Message from the Chair

Dear Committee Members and Friends:

I'm happy to report that after much planning by our committee leadership, and with the help and contributions of many of you, the much anticipated ABA Business Law Section Spring Meeting takes place this week from April 16th to the 18th in San Francisco! The Committee is involved in a number of interesting CLE programs and other substantive meetings and events. I wanted to highlight a few of these in advance so that you can plan accordingly and make the best use of your time. Please see the enclosed meeting schedule and subcommittee reports for a full schedule of events.

We are pleased to again have Houlihan Lokey as the sponsor for this year's dinner and thank Houlihan for its support! The dinner is scheduled for Thursday, April 16th, at 7:30PM at the very popular Scala's Bistro. Attendance is limited to 50 registrants and we expect the dinner to sell out. So, please book your reservations in advance.

We will hold a full meeting of the Private Equity and Venture Capital Committee on Thursday, April 16, 2015 from 1:00PM - 2:30PM. At this main meeting Youmna Salameh and Robert Rosenberg from Houlihan Lokey will provide a market update and discuss the role of financial advisors in PEVC transactions. There will also be short presentations on both B Corporations and the Delaware Rapid Arbitration Act. This main meeting is also a great opportunity to get caught up on committee wide business and will include a report from each of our Subcommittee chairs.

Our Committee is involved in several CLE programs in San Francisco and we are the lead sponsor of two of these. On Saturday, April 18th, at 8:00AM, we will host "Deal Point Considerations in Venture Backed M&A". This panel will be moderated by Jessica Pearlman, Partner at K&L Gates, and will include Glenn West, Partner at Weil, Gotshal & Manges; Sayre Stevick, Partner at Fenwick & West; and Joseph Conahan, Partner at WilmerHale. On Saturday, April 18th, at 10:30AM, we will host "The Current State of Venture Capital Documentation: What's Hot and What's Not". This panel will be moderated by Kathi Rawnsley, Partner at Lowenstein Sandler, and will include Jennifer Kercher, General Counsel of Google Ventures; Howard Zeprun, General Counsel of Trident Capital; and Stephanie Brecher, General Counsel of New Enterprise Associates. Thanks to Eric Klinger-Wilensky, Chair of the Programs Subcommittee, for all his efforts in putting these programs together. Please note in the schedule that we are also co-sponsoring other CLE programs that we believe should be of particular interest to our members.

We are also pleased to report the release of the most recent issue of Preferred Returns, the online publication of the Private Equity and Venture Capital Committee. The publication has a number of useful articles as well as information about the upcoming meeting. You may note that the annual survey of cases that is typically released as part of the spring issue of Preferred Returns is not included. That is because this year's survey has been accepted for publication in The Business Lawyer for later this year. Special thanks to Lisa Stark, Chair of the Venture Capital Jurisprudence Subcommittee, for all her efforts in putting this issue of Preferred Returns together as well as leading the significant effort on this annual survey. This is a great accomplishment for our Committee and we will all
I look forward to the annual survey when it is published!

Our Committee has a number of exciting initiatives underway. As always, we welcome input and participation from all of you as we tackle a number of projects. The more involvement and participation we have, the more useful and relevant our content and programming will be for all of our members. Feel free to contact me any time with your ideas and suggestions. Also please note that while we hope you are planning to attend in-person, if you are unable to be in San Francisco, you will be able to join certain meetings by teleconference.

I look forward to seeing you in San Francisco!

Jon Gworek  
Chair, Private Equity and Venture Capital Committee

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**Featured Articles**

**A Tale of Two Entities: Tax Considerations for Choosing the Proper Investment Vehicle - The Corporation and the LLC**  
*By Jerome Schwartzman*

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Below, I discuss some of the factors that may assist you in being able to say with hindsight, it was the best of legal entities.

Read more...

**Conversions of Limited Liability Companies to Corporations in the Context of Venture Capital Financing: Practical Considerations & Drafting Issues**  
*By Helen Reeves*

The initial legal entity that is chosen by an entrepreneur can have significant ramifications on the future financing opportunities of the business. For the typical entrepreneur deciding which entity to choose, the choice usually comes down to a corporation or a limited liability company ("LLC"). Many founders elect to form an LLC to take advantage of the tax flexibility LLCs provide. *(For more details on the tax flexibility of LLCs, please see the excellent article by Jerome Schwartzman also included in this issue of Preferred Returns).* When an early-stage business seeks investment from professional investors, founders often find that such investors will condition their investment on the conversion of the entity from an LLC to a corporation. The purpose of this article is to outline the business implications and drafting challenges practitioners may face when converting an LLC to a corporation in the context of a venture-capital fundraise.

Read more...

**Differences between UK and US Venture Capital Transactions**  
*By Steve Wilson and Simon Jones*

Venture capital is very familiar to start-up and emerging businesses on both sides of the Atlantic. Whilst Silicon Valley is without doubt the birthplace of venture capital and continues to dominate the globe in terms of funds committed, Europe's VC industry has developed into a significant player in the global support of entrepreneurs. Indeed, even the UK government is now seeking to establish its own funds and encourage entrepreneurialism in an attempt to secure success stories for the future. Although venture capital investments are essentially the same type of transaction in the US and the UK, certain elements and approaches are distinctly different and can often cause confusion or unnecessary dispute when applied across borders. This note is aimed at providing a high level overview of some of the key differences between approaches to venture capital transactions in the two jurisdictions.
Switzerland: New Impediments for Dividend Recapitalizations
By Oliver Blum

Private equity firms often seek to recapture part of their investment by way of a dividend from the portfolio company; in particular by way of having the portfolio company borrow money to fund the dividend (dividend recap). Under recent decisional law, dividend recapitalizations have become significantly more difficult in Switzerland.

As is probably the case in most jurisdictions, a Swiss company may distribute dividends only against balance sheet surplus. Any formal dividend distribution will accordingly reduce the balance sheet surplus. As a general matter, constructive dividends will also have that effect, a "constructive dividend" being any disbursement of the company for the benefit of an affiliate (other than a direct or indirect subsidiary of the company) which is not at arm's length.

Committee and Subcommittee Reports and Schedules

Angel Venture Capital Subcommittee

The subcommittee will hear a brief presentation from Mark Hiraide of Petillon Hiraide LLP on the current state of crowdfunding at both the federal and state level and discuss the viability of crowdfunding as a means of seed stage financing. Meeting Date: Thursday, April 16, 2015; Time: 2:30 to 3:30PM, Chair, Jonathan Gworek.

International Subcommittee

At each of our meetings, we invite participants from various jurisdictions around the world to share developments of interest in the law (both statutory and case law) or in practice which impact the private equity and venture capital community. Each presentation is short (less than 10 minutes) and may result in a group discussion on issues of interest. We also will have a market update presentation from Pitchbook, examining activity and trends in cross border deals over the last 12 months. Meeting Date: Friday, April 17, 2015; Time: 2:30 to 3:30PM, Meeting Co-Chairs, Samantha Horn; Partner; Stikeman Elliott LLP; Toronto, Ontario, Steve Wilson;Partner; Osborne Clarke; Palo Alto, CA.

Private Equity and Venture Capital Jurisprudence Subcommittee

Private company acquisition agreements frequently contain various mechanisms by which the purchase price may be adjusted post-signing in the form of earn-outs, escrow holdbacks, indemnification, contingent payment provisions and releases. Recent decisions suggest that practitioners should be mindful when drafting purchase price adjustment provisions because some common forms may be ineffective for the intended purpose. The subcommittee meeting will focus on drafting tips for structuring purchase price adjustments in light of recent case law, including Cigna Health and Life Insurance Company v. Audax Health Solutions, Inc. We will be joined by Jessica Pearlman of K&L Gates LLP and Pamela L. Millard of Potter Anderson & Corroon LLP: Meeting Date: Friday, April 17, 2015; Time: 11:00-12:00 a.m., Chair, Lisa R. Stark, K&L Gates LLP.

Venture Capital Transactional Documents and Issues Subcommittee

The subcommittee will hear a brief presentation from James Honaker of Morris, Nichols, Arsht & Tunnell LLP on best practices in executing down-round financings in light of recent Delaware case law, including the benefits of a properly conducted rights offering. Meeting Date: Friday, April 17, 2015; Time: 1:30 to 2:30PM, Chair, Jon Gworek, Morse, Barnes-Brown & Pendleton, P.C.

Private Equity and Venture Capital Funds Subcommittee
Benedict Kwon will speak regarding the regulatory considerations that are relevant to forming a venture capital fund (including securities law, the Investment Advisers Act of 1940, Investment Company Act of 1940, and tax considerations). Muhammad Akram will address fund administration matters that are relevant to operating a venture capital fund. **Meeting Date: Saturday, April 18, 2015: Time: 2:00 PM - 3:00 PM,** Chair, Benedict Kwon, Partner, Stradling Yocca Carlson & Rauth

Full Committee Meeting

At this meeting we will discuss the various initiatives of the committee and hear reports from each of the subcommittees. We also have on the schedule presentations from Houlihan Lokey on the role of investment advisor; Rick Alexander of Morris Nichols Arsht & Tunnell on B Corporations; and Blake Rohrbacher of Richards Layton & Finder P.A. on the Delaware Rapid Arbitration Act. **Meeting Date: Thursday, April 16, 2015; Time: 1:30 p.m.-2:30 p.m.,** Chair, Jonathan D. Gworek.

Articles and Authors Needed

The Committee is collecting articles for future newsletters which are circulated to our members worldwide. Please send your submissions to Lisa Stark at lisa.stark@klgates.com.

Articles should be 1500 words or less, and on any topic of interest to practitioners in the private equity and venture capital sectors. From short scholarly articles, to practice tips, reviews/summaries of a Section program, life in the trenches, interesting pro bono projects, humorous looks at life and the law, or even how you balance work and personal life. We appreciate your help in making this newsletter a success.
A Tale of Two Entities: Tax Considerations for Choosing the Proper Investment Vehicle – The Corporation and the LLC

By: Jerome Schwartzman

It was the best of legal entities; it was the worst of legal entities. Unfortunately, as with the French Revolution, we often don’t know whether it was the best, or worst, until we have the benefit of hindsight (and, even then, it may depend on where your neck is when the guillotine drops).

Below, I discuss some of the factors that may assist you in being able to say with hindsight, it was the best of legal entities.

Introduction

The primary considerations for choosing the appropriate legal entity for a new venture include:

1) minimizing overall income taxes to the entity and its owners;
2) the availability of tax losses;
3) compensating management (including incentive compensation);
4) taxation of distributions;
5) financing the entity’s operations;
6) converting the entity to a different tax status; and
7) exiting the investment.

My personal perspective is that the limited liability company (“LLC”) generally provides the most efficient and flexible tax structure for commencing a new investment. This is because an LLC may provide the lowest overall taxes to the entity and its owners. In addition, it allows the owners to immediately utilize tax losses from the venture and allows structuring of incentive compensation that may be taxed to individual owners at a lower tax rate. Moreover, it allows for the tax-free distribution of cash and allows for the tax-free conversion to “C” corporation status. Finally, an LLC is not only easy to exit, but may provide the seller additional proceeds as a result of the nature of the LLC structure.

Despite my personal perspective, the aim of this article is to impart enough basic tax wisdom to assist practitioners in advising their clients on the most appropriate vehicle, in conjunction with legal (see Helen Reeves’ excellent article, ABA to insert reference), regulatory and other pertinent considerations.

1 Mr. Schwartzman is a director at Houlihan Lokey in New York, NY.
Basic Income Taxation of Corporations, LLCs and Their Owners (for those of you who inadvertently missed that class in law school)

The major distinction between the corporation and the LLC is that corporate earnings are taxed twice, while LLC earnings are taxed only once. However, this assumes that corporate earnings are distributed to the owners and ignores certain quirky state tax regimes that impose entity-level taxes on LLCs.

The Corporation

United States tax law imposes what is known as “double taxation” on corporate earnings. That is, the corporation’s income is taxed at the entity level, and is then taxed again when the corporation’s earnings are distributed to its shareholders in the form of dividends. As a result, the overall effective tax rate for corporations is the federal and state taxes at the corporate level, plus the shareholders’ federal and state tax rates on the dividends. As an illustration, the effective tax rate on $100 of corporate earnings would be 55%. This results from the 40% federal and state taxes on $100 of corporate earnings, leaving $60 to be distributed as dividends. That $60 is then taxed at 25% (federal and state), or $15, so the total taxes on the $100 is $55 ($40 corporate level and $15 shareholder level). This is an illustration based on assumed, but reasonable, tax rates.

If the corporation generates tax losses, which is common in the beginning years of a new or highly leveraged venture, those tax losses can generally be carried forward for 20 tax years to offset future earnings of the corporation. The losses cannot be used by the shareholders, so the shareholders obtain no current benefit from these tax losses. If there is a more than 50% change of control, which may occur as a result of sale of the corporation or as a result of serial equity financings, the corporation’s ability to use the tax losses to offset its taxable income tax losses may be severely limited.

A shareholder’s tax basis in his stock is used to measure the shareholder’s gain or loss on disposition or liquidation. The shareholder’s tax basis in his stock is the price paid for the stock (or the tax basis of assets contributed to the corporation) and typically does not change over time.

The Limited Liability Company

The LLC is a relatively new entity in the US, with the first LLC statute adopted by Wyoming in 1977. For income tax purposes, LLCs are generally taxed as partnerships, though they may elect to be taxed as corporations. If owned by a single member, LLCs are generally disregarded for income tax purposes. For example, an LLC wholly-owned by an individual would be treated as a sole proprietorship; if owned by a corporation, it would be treated as a division of the corporation for income tax purposes.
Generally, LLCs/partnerships do not pay income tax. Instead, they report their income on partnership income tax informational returns, and the members/partners pay tax on their pro rata portion of the entity’s taxable income. As an illustration, if an LLC had two 50% members and generated $100 of taxable earnings, it would allocate the earnings $50 each to the members. The members would pay tax based on their federal and state/local tax rates. For example, if one member lived in Florida, she may pay 40.5% federal tax, but no state income tax because Florida does not impose state personal income tax. If the other member lives in New York City, he would pay the federal rate, as well as New York State and New York City taxes. I note that some states impose entity-level taxes on LLCs/partnerships.

Significantly, to the extent the earnings are distributed to the members, they would not be taxed again. Overall, the effective tax rate of the LLC earnings may be less than the same earnings generated by a corporation because the LLC earnings are only taxed once, at the owner level. That being said, this comparison assumes distribution of earnings, though many early stage businesses may choose to re-invest the earnings in the business (or pay down debt) rather than distribute them to the owners, which should also be taken into account.

If the LLC generates tax losses, which is common in the beginning years of a new venture, those tax losses are allocated to the members and the members can use them on their respective tax returns, subject to certain limitations.

An LLC member’s tax basis in his membership units is used to measure the member’s gain or loss on disposition or liquidation. The tax basis is the price paid for the units (or the tax basis of assets contributed to the LLC). One benefit of an LLC/partnership is that the tax basis may increase over time. This is because the member’s tax basis is increased for earnings allocated to the member, though reduced by distributions. In the example where a member is allocated $50 of taxable earnings, the tax basis increases by $50. If, as provided in many LLC operating agreements, up to 50% of allocated earnings are distributed to enable the owners to pay cash taxes, the tax basis would be reduced (in this example by $25, or 50% of the $50 allocated earnings), so the net increase to basis for that year would be $25. As a result, a member’s tax basis in her stock may increase substantially by the time of exit. Accordingly, the gain on exit would be lower.

Many private equity funds do not invest directly in LLCs if they have tax-exempt or foreign limited partners. This is because tax-exempt investors generally prohibit direct partnership income, which may impact their tax-exempt status, and foreign investors do not want direct US partnership income, which may require them to file US tax returns, which they avoid like the plague. With this limitation, private equity investors often invest in LLCs through “Blocker Subs,” which are corporations that hold the LLC investment.

I have not discussed “S” corporations, which are corporations that elect to be taxed on a flow-through basis. While the flow-through nature of the S corporation makes it similar to the
taxation of LLCs/partnerships, they are not the same. I would generally choose an LLC over an S corporation. Some of the limitations on S corporations are the 100 maximum number of shareholders, shareholders must generally be individuals (not corporations or partnerships, though certain estates and trusts are allowed), and S corporations have a built-in gain period during which corporate-level tax is imposed on the sale of assets for ten years after conversion to S status. However, if an entity is already a corporation, it may generally be more tax efficient to achieve flow-through tax status by electing S status than by converting to an LLC.

**Compensating and Incentivizing Management**

Both corporate shareholders and LLC members are taxed on the compensation they receive for services rendered to their entities and the tax rates should be the same. Shareholders who provide services directly to their corporations are generally employees who are taxed on this compensation income (via Form W-2). Members of an LLC, on the other hand, are treated as partners who are taxed on their allocations of income (via Form K-1).

Both corporations and LLCs can incentivize employees with options to acquire equity, which very generally operate the same for tax purposes. They both can also issue cash bonuses based on the appreciation in value of the equity, known as Stock Appreciation Rights (or “SARs”) for corporations.

LLCs, however, have an additional tool for incentivizing management. An LLC can issue what is known as a “profits interest,” which may vest immediately or over time. Under IRS rules, a member who receives an unvested profits interest, can elect to be taxed currently (treating the taxable value as zero) and not to be taxed when the interests subsequently vest. By doing so, all future appreciation would be taxed at the much lower capital gains rate. While corporations can also issue stock that vests over time and the same election to be taxed currently is available, the stock would have to be valued (there is no presumption of zero value for corporate stock).

There are nuances related to employee benefits and self-employment taxes, which should also be considered when deciding whether to organize a venture as a corporation or as an LLC.

**Changing the Tax Status of the Entity/Financing Operations**

An LLC can be easily converted to corporate form. Under the IRS rules, the conversion can be done tax-free. If an IPO is considered, the LLC can be converted to corporate status tax-free as part of the IPO process.

Converting from corporate status to LLC status is generally taxable. As noted above, a corporation can elect S status if the objective is to achieve flow-through status for income tax purposes. However, for the 10-year period after conversion from “C” to “S” status, the S corporation would be taxed at the corporate level on any so-called built-in gain (value minus tax
basis) existing at the time of conversion. As a result of this rule, the shareholders of the S corporation generally could not offer a buyer a tax basis step-up on exit for a 10-year period after conversion from C corporation status. A corporate conversion to LLC status is generally taxable, but may be achieved in a relatively tax efficient manner if the corporation has sufficient tax losses. Depending on the ultimate objective in converting, other structuring alternatives may exist.

As a practitioner, I have often reviewed situations where an LLC (or S corporation) had converted to corporate status because of a proposed financing, including proposed equity investments. This was because the lender or investor preferred corporate status or, in the case of a proposed equity investment, could not invest in an S corporation (which generally cannot have corporations or partnerships as equity holders).

In many of these situations, the proposed financing or equity investment never materialized. However, the entity had already converted and could not undo the conversion. Accordingly, I caution practitioners to avoid converting LLCs to corporate status and to do so only when the financing source refuses other alternatives and no other financing sources are available. I also recommend waiting until there is a written commitment to provide the financing.

**Exiting the Investment**

One of the most important decisions regarding the choice of legal entity is the exit. That is often the “it was the best of legal entities, it was the worst of legal entities” moment. When shareholders of a corporation sell their corporate stock, they are generally taxed once on the difference between the consideration and their tax bases in the stock. The shareholders’ tax bases likely will be the same as on the day of incorporation or initial purchase of the shares. Individuals are taxed at the lower capital gains rate. In this situation, the buyer obtains no tax benefit for the premium paid over the corporation’s tax basis in its assets (that is, there is no step-up to the tax basis of the corporation’s assets).

If the corporation has tax losses, the buyer would benefit from them, though they would be subject to limitation as a result of the sale. Tax advisors generally advise sellers of corporations with NOLs to value the NOLs and to ask for additional purchase price based on the value of the NOLs. On the other hand, they advise buyers not to pay a premium for NOLs because they do not impact EBITDA and should be considered merely gravy (or cake, as the case may be).

On the other hand, the sale of LLC units may be much more beneficial to the members. First, although the business will likely be valued the same as a corporation (as a multiple of EBITDA), sellers of an LLC may ask for additional consideration because the buyer will obtain a tax benefit for the premium over the LLC’s tax basis in its assets. This is a result of the tax law that permits a buyer of an LLC (either in whole or in part) to step up the tax basis of the assets to FMV. If the tax benefit is material, the sellers may be able to negotiate additional consideration (there is no step-up on the purchase of stock of a subsidiary of a blocker corporation from a private equity
fund). Second, as described above, the LLC members’ tax bases in their units may have increased over time. This would occur if the earnings allocated to the members exceeded the cash distributions to those members. Overall, the exit from the LLC may result in additional consideration as a result of the buyer’s step-up and in less tax to the sellers because of the increase to their tax bases over time.

**Summary**

To summarize, the decision to use a corporation or LLC as a business vehicle depends on the assessment of numerous tax considerations, in addition to the legal, regulatory and personal desires of the clients. The tax advantages of the corporate vehicle are that corporations are well-established and compensation and financing may be simpler for practitioners who are more familiar with this structure. A corporation may also offer a buyer the benefit of tax losses that have accrued over the start-up phase of the business. The disadvantages are that earnings are subject to double taxation if earnings will be distributed, and tax losses cannot be used directly by the shareholders.

The tax advantages of the LLC vehicle are that earnings are only taxed once at the owner level, tax losses may be used directly by the owners, the owners’ tax basis in their equity may increase over time, and the owners may obtain additional value on exit as a result of providing a buyer with a tax basis step-up. The LLC is also very flexible and may be easily converted to corporate status, if required for equity or debt financing.

As you know, each situation has its own specifics facts and I recommend that you consult a tax advisor before deciding which legal entity to use.
Conversions of Limited Liability Companies to Corporations in the Context of Venture Capital Financing: Practical Considerations & Drafting Issues

Helen Reeves, Esq.¹

I. Introduction

The initial legal entity that is chosen by an entrepreneur can have significant ramifications on the future financing opportunities of the business. For the typical entrepreneur deciding which entity to choose, the choice usually comes down to a corporation or a limited liability company (“LLC”). Many founders elect to form an LLC to take advantage of the tax flexibility LLCs provide. (For more details on the tax flexibility of LLCs, please see the excellent article by Jerome Schwartzman also included in this issue of Preferred Returns). When an early-stage business seeks investment from professional investors, founders often find that such investors will condition their investment on the conversion of the entity from an LLC to a corporation. The purpose of this article is to outline the business implications and drafting challenges practitioners may face when converting an LLC to a corporation in the context of a venture-capital fundraise.

II. The Key Challenges

The complexity involved in converting an LLC into a corporation largely depends on the capital structure of the LLC. Legal practitioners should first review the LLC operating agreement to get a clear understanding of whether the capital structure presents any complicating issues. If the capital structure of the LLC is relatively simple (a single class of units of membership interest, for example), then the lawyer can breathe a sigh of relief; conversion of the LLC into a corporation will likely only hinge on filing the requisite documents (in the case of Delaware, a certificate of conversion). If, however, the operating agreement reveals a more complex LLC capital structure (such as multiple classes of units with different rights and privileges), the attorney would be well-advised to pay special attention to any (i) complex or shifting allocations of profits and losses, (ii) profits interest grants made as incentive compensation and (iii) special rights and privileges given to prior investors in the LLC. Each of these LLC structures are discussed below.

(a) Allocations of Profits & Losses; Personal Tax Implications.

An LLC can elect to be taxed as a partnership or as a corporation. In most cases when an entrepreneur selects an LLC as the initial entity for the business, the LLC will elect to be taxed as a partnership, which means that any income or losses generated by the LLC will be allocated to the owners of the LLC and reflected on such owners’ personal tax returns. Because early-stage companies typically operate at a loss in their growth years, many founders elect to form an LLC so that the losses of the business can be used to offset other personal income. Where an LLC has multiple owners with different personal tax needs, operating agreements can become quite complex, reflecting allocations that sometimes bearing little direct relationship to the equity ownership of the founders.

¹ Helen Reeves, Esq. is an associate in the Corporate & Finance Department of Frankfurt Kurnit Klein & Selz, P.C., a law firm located in midtown Manhattan. The focus of Ms. Reeves’ practice is advising early-stage and start up businesses, with a special emphasis on early-stage financing (seed, angel and venture capital). Ms. Reeves can be reached at hreeves@fkks.com. Finally, Ms. Reeves would like to give special thanks to Mr. Jerrold B. Spiegel, Esq. for his help in the preparation of this article for publication.

² For the purposes of this article, all references to “corporations” refer exclusively to c-corporations.
In the event that an LLC with a complex allocation structure is required to convert into a corporation, the members will need to understand that upon conversion all taxable income or loss of the business will be recognized and taxed at the corporate level and members will lose the flexibility in allocating income, loss and distributions. Practitioners should be sure to explain this to early stage clients. To the extent that founders are relying on certain allocations for their personal taxes, practitioners should encourage clients to speak with their personal accountants right away about the impact the conversion will have on their individual tax filings.

(b) Incentive Compensation: Profits Interests.

The granting of “profits interests” by an LLC is another potential complication to the conversion process. A “profits interest” is a membership interest in an LLC typically granted to an employee or service provider. These membership interests are also typically subject to vesting over time or upon the occurrence or non-occurrence of certain events. A profits interest entitles the grantee to share in the subsequent appreciation in value of the LLC after the grant date. Because the grantee of the profits interest would receive nothing if the LLC were liquidated immediately after the profits interest was granted, the grant of the profits interest is deemed to have a value of zero as of the grant date. The grantee is therefore not subject to any income tax at the time of grant (although the grantee would be responsible for capital gains tax upon the sale of the interest, subject to applicable holding periods). Entrepreneurs operating as LLCs often rely on profits interests as a tax-free way to grant incentive compensation to employees and consultants in lieu of non-qualified options (which are taxable as ordinary income on exercise).

Corporations cannot grant profits interests, nor is the capital structure of a corporation designed to accommodate such interests. As a result, converting an LLC that has outstanding profits interests to a corporation can present challenges that will require creativity in drafting and significant attention to detail. As a practitioner crafts the new capital structure for the corporation, he or she might consider creating a new class (or multiple classes) of shares to reflect the profits interest grants previously made by the LLC. These new shares might be structured as a separate class of common shares with economic rights that are junior in the waterfall to other common shares that are being issued to the founders (and to the preferred shares that will be granted to the venture capital investors). The goal in creating a junior class would be to reflect the economic intentions of the parties by mirroring the “reverse liquidation preference” of the profits interest as it existed in the LLC context. These provisions would need to be carefully drafted in the corporation’s certificate of incorporation, especially in light of any liquidation preference being granted to investors. Prior to the investment, practitioners should take special care to explain and, if necessary, negotiate with profits interest holders the terms of the junior class of common equity to ensure all parties understand the new preferences post-venture capital investment.

(c) Existing LLC Investors’ Rights & Privileges.

The LLC may have received prior equity financing, perhaps from an angel/seed investor, before the anticipated venture capital fundraise. Individual angel investors are often more willing to invest in LLCs because LLCs allow angels to use the start-up’s losses to offset other taxable income. However, in anticipation of the conversion of the LLC, practitioners should be sure to review the operating agreement for the rights and privileges granted to these existing LLC investors. Special attention should be given to what kind of liquidation preference (if any) was given to the existing LLC investors and how it will be translated into a corporate structure. Also, while
some operating agreements use similar concepts as certificates of incorporation, many of the rights and privileges that are typically reflected in a certificate of incorporation may not be included in an operating agreement. For example, the certificate of incorporation for the resulting corporation may need to address what, if any, protective provisions and/or anti-dilution protections will be granted to the existing LLC investors in the new corporation. Moreover, any rights and privileges that will be granted to the existing LLC investors may also need to be reviewed and considered by the venture capital investors to avoid surprises or delay in closing the new investment round. In this way, the conversion of the LLC to a corporation in the context of the financing may lead to expanded negotiations among the parties and require more complex draftsmanship.

III. **Summary.**

The first round of institutional financing is transformative for any early stage business. The conversion of the business from an LLC into a corporation will be significant from a tax and corporate perspective. Many of the corporate and tax flexibilities that made the LLC structure initially attractive may inadvertently create complications and result in the need for extended negotiations in the context of the conversion process. Practitioners in the early stage financing space who are working with LLCs that are converting into corporations should be on the alert and prepared to address bumps in the road as the process begins. By reviewing the LLC’s existing operating agreement, understanding any complexities in the LLC’s capital structure, anticipating the eventual conversion and thinking creatively about ways to mirror the economic intentions of the LLC’s members in the new corporation, practitioners should be able to smoothly guide their early stage clients to close a successful conversion and venture capital raise.
Differences between UK and US Venture Capital Transactions

By Steve Wilson (UK lawyer and Head of Silicon Valley office) and Simon Jones (UK lawyer – Bristol, UK) from Osborne Clarke: global law firm advising US clients on overseas legal matters.

Introduction

Venture capital is very familiar to start-up and emerging businesses on both sides of the Atlantic. Whilst Silicon Valley is without doubt the birthplace of venture capital and continues to dominate the globe in terms of funds committed, Europe's VC industry has developed into a significant player in the global support of entrepreneurs. Indeed, even the UK government is now seeking to establish its own funds and encourage entrepreneurialism in an attempt to secure success stories for the future. Although venture capital investments are essentially the same type of transaction in the US and the UK, certain elements and approaches are distinctly different and can often cause confusion or unnecessary dispute when applied across borders. This note is aimed at providing a high level overview of some of the key differences between approaches to venture capital transactions in the two jurisdictions.

Documentation and terminology

The following summarises the key documents that are involved in US and UK venture capital transactions and highlights the differences in terminology and approaches to how investments are documented.

US:

- **Stock Purchase Agreement** – this sets out the terms on which the investor agrees to purchase company stock, including representations and warranties and closing conditions. The investor will typically purchase convertible preferred stock while the management team will hold common stock.

- **Stockholders’ Agreement** – this agreement covers board composition, pre-emption rights on the sale of existing or issue of new stock, co-sale and drag-along rights.

- **Certificate of Incorporation/Registration or Certificate of Designation and By-Laws** – these are the constitutional documents of the investee company and set out stock rights, including dividend, liquidation preference, anti-dilution and conversion rights.

- **Investor Rights Agreement** – this agreement provides the investor with information rights, rights of first refusal on future funding rounds and registration/piggyback rights.
UK:

- **Investment Agreement or Subscription and Shareholders' Agreement** – this is similar to a combination of the Stock Purchase Agreement, Stockholders' Agreement and Investor Rights Agreement. The Investment Agreement sets out the terms on which the investor will agree to subscribe for shares in the company, including closing conditions and warranties, and also provides the investor with information rights, veto rights over certain actions of the company and the benefit of restrictive covenants given by key managers. The investor will typically subscribe for Preferred Shares while the management team will hold Ordinary Shares.

- **Articles of Association** – this is the key constitutional document of the company and sets out the rights attaching to shares, including voting, dividend, liquidation preference and pre-emption rights. The articles also typically include anti-dilution, tag-along/co-sale and drag-along rights. The document is required to be filed at the UK Company Registry and therefore is publicly accessible. It is therefore important to distinguish which terms should be included in this document (which remains a key transactional document) versus the Investment Agreement (which is a private contract between the parties).

- **Disclosure Letter** – whereas the Stock Purchase Agreement contains a schedule setting out exceptions to investor representations and warranties, in the UK general and specific disclosures to the warranties contained in the Investment Agreement are contained in a separate disclosure letter.

- **Employment / Service Agreements** – new agreements may be required to be entered into as a condition to closing in both US and UK transactions. UK employment agreements are materially different from the US offer letters and no employment-at-will concept exists across Europe.

**Registration Rights**

As a general rule in the US and the UK, equity in private companies may not be offered for sale to the public. Registration rights, contained within the Investor Rights Agreement, are a particular feature of US venture capital investments, which provide the investor with an ability to require the company to register stock in order to publically sell stock and create liquidity. Such rights take two forms: demand rights pursuant to which the company is required to seek the registration of the stock held by the investor with the US Securities and Exchange Commission; and piggyback rights, which require the company to include the investors stock as part of any future SEC registration. It is notable that any registration filed with the SEC will only extend to the stock specifically identified and will not automatically cover new stock issued post-registration.

In the UK, there is no similar, equivalent registration procedure, save for a public listing of a company's shares on the London Stock Exchange markets, which will create liquidity for the entire issued share capital of the company. However, as in both jurisdictions, all investors would
expect to be included in the decision to appoint of bankers/brokers and actively participate in the exit process.

**Representations and Warranties, Disclosure and Limitations on Liability**

US Stock Purchase Agreements typically contain a set of representations and warranties given by the company in favour of the investor. In the UK, investors usually only have the benefit of contractual warranties, however notably, key managers are generally required to provide warranties alongside the company. The consequence of this is that a breach of a representation results in a misrepresentation claim which is potentially more onerous than a claim for breach of warranties as it could lead to rescission of the agreement and damages calculated on a tortious rather than contractual basis.

The process of disclosure also differs significantly between the US and the UK. In the UK, disclosures set out in the Disclosure Letter take the form of general disclosures of publically available information (e.g. company registry searches) and specific disclosures, which although referenced against specific warranties, are explicitly stated as applying to all of the warranties. The Disclosure Letter is accompanied by a bundle of documents, the contents of which are deemed to be disclosed to the investor. In the US, specific disclosures against representations and warranties are set out in a schedule to the Stock Purchase Agreement and UK-style general disclosures are usually not acceptable.

Such disclosure typically follows a comprehensive due diligence exercise in the UK. Often investors will commission reports from professional advisors (market, legal, accounting, environmental and tax) as well as undertaking their own interviews with the managers. Warranty claims are materially less common and taking action against their own portfolio company and its managers is avoided at all costs. This compares with a lighter touch diligence in the US, although research around intellectual property is often key to value and decisions to invest.

In the UK, the liability for a breach of warranty is limited in several ways under the terms of the Investment Agreement. In addition to a de minimis claim hurdle requirement, the company's maximum liability is usually capped at the aggregate total amount of the investment being made and the managers' maximum liability is capped at usually 2-3 times annual salary. The investor is also prevented from bringing a claim for breach of warranty after an initial period of typically 1-2 years. In the US, such limitations on liability are uncommon.

**Investor Protections**

The approach taken to investor protections is broadly similar in the US and the UK. Investors in both jurisdictions will typically have the benefit of anti-dilution, pre-emption, drag-along, information, board composition and veto rights set out in the investment documentation.

In addition, the investor usually has the benefit of restrictive covenants given by managers (e.g. non-compete restrictions), which apply during the time they are employed by the company and for a period following termination of their employment. In the UK, restrictive covenants will be found both within employment contracts and Investment Agreements as restrictive covenants
contained in employment contracts are generally considered to be more difficult to enforce than similar provisions contained within an Investment Agreement. As a result, restrictive covenants contained in employment agreements tend to cover a period of up to 6 months post-termination but similar Investment Agreement provisions cover a period of between 1-2 years post-termination. In the US, although there is variation from state to state, the enforceability of such provisions is not generally linked to document they are contained within.

Incentivisation of Key Managers

In both jurisdictions, while incentivisation of key managers could be achieved through bonus schemes, it is generally preferable to incentivise such employees through equity as any increase in value should be taxable as a capital gain at a lower rate than income tax. As a result, managers should take equity or be granted options to purchase equity as early as possible to secure it at the lowest price possible. There are various tax efficient schemes available in both jurisdictions and local tax advice should always be sought to ensure that any equity incentivisation arrangements are set up in the most tax efficient manner possible.

Process

Finally, the legal part of deals is typically completed more quickly in the US. Part of the reason for this is the lighter touch diligence process, but also because of the widespread use of template investment documents prepared by the National Venture Capital Association. Similar documents exist in the UK but have typically only been used for very early-stage seed funding, resulting in varying versions (and quality) of documents prepared by funds and law firms.
By Oliver Blum

Private equity firms often seek to recapture part of their investment by way of a dividend from the portfolio company; in particular by way of having the portfolio company borrow money to fund the dividend (dividend recap). Under recent decisional law, dividend recapitalizations have become significantly more difficult in Switzerland.

As is probably the case in most jurisdictions, a Swiss company may distribute dividends only against balance sheet surplus. Any formal dividend distribution will accordingly reduce the balance sheet surplus. As a general matter, constructive dividends will also have that effect, a "constructive dividend" being any disbursement of the company for the benefit of an affiliate (other than a direct or indirect subsidiary of the company) which is not at arm's length.

When it comes to constructive dividends, loans to shareholders and their affiliates have to be examined with special care, because it is not self-evident that their terms comply with market conditions in all respects. Up until now, it has been commonly agreed that, if and to the extent the terms of a loan to shareholders do not satisfy the arm's length test (e.g. unusually low interest rate; lack of security where an independent third party would request collateral), the pricing difference to the "market loan" (e.g. difference between agreed interest rate and market rate; price of obtaining security) constitutes a constructive dividend. Only in those instances where both lender and borrower in fact do not intend the "loan" to be repaid (and, consequently, no loan in the legal sense exists), the entire principal sum must be qualified as a constructive dividend.

However, the Swiss Federal Court, the highest Swiss judicial instance, recently upheld a decision of the Zurich Commercial Court according to which the failure of a loan to a shareholder to satisfy the market test in any way results in the qualification of the entire loan as a constructive dividend even if the repayment of the loan as such is not in doubt\(^1\). As a consequence, the entire principal sum of a loan to an affiliate could qualify as a constructive dividend only because the loan agreement does not contain the financial covenants which a market loan in similar circumstances would usually provide for, or because the loan is not secured even though an independent third party would usually request this type of borrower to provide collateral. This has a far greater impact on the dividend capability than a treatment of only the pricing difference as a distribution.

In addition, both courts, from different angles, set the thresholds for market compatibility unrealistically high. In particular, the Federal Court seems to hold the view that loans to shareholders must as a general rule be secured by viable collateral in order to pass the market test.

In the case at hand, the auditors of a Swiss company were found to be liable because they had approved a dividend proposal of the board of directors which did not take into account the reduction of the balance sheet surplus by the outstanding loans to shareholders. Consequently, the Swiss Treuhand-Kammer, the professional organization of the Swiss audit firms, has been quick to issue new, restrictive guidelines for the assessment of the market compatibility.
of loans to shareholders, and Swiss auditors will likely take a conservative approach in this respect. While these guidelines are more differentiated than the market test which was applied by the two courts, it must still be expected that the terms and conditions of loans to shareholders which until now were usual for Swiss companies will often fail to pass this assessment and will thus be considered to reduce the balance sheet surplus in the full amount of their principal sum.

As a consequence, private equity investors with Swiss portfolio companies will have to carefully review the market compatibility of the outstanding loans on the balance sheet of their companies when assessing the possibility of a dividend recap.

Another area relevant for private equity investors which will be negatively impacted by this new practice is the exit from investments: M&A transactions frequently involve, or are immediately preceded by, restructurings of the company to be sold. From a corporate law point of view, such restructurings often constitute dividend distributions, in particular if the carve-out of parts of the business of the target company is intended. Just like any other dividend distribution, such carve-outs must avail themselves of available balance sheet surplus of the target company, and the lack thereof restricts the respective possibilities or even makes such carve-outs impossible. This is an aspect which private equity investors have to keep in mind when planning their exit from a Swiss portfolio company.

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1 Decision of the Zurich Commercial Court of January 20, 2014 (HG130015) and decision of the Swiss Federal Court of October 16, 2014 (BGE 140 III 533).