although it is permissible for such tender offer to be conditioned on T shareholders tendering a minimum number or percentage of T's shares),

  (c) “Immediately following the consummation of the [first-step tender] offer,”’’ the T stock purchased by AcquiringCorp in “such [tender] offer . . . , together with the [T] 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 T’s charter), generally more than 50%,

  (d) all non-tendered T 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 T 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),

  (e) T is incorporated in Delaware, and

  (f) the merger agreement expressly permits or requires this procedure.

  “Rollover stock” means T shares covered by “a written agreement requiring such [T] shares to be transferred . . . to [AcquiringCorp] . . . in exchange for [AcquiringCorp] stock,” so long as such T shares have actually been transferred
to AcquiringCorp no later than “immediately prior to the time the merger becomes effective.”

The 2016 amendment made two salutary changes to §251(h):

(i) Before the 2016 statutory amendment, all non-tendering T shareholders were required to receive (in the squeeze-out merger) the same type and amount of consideration per share for their T stock as the tendering T shareholders (i.e., requirement (d) above but without the parenthetical exception for rollover stock which was added by the 2016 statutory amendment). However, after the 2016 statutory amendment to requirement (d), AcquiringCorp can now acquire T shares owned by one or more T shareholders (including T executives) “in exchange for [AcquiringCorp] stock,” even though all of T’s other shareholders receive cash for their T shares (both in the tender offer and in the squeeze-out merger).

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

(ii) After the 2016 statutory amendment, rollover stock is generally counted (along with tendered T stock) toward requirement (c)’s sufficient-T-stock-to-approve-the-merger test.

Especially where P is a new entity (formed by a PE fund to acquire T in an LBO), new P may (after the 2016 amendment) offer T executives (who will post-merger become key P executives) an opportunity to exchange their T shares for P shares tax-free (as part of P’s Code §351 formation and buyout of T), thus allowing such T executives to exchange their low tax basis T stock without CG recognition for higher FV P stock (which takes a post-merger low carryover tax basis from their old T stock).

- **Complexity of scheduling §251(h) transaction steps in compliance with state law fiduciary duty and federal tender offer rules.** After the 2016 Delaware amendment became effective on 8/1/16, there is complexity in scheduling P’s §251(h)-compliant two-step acquisition of T with (x) T executives receiving P stock and (y) other T shareholders receiving cash, in both cases in exchange for their T stock. For the reasons explained below, the best schedule would generally be as follows:

  1. P announces and then (after a 20-business-day wait, as required by the federal tender-offer rules) closes its cash tender offer for any and all T stock, but T executives to whom P is planning to offer P stock do not tender their T shares for cash.
(2) Immediately after tender offer closing P and such T executives enter into a written (rollover) agreement obligating P to issue P stock in exchange for such executives’ T rollover shares, calling for an immediate closing (e.g.) one minute or so after signing the rollover agreement.

(3) P and such T executives then (one minute or so after signing the rollover agreement) complete the exchange of P stock for T rollover stock (thus satisfying Delaware §251(h)’s requirement that the T rollover stock is actually transferred to AcquiringCorp no later than “immediately prior to the time the merger becomes effective”).

(4) The merger is then consummated immediately thereafter.

This tightly scripted time schedule is necessary in order to satisfy all the requirements of Delaware §251(h), state law fiduciary duty, and the federal tender offer rules:

(A) **P cannot acquire or contract to acquire T executives’ T stock before announcing the tender offer, or indeed probably until after tender offer completion.** T’s executives have a state law fiduciary duty to (i) maximize the consideration for T’s shareholders and to (ii) treat all bidders for T equally, which would certainly appear to be breached if one or more T executives were to join forces with P (by contracting to sell their T stock to P in exchange for P stock) before P’s tender offer for T had been announced, or indeed at any time before tender offer completion, since other bidders competing (or planning to compete) with P to acquire T may still be in the game and may still top P’s bid and engage in a bidding war to acquire T.

In addition, a T executive probably would not want to transfer or commit to transfer his T shares to P at P’s forthcoming tender offer valuation when another higher bidder for T may yet arise.

And P may well not want to acquire (or commit to acquire) the T executives’ T stock until P is certain P’s tender offer will be successful, so that P can complete its acquisition of 100% of T’s stock.

(B) **P cannot acquire or contract to acquire executives’ T stock while the tender offer is pending.** The federal tender offer rules prohibit P (after public announcement of the tender offer) from acquiring or entering into an agreement to acquire the executives’ T stock (or indeed anyone’s T stock) outside the tender offer until after the tender offer has expired.

(C) **P cannot make two simultaneous tender offers: a stock-for-stock tender offer for the executives’ T stock and a cash tender offer for the other T shareholders’ stock.** The federal tender offer rules prohibit P from offering disparate
consideration to T’s executives and T’s other shareholders in the tender offer, i.e., P stock in exchange for the executives’ T stock and cash in exchange for the other T shareholders’ stock, because SEC Rule 14d-10 requires that a tender offer afford “equal rights [for all shareholders] to elect among each of the types of consideration offered.” See discussion of Delaware law at ¶1702.8.3(4) and federal tender offer rules at ¶1702.8.1(2).

**Definition of 1934 Act registered company.** A company required to register a class of its securities with SEC under the 1934 Act is thereafter obligated to make frequent and complex SEC filings (e.g., annual 10-Ks, quarterly 10-Qs, periodic 8-Ks, annual proxy statements) and is then subjected to numerous SEC rules either prohibiting such 1934 Act registered company from taking certain actions or mandating that it take certain other actions.

Over the last several years there have been a series of changes in the rules for when an entity is required to become a 1934 Act registered company. We set forth below an up-to-date description of the rules as they now stand:

A company is required to register a class of its securities with SEC (and hence become a 1934 Act registered company) if such class of securities meets any of the following three tests:

1. A class of securities (debt or equity) listed on a national securities exchange, e.g., NYSE and Nasdaq Stock Market—1934 Act §12(b) company.

2. A class of equity securities (viewing different classes with substantially similar character and substantially similar rights and privileges as one class) with either 2,000 or more record holders or 500 or more non-accredited investor record holders, so long as the company has consolidated gross assets of at least $10 million (based on its consolidated balance sheet prepared in accordance with generally accepted accounting principles)—1934 Act §12(g) company.

---

3 A company determines the number of record holders:

- based on its “records...maintained by or on behalf of the issuer...in accordance with accepted practice,”

- but by also looking through “a deposit agreement or similar arrangement,” such as Cede & Co. (which is nominee for Depository Trust Co.) to Cede’s brokerage, banking, and other members,

- and also by treating “securities identified as held of record by a corporation, a partnership, a trust..., or other organization [e.g., a Cede member]...as...held by one person,...”

- except that the company must look through such custodian or entity where “the issuer knows or has reason to know that the form of holding securities of record [e.g., by a custodian or entity] is used primarily to circumvent” the 1934 Act record holder test (i.e., by reducing the number of record holders). SEC 1934 Act Rule 12g5-1.

4 SEC rules determine accredited investor status as of the last day of the company’s fiscal year.
In counting the company’s record holders for this purpose, the company can ignore:

(i) securities the equity holder received under an employee compensation plan in a transaction exempt from 1933 Act registration (such as SEC Rule 701, discussed at ¶1702.9.3)\(^5\) and

(ii) “securities issued pursuant to the 1933 Act §4(a)(6) [crowdfunding] . . . exemption, even if transferred” from the original purchaser to one or more new holders, until approximately 2 years after the end of the company’s first fiscal year when its GAAP assets exceed $25 million.

Of course, if a shareholder holds stock covered by these disregard rules and also holds stock not disregarded, these disregard rules would be irrelevant, because the shareholder’s non-disregarded stock would cause him to count as a shareholder.

A company which has registered under §12(g) can subsequently de-register if no class of its stock is then held (x) by 300 or more persons\(^6\) or (y) by 500 or more persons where the company’s GAAP assets have not exceeded $10 million on the last day of each of its three most recently ended fiscal years.\(^7\)

Until 4/12 the test for §12(g) registration had simply been 500 or more record holders (whether accredited or not, whether the stock was received under an exempt employee compensation plan or not, and whether the company was a bank, BHC, or S&L holding company or not) plus at least $10 million of consolidated GAAP assets. A company which had 500 or more shareholders and had already completed a 1934 Act registration before the 4/12 statutory amendment raised the bar is not permitted to invoke the post-4/12 registration rules in order to withdraw its 1934 Act registration (i.e., the company’s prior 1934 Act registration continues indefinitely even though the company has fewer shareholders than would require a post-4/12 registration), unless the company qualifies for the de-registration test (generally less than 300 shareholders) described above.

---

\(^5\)Generally including securities (A) received and still held by a service provider, former service provider, or family member, (B) issued by the service recipient, a related entity, its predecessor, or a company acquired by the service recipient, and (C) issued in substitution or exchange (including conversion or exercise) for securities otherwise eligible for this exclusion, so long as such securities have not subsequently been transferred to a holder not specified in (A) immediately above.

\(^6\)Where the company is a bank, BHC, or S&L holding company, this de-registration test is that no class of stock is then held by 1,200 or more persons.

\(^7\)The above described exclusions for (i) employee-compensation shares and (ii) crowdfunding shares (applicable in counting shareholders for the 2,000-or-500-shareholder registration test) are not applicable in counting shareholders for either the less-than-300-shareholder or the less-than-500-shareholder de-registration tests described in (x) and (y) above.
(3) A class of securities (debt or equity) as to which the company has made a
1933 Act registered public offering (although such a reporting company can,
after the first fiscal year as a reporting company, de-register if it is held by fewer
than 300 persons or fewer than 500 persons where the company’s GAAP
assets have not exceeded $10 million on the last day of each of its three most
recently ended fiscal years)—1934 Act §15(d) company. See discussion at ¶1702.8.6.

• **P shareholder’s private secondary resale of P restricted stock.** A holder of P
restricted stock (purchased from P for cash or received from P as consideration for
services rendered to P or received from P in exchange for T stock in P’s acquisition of
T, in each case under Reg. D or Rule 701) can resell such P restricted stock in a
secondary private placement (without 1933 Act registration) under any of three 1933
Act exemptions.

  - **1933 Act §4(a)(1½) resale.** There is a long-standing implicit exemption from 1933
Act §5 registration where a holder of restricted P stock resells such restricted stock
in a private placement to one or a few (generally) accredited investors, in which
case the stock continues to be restricted in the buyer’s hands.

    Although SEC generally applies Reg. D principles by analogy in determining
whether a secondary sale of restricted stock involves a private offering and hence
qualifies for the §4(a)(1½) exemption, SEC has never enunciated specific
parameters for applying the §4(a)(1½) exemption. Thus apparently:

    ▲ The case for such a secondary private placement is strongest if all buyers are
accredited investors, although it may be acceptable for a few non-accredited
investors (so long as sophisticated alone or along with a purchaser
representative) to participate (although likely substantially fewer than Reg. D’s
35 permitted non-accredited investors).

    ▲ If one or more non-accredited buyers are permitted to participate, such buyers
should receive substantial information about P, and perhaps even the same
information that would be required in a Reg. D private offering memorandum.

    ▲ No general solicitation or advertising is permitted, i.e., the seller (or the seller’s
investment adviser) must have a pre-existing substantive relationship with each
prospective buyer being solicited, and it is unlikely that a seller would be
permitted to elect a Rule 506(c)-type sale (which permits general solicitation
and advertising so long as all buyers are accredited investors).

    ▲ The seller should have held the restricted securities being sold for a substantial
period, perhaps at least 90 days, or perhaps longer, e.g., 180 days.
Thus, while the existence of an implicit §4(a)(1½) exemption is well accepted, SEC has not provided guidance on its contours and hence its requirements are vague.

- **1933 Act §4(a)(7) resale.** Because of the §4(a)(1½) exemption’s ambiguity, Congress in 2015 enacted 1933 Act §4(a)(7), which allows:
  - a holder of P restricted stock to sell such stock without 1933 Act registration,
  - to an unlimited number of accredited investors,
  - without any general solicitation or advertising,
  - so long as, where P is not a 1934 Act reporting company, the buyer(s) obtain specified information from P, and
  - so long as securities of the class being sold under §4(a)(7) have been outstanding for at least 90 days,

in which case the stock in the hands of the buyer(s) continues to be restricted.

- **Rule 144 resale.** SEC Rule 144, allows a holder of P restricted stock to resell such stock *publicly* without 1933 Act registration if such seller meets specified requirements—with more onerous requirements where the seller is (or has within 3 months been) a P affiliate—in which case the buyer receives unrestricted stock. However, Rule 144 is not limited to a public resale of restricted stock and can also be invoked by a seller who is not (and has not at any time during the 3 months preceding the sale been) a P affiliate for a private resale of restricted stock, so long as such seller meets the requirements for a P non-affiliate set forth in Rule 144, including:
  - the seller has a 1-year holding period for the stock being sold or 6 months if P is a 1934 Act reporting company, and
  - extensive information about P is publicly available if the seller does not have at least a 1-year holding period for the P stock being sold.

Where restricted stock is sold in compliance with Rule 144, the buyer receives unrestricted stock, which the buyer can generally publicly resell without 1933 Act registration, although the buyer in a sale effectuated pursuant to the 1933 Act §4(a)(1½) or §4(a)(7) exemptions (discussed above) receives restricted stock which

---

8Technically Rule 144 could also be used by a seller who is (or has within 3 months preceding the sale been) a P affiliate, but in such case one of the Rule 144 requirements is that the sale be effectuated through a broker or market maker without solicitation. In such case, the sale would be more properly categorized as a public Rule 144 secondary sale into the market than as a private Rule 144 secondary sale and hence the applicable rules are as described in ¶1702.9.5.3(2) dealing with an unregistered public Rule 144 resale.
cannot be publicly resold without either 1933 Act registration or an applicable exemption. Hence if a secondary sale can be structured to meet Rule 144’s requirements, the buyer would generally prefer that it be so structured.

Apparently no election between the three exemptions (§4(a)(1½), §4(a)(7), and Rule 144) need be made (by buyer or seller) at the time of the secondary sale. See discussion at ¶1702.9.5.3(3).

**Compliance with state securities laws.** In addition to compliance with the federal 1933 Act, any offering of a company’s securities—including primary sales by the company to existing or new shareholders, as well as secondary resales by any shareholder to third parties—must (absent federal preemption) also comply with the applicable securities (blue sky) laws of each state where:

- an offer to sell securities originates,
- an offer to sell securities is directed, or
- a sale of securities occurs (i.e., where the act occurs that creates an irrevocable contractual commitment).

Where federal preemption applies, a state is prohibited from requiring anything more than form filing plus a fee. In general, the following types of offerings are covered by federal preemption:

- a Rule 506 private offering,
- an offering of securities listed on NYSE, Nasdaq Stock Market, or any other national securities exchange designated by SEC (or any security of the same issuer that is equal or senior in priority to a security so listed), whether or not such offering is registered under the 1933 Act (no form filing or fee can be required),
- a 1933 Act §4(a)(7) secondary private offering,
- a Reg. A Tier 2 offering, and
- a 1933 Act §4(a)(6) crowdfunding offering.

Most states have an exemption (although some impose additional conditions) for the following types of securities offerings:

- a Rule 505 offering and
- a Rule 701 offering.

The following types of securities offerings typically require more extensive state compliance:

- a Rule 504 offering,
• a 1933 Act §4(a)(2) offering outside Reg. D, and
• a 1933 Act registered offering of securities not listed on a national securities exchange (unless equal or senior in priority to a security of the same issuer which is so listed). See discussion at ¶1702.9.6.

• ... and much, much more.