The recent cryptocurrency frenzy has generated much buzz about blockchain technology, and attorneys everywhere are scrambling to get up to speed on the underlying tech and its applications. However, rather than taking a deep dive into the bits and bytes, attorneys would be better served if they focus on how they and their clients can leverage the new technology, and prepare themselves for the risk, disruption, and opportunity that blockchain technology presents.1

Blockchain networks, distributed ledgers and smart contracts enable a radically different way of forming commercial relationships and executing transactions.2 Attorneys in virtually all practice areas must now start to engage with the wider blockchain ecosystem and explore related issues to better serve their clients, and to ensure that their practices remain relevant. The most forward-looking attorneys will consider how to leverage blockchain technology to grow their practices.

The media, thought leaders and entrepreneurs describe blockchain technology as the most important disrupter since the Internet. Now that blockchain has entered the mainstream, attorneys need to begin to understand and address the vagaries of this technology and the key issues that will impact their clients’ businesses, as well as their law practices. How do you best help your clients navigate the blockchain tech terrain, 2

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1 The author is actively engaged on a wide variety of blockchain-related matters and from time to time may have worked with or may work with organizations mentioned in this article. The author wishes to thank Lewis R. Cohen, Esq., for his careful review of this article, as well as Melanie Glitron, Esq., and Ron Quaranta, Chairman of the Wall Street Blockchain Alliance, for their thoughtful input.

2 For those interested in going back to the very beginning of blockchain, Satoshi Nakamoto’s white paper makes for a compelling read. Blockchain technology was invented by Satoshi Nakamoto in the development of bitcoin, the first ever decentralized digital currency.
rafting this letter with the snow coming down outside, it is hard to believe that it is April and our Spring Meeting is only a week away. I am looking forward to seeing many of you in Orlando – sans sweater, hat and gloves!

Our sponsors for this meeting are Houlihan Lokey, Symbiont, SecureDocs and Morris Nichols. Thanks to their generosity, we have an incredible dinner planned for Thursday evening at the Terrace of the Four Seasons Golf Club. There are still a few tickets available for purchase if you do not yet have Thursday dinner plans and would like to join us. Tickets can be purchased through the ABA website or onsite.

The theme for our meeting is “Blockchain and ICOs.” On Thursday, April 12, from 2:30-4:30 PM, we are sponsoring a program entitled “ICOs – What are they and what laws apply to them.” At our main committee meeting, we will hear from Andrea Tinianow, who spearheaded Delaware’s Blockchain Initiative, as well as from one of our sponsors, Symbiont, which is a leader in the blockchain technology space. Many of our subcommittees will be addressing blockchain as well, including a discussion at our Venture Capital Financing subcommittee meeting regarding the use of Simple Agreements for Future Tokens (SAFTs).

Our main committee meeting will take place on Thursday April 11, from 4:30-6:30 PM. In addition to the blockchain-related presentations from Andrea Tinianow and Symbiont, we will hear from Houlihan Lokey regarding market trends. Capping off the main committee meeting will be a mock oral argument, presided over by Vice Chancellor Glasscock of the Delaware Court of Chancery, regarding the validity of imposing a midstream pay-to-play.

Also at this meeting, we will be launching a new Private Equity and Venture Capital Dictionary Task Force. This Task Force, to be chaired by Jenna Nand and Jonathan Cardenas, will create a dictionary of terms used in the private equity and venture capital space. It is a great opportunity to increase your involvement with the committee and I hope many of you will attend. The inaugural meeting will be Friday, April 13, from 4:30-5:30 PM.

Information regarding our other subcommittee meetings and the three additional CLE’s we are sponsoring is included in this edition of Preferred Returns. Thanks, as always, to Brett Stewart for all of the hard work (on top of her day job!) she has put in to this edition.

See you in Orlando!

Best,
Eric

Eric Klinger-Wilensky
Chair

FOLLOW US ON LINKEDIN & FACEBOOK!

ABA Private Equity & Venture Capital Committee Social Media Pages

www.linkedin.com/groups/2395267
www.facebook.com/ABABLSPEVC
At our full committee meeting we will hear from Andrea Tiananow, who spearheaded Delaware's Blockchain Initiative, as well as from one of our sponsors, Symbiont, Houlihan Lokey and SecureDocs. In addition, Vice Chancellor Glasscock will preside over a mock oral argument on midstream pay-to-plays.

Toll-free dial-in number (U.S. and Canada): (866) 646-6488
International dial-in number: (707) 287-9583
Conference code: 1145265056

The Angel Venture Capital Subcommittee will host a CLE presentation on federal and state laws governing finder’s fees, potential legislative changes to finder fee limitations and practical solutions for early stage companies in lieu of its usual meeting.

Due to this being an accredited CLE presentation, no dial-in will be provided.

Our international subcommittee meeting will feature a discussion on ICOs in the European context.

In light of the increased popularity of - and the regulatory uncertainty surrounding - ICOs and token sales as methods of capital raising by private companies, the subcommittee will discuss the Simple Agreement for Future Tokens (SAFT) and consider the benefits and drawbacks of the SAFT framework. The subcommittee will also provide a brief overview of the recently released updates to the NVCA venture capital model financing documents.

Looking Ahead to Orlando

What the Committee Has in Store

>> Continued on Page 4
The meeting will have two major segments; as part of the “Recent Developments” series, a panel discussion on “Trump Tax Reform and Private Equity M&A” discussing how the recent changes to our tax code might effect Private Equity M&A and our practices. Then, as part of the “The Experts Speaks” series, Glenn West of Weil, Gotshal & Manges LLP will discuss “Private Equity Deal Issues that keep Recurring – Why are we not learning the lessons from Caselaw.” See page 19 for more details.

Toll-free dial-in number (U.S. and Canada): (866) 646-6488
International dial-in number: (707) 287-9583
Conference code: 4027564183

The Fund Formation Subcommittee will discuss regulatory updates in the European fintech space and will also discuss the U.S. regulatory aspects of creating a cryptocurrency focused investment fund.

Toll-free dial-in number (U.S. and Canada): (866) 646-6488
International dial-in number: (707) 287-9583
Conference code: 6304783957

Our jurisprudence subcommittee will provide a CLE program entitled ‘Survey of Recent Judicial Developments Pertaining to Private Equity and Venture Capital’ in lieu of its regular meeting. See page 5 for more details.

Due to this being an accredited CLE presentation, no dial-in will be provided.

Join our PE&VC Dictionary Task Force for their inaugural meeting as they undertake the challenge of creating a dictionary for the Private Equity and Venture Capital industry. The Task Force is looking for volunteers and is a great way to get involved in the Committee!

Toll-free dial-in number (U.S. and Canada): (866) 646-6488
International dial-in number: (707) 287-9583
Conference code: 4961649712

After a series of initial meetings discussing the scope and nature of the Task Force's planned publication, the Task Force has determined to move forward on a book focused on the Top 10 issues in governance of contractual business entities. The Task Force plans to discuss ideas for topics to include in the book, review a sample chapter and topic outline, and begin the task of assigning authors for individual chapters or topics. Anyone interested in participating is invited to attend.

Toll-free dial-in number (U.S. and Canada): (866) 646-6488
International dial-in number: (707) 287-9583
Conference code: 2527406387

ABA PRIVATE EQUITY AND VENTURE CAPITAL COMMITTEE LEADERSHIP LUNCH
CHICAGO, 2017
We have 4 fantastic CLE panels planned!

**ICOs – WHAT ARE THEY AND WHAT LAWS APPLY TO THEM?**
Thursday, April 12 (2:30 PM – 4:30 PM) | **Sebastian I-3, Level 1**

Panelists, including Brady Bohrman of Avalon Ventures, Rob May, CEO of Talla Inc., and Luke Cadigan and Al Browne from Cooley LLP, will examine a case study involving a decision to pursue an ICO as a funding strategy, the underlying business rationale for the financing strategy, and the legal issues examined along the way.

*Chair:* Jonathan Gworek, Morse Barnes-Brown & Pendleton, PC

*Co-sponsoring Committee:* Federal Regulation of Securities

**FINDER’S FEES: STATUTORY CHALLENGES FOR STARTUPS**
Thursday, April 12 (9:00 AM – 10:00 AM) | **Sebastian I-1, Level 1**

This program will cover federal and state laws governing finder’s fees, potential legislative changes to finder’s fee limitations, and practical solutions for early stage companies. This CLE is offered in place of our Angel Venture Capital Subcommittee’s usual meeting.

*Co-Chairs:* Emily Yukich and Matthew Kittay of Fox Rothschild LLP

*Co-sponsoring Committee:* Federal Regulation of Securities, Middle Market and Small Business, State Regulation of Securities

**ANALYSIS OF THE LATEST NVCA FORM DOCUMENTS**
Friday, April 13 (8:00 AM – 10:00 AM) | **Sebastian I-1, Level 1**

Panelists including Jon Gworek of Morse Barnes-Brown & Pendleton, Kelly Warrick, Chief Investment and Associate General Counsel at GE Ventures, and Jeff Wolters from Morris Nichols Arsht & Tunnell LLP will discuss the underlying rationale of many of the changes to the latest NVCA Form Documents, which include, for the first time, provisions specific to life sciences transactions.

*Chair:* Jonathan Gworek, Morse Barnes-Brown & Pendleton, PC

**SURVEY OF RECENT JUDICIAL DEVELOPMENTS PERTAINING TO PRIVATE EQUITY AND VENTURE CAPITAL**
Friday, April 13 (3:30 PM – 4:30 PM) | **Sebastian I-4, Level 1**

Our regular Jurisprudence Subcommittee Meeting will consist of a CLE-accredited discussion of recent judicial developments which are significant to private equity and venture capital, including cases relating to (i) liquidity events for venture-backed companies, (ii) the nature of preferred stock, and (iii) the fiduciary duties of portfolio company directors.

*Co-Chairs:* Lisa Stark K&L Gates LLP and Tom Mullen, Potter Anderson & Corroon LLP

*Co-sponsoring Committee:* Federal Regulation of Securities, Mergers and Acquisitions
# Schedule of Events

Business Law Section’s Spring Meeting | Orlando | April 2018

<table>
<thead>
<tr>
<th>Location / Dial-in Code¹</th>
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<tbody>
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<td>Dial-in codes listed below</td>
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<table>
<thead>
<tr>
<th>Thursday April 12, 2018</th>
<th>Location / Dial-in Code¹</th>
<th>Time</th>
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<tbody>
<tr>
<td>CLE Program: Finder’s Fees: Statutory Challenges for Startups</td>
<td>Sebastian I-1, Level 1 (No dial-in for CLEs)</td>
<td>9:00 AM – 10:00 AM</td>
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<tr>
<td>International VC &amp; PE Subcommittee Meeting</td>
<td>Panzacola F-4, Level 1 Conference code: 1145265056</td>
<td>11:00 AM – 12:00 PM</td>
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<tr>
<td>Committee Leadership Lunch (By Invitation Only)</td>
<td>Clubhouse Grille</td>
<td>12:00 PM – 1:30 PM</td>
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<tr>
<td>Venture Capital Financing Subcommittee Meeting</td>
<td>Panzacola F-4, Level 1 Conference code: 1145265056</td>
<td>1:30 PM – 2:30 PM</td>
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<tr>
<td>CLE Program: ICOs – What Are They and What Laws Apply to Them</td>
<td>Sebastian I-3, Level 1 (No dial-in for CLEs)</td>
<td>2:30 PM – 4:30 PM</td>
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<tr>
<td>Private Equity and Venture Capital Committee Meeting</td>
<td>Panzacola F-4, Level 1 Conference code: 1145265056</td>
<td>4:30 PM – 6:30 PM</td>
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<tr>
<td>Private Equity and Venture Capital Committee Dinner (Ticketed Event)</td>
<td>Tranquilo Private Dining Room, Four Seasons Orlando</td>
<td>7:15 PM – 10:00 PM</td>
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<tr>
<th>Friday April 13, 2018</th>
<th>Location / Dial-in Code*</th>
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<tr>
<td>CLE Program: Analysis of the Latest NVCA Form Documents</td>
<td>Sebastian I-1, Level 1 (No-dial in for CLEs)</td>
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<tr>
<td>Contractual Governance of Business Entities Joint Task Force Meeting</td>
<td>Wekiwa 8, Level 2 Conference code: 2527406387</td>
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<tr>
<td>Private Equity M&amp;A Joint Subcommittee Meeting</td>
<td>Sebastian L 2-4, Level 1 Conference code: 4027564183</td>
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<tr>
<td>Private Equity and Venture Capital Funds Subcommittee Meeting</td>
<td>Wekiwa 3, Level 2 Conference code: 6304783957</td>
</tr>
<tr>
<td>CLE Program: Survey of Recent Judicial Development Pertaining to Private Equity and Venture Capital</td>
<td>Sebastian I-4, Level 1 (No-dial in for CLEs)</td>
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<tr>
<td>Private Equity and Venture Capital Dictionary Task Force Meeting</td>
<td>Wekiwa 2, Level 2 Conference code: 4961649712</td>
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¹ Note: CLE Programs are not accessible by Dial-in.
steering clear of minefields and jumping on the brightest opportunities? Finally, and for the most ambitious attorneys, how do you establish blockchain legal practices that set you (and your law firms) apart and attract high value and exciting legal clients and matters?

This article seeks to provide a foundation for this exploration, including a roadmap with guideposts on significant areas for growth and exploration as well as an accompanying toolkit of resources, including links to articles, and suggestions for experts to follow on LinkedIn and Twitter.

GETTING STARTED

You don’t have to be a technologist to grasp the transformative nature of blockchain technology, you just need a little imagination.3 Picture a Google document that several parties to a transaction are updating at the same time. Now, imagine the very same scenario, but this time, Google is not involved. Instead, the parties’ computers are connected directly via a protocol (software) that both cryptographically secures the information and also enables the parties to review the document in real time and sign off without the need for a third-party administrator or trustee. Once signed off, the document is secure and cannot be changed unless all interested parties have approved it. If you can imagine that, you can imagine how blockchain technology will radically change the way we form commercial relationships and execute transactions, among other things.

Blockchain technology allows parties who normally would not trust each other to transact business directly, securely and efficiently, without the need for a trusted third-party intermediary. The parties review relevant information, including actual legal documents, online in real-time. In fact, every attempt of any party to change something in the shared system is recorded. When the parties approve the terms of the transaction, a permanent and immutable record of the deal is created, including an audit trail of who did what and when. The system can be designed so that only parties who are authorized can review and participate in the transaction. Once agreed upon, a permanent record of all that transpired is generated that cannot later be changed or otherwise altered.

The above illustration employs both distributed ledger and blockchain technologies. Although the terms are often used interchangeably, there is a distinction. While there can be numerous variations, generally with distributed ledger technology (DLT) there is no central administrator. Instead, information is replicated and shared among many different computers (known as “nodes”) that are linked together in a network. Each of these nodes validates the information in a proposed transaction and all nodes together arrive at a consensus regarding the validity (or lack thereof) of the proposed transaction before any data is stored. The term blockchain technology generally refers to a type of distributed ledger database that generates a growing list of append-only transaction records that are linked together cryptographically, which creates protections against later tampering and revision.

SMART CONTRACTS

Another important related concept is smart contracts. Perhaps no tech terminology has caused so much confusion, especially for lawyers. In blockchain parlance, smart contracts do not refer to legal contracts in any traditional sense. While a standard legal contract outlines the terms of a commercial relationship (usually one enforceable by law), a smart contract allows for the enforcement of some or all of the terms of that relationship using code that is “locked” into a blockchain record.4 In its simplest terms, smart contract code is decentralized software that allows for the automation of commercial relationships.

Consider when you pay your bills online. You input specific information into your bank’s interface, including the name of the payee, the amount to be paid, and the payment date. When the appointed date arrives, so long as you have enough money in your account, the bank automatically makes the payment using the information you input earlier. Of course, the online banking interface is not a smart contract because it is not connected to a distributed ledger (meaning it is dependent on a single party — your bank — to ensure that it actually does what you instructed). In addition, in this example, the money does not go from your bank account directly to the payee. Instead the money travels through multiple channels before it gets to the intended payee. But this gives you an idea of how a smart contract might work if it were part of a distributed ledger.

Smart contracts can be simple, or complex. The French insurance company, AXA utilizes a fairly straightforward smart contract to offer flight insurance. When an insured’s flight is more than two hours late, the smart contract stored on a blockchain

3 This article provides a helpful explanation about blockchain technology using a basketball analogy.
4 This article looks at smart contracts in the context of the transfer of real property.

>> Continued on Page 8
is triggered and a payment is made automatically to the insured.

A more sophisticated use of smart contracts is the stock ledger that Symbiont, the smart securities blockchain company, has developed. When shares are issued to stockholders via a stock ledger, the shareholders cannot sell or move the shares unless they have first satisfied the criteria related to the shares set forth in the corporation's governing documents. So, for example, if the company's stock has a two-year holding period and a shareholder attempts to sell her shares before the end of two-year period, the shareholder will be unable to move the shares to another stockholder. Similarly, if the company is authorized to issue 10,000,000 shares, the company will not be able to issue more than 10,000,000 shares.

PUBLIC VS. PERMISSIONED BLOCKCHAINS

Not all blockchain networks operate in the same way. Some blockchains are public, like Bitcoin or Ethereum, which allow anyone to download the software and connect to a single global network. Other blockchains are private or "permissioned," which means that only parties that have been vetted can join as a node on the network. And, just because some-thing is called a "distributed ledger," that does not mean the network is truly decentralized. A truly decentralized distributed ledger means that all nodes on the network have exactly the same rights, and no single node has super authority to make changes to the information once it has been recorded to the ledger. On some systems, certain nodes serve as "administrators" or "trustees." These nodes have been granted extra power and may have the ability to override what the other parties to the transaction have agreed to. They can change the rules. They can usually see all private data. And, even though they may be, and often are, a trusted party, their presence deprives the blockchain of truly decentralized status.

BLOCKCHAIN IN PRACTICE

Opportunities for attorneys seeking to provide guidance to clients in the blockchain space and examples of how attorneys can deploy blockchain technology to grow their practices.

Working with Blockchain Entrepreneurs

Blockchain entrepreneurs will often come to you with a dream and not much more. There is a lot of (mis) information regarding blockchain technology, so prospective clients may have unrealistic expectations about what the technology can do. These entrepreneurs will need legal counsel on many fronts, including when fundraising through the sale of blockchain-based tokens is involved, how to raise money without running afoul of the regulations promulgated by the U.S. Securities and Exchange Commission (SEC) as well as several other state and federal regulatory bodies.

As the attorney providing guidance and support, an ideal way to service these entrepreneurs would be to convene a multi-disciplinary group in your firm, comprising attorneys from several practice areas, including: business, securities, intellectual property, and others. Ideally, your firm would develop a toolkit for blockchain (and other) entrepreneurs that leverages the firm's strengths and could be customized for each client.

You will want to be creative and flexible when structuring a payment schedule. Perhaps your firm will be willing to be paid (at least in part) in cryptocurrency, like Bitcoin or Ether. Many blockchain entrepreneurs invested early in bitcoin and would welcome the opportunity to pay even a portion of their legal fees in cryptocurrency. Entrepreneurs are developing blockchain applications in almost every industry. No doubt, sometime soon, your mainstream clients will ask you to help with blockchain transactions, develop smart contracts to make their business more efficient or collaborate with others to generate new value and create new revenue streams by deploying blockchain technology. Your clients may also ask you to help them to transact business via smart contracts. They may want to create a smart contract or work with one that has already been developed. You will need to first discuss the terms of the deal with your clients. Next, you will need to review the computer code in the smart contract to make sure that it accurately reflects your client's expectations. Yes, lawyers (and/or their experts and/or colleagues) will need to be able to review computer code. They will need to consider the type of comfort they can give clients that the code correctly reflects the terms of a business arrangement written in standard legal prose. Of course, for the more enterprising attorneys and law firms, this could become an area of specialization which could, in return, become a source for referrals and additional fees.

Also, many new venture funds and hedge funds focused on blockchain and crypto-assets are seeking legal advice about structure, jurisdiction, etc. Lawyers need to be prepared for these opportunities. Perhaps this function overlaps within existing law firm expertise. All of the above also comes with tax implications, so attorneys should make sure to seek out taxation advice.

Here are key questions/issues to consider when advising clients considering blockchain:

- Is the blockchain public or private?
- If public, does your client know the identities of the parties to the transaction, or are they anonymous? If the parties are anonymous, help your client assess the additional risks that this could present.
- What is the mechanism for dispute resolution? Is it reasonable? It can be tricky to create effective dispute resolution mechanisms among parties who transact business anonymously.
- Is the smart contract a standard template or was it customized for the specific transaction? Has a code auditing firm reviewed the code?
for bugs and other vulnerabilities?

- Will your client be paid in fiat currency or cryptocurrency? If your client is paid in cryptocurrency, you will need to consider issues related to protecting against swings in the value of the currency as well as money laundering considerations.

**Distributed Ledger Shares and Forming a Corporation on a Blockchain**

In the summer of 2017, the State of Delaware enacted legislation expressly authorizing corporations to maintain their corporate records on a blockchain, including its stock ledger. Other states are exploring or have passed similar or identical legislation. Since that time, companies have begun to consider how to move their corporate records onto a blockchain. This is fertile ground for attorneys who wish to engage with blockchain-savvy companies.

Symbiont, for example, is developing a smart-contract application that lawyers can use to better manage their clients’ corporate governance activities through the entire lifecycle of the corporation, from incorporation to IPO. They can also use this platform as an opportunity to stay engaged with their clients and provide additional services that will lead to additional revenue streams. A number of other companies are developing suites of tools to help companies manage their business using blockchain tech.

Also, since Delaware’s legislation is geared toward new companies, traditional corporations that wish to maintain their corporate records on a blockchain will need to convert to a “distributed ledger share” model. Corporations will need legal guidance on how to do this.

You can help clients with this transition. If you position yourself as (and actually become) an expert, your clients will appreciate that you are staying current with the most innovative legal trends, and you will become a beacon to new clients that wish to take advantage of all of the benefits that accrue to companies that deploy blockchain technology.

**Capital Formation**

The immutability of a blockchain, coupled with the relatively easy access to capital through the sale of digital tokens (sometimes rather misleadingly known as “initial coin offerings” or “ICOs”, a term we seek to avoid) have been the impetus for many, many entrepreneurs to develop new, innovative blockchain-enabled applications in virtually every business sector, from banking and finance to healthcare to manufacturing. Behemoth Internet companies such as Uber and Facebook are facing challenges from competitors seeking to provide the same or similar services using blockchain-enabled decentralized business models.

Many of these blockchain-enabled applications utilize digital units (also referred to as tokens) that allow access to specific services, such as cloud storage or WiFi, or which can be exchanged for other tokens or digital currency. Notably, these types of tokens have often been bought not so much for the specific service associated with the offering, but rather for their speculative value, although the SEC and other regulators have been clamping down on this practice.

Nevertheless, because so many tokens have appreciated in value, there has been a torrent of token sales and increasing demand for new and different types of tokens. In fact, according to some estimates, about $5 billion in funds were raised through the sale of digital tokens in 2017. This phenomenon led SEC Chairman Jay Clayton to urge caution on the part of investors, compliance on the part of issuers and, significantly, a rebuke and warning to attorneys who advise clients regarding whether or not token sales implicate federal securities laws.

Sooner or later, clients will ask how they can raise capital through an “ICO”. The overarching question will be whether the issuance and the tokens constitute a “security” in any jurisdiction in which they are offered. This is not always clear cut. The Howey test is the standard for making a determination of whether a particular commercial arrangement constitutes an “investment contract” and, thus, a security. Recent cease and desist orders, testimony and statements from the SEC, the U.S. Commodities Futures Trading Commission (CFTC) and state enforcement agencies provide some guidance about issuing tokens.

When you get your first token sale transaction, don’t go it alone! Consult with one or more blockchain attorneys who have substantial experience working on token sale matters. They can serve as “sherpas” for attorneys who are at the beginning of their journey in this space.

Clients may also turn to you for advice as they consider investing in token offerings. You and your client will want to discuss appropriate corporate governance models and investors’ rights with regard to token offerings.6

**Blockchain Technology and the Finance Sector**

The financial sector would like blockchain technology to fix the problem of duplication and reconciliation of administrative processes and data. The adoption of a distributed ledger solves inefficiencies that financial institutions face in the coordination of their back-office systems. Some estimates of financial market cost savings with blockchain are $20 billion per year.

For example, in the syndicated loan market, a dozen banks will receive the same fax about a loan. Each bank enters the same data contained on that fax into their internal ledgers, and then they reconcile any discrepancies. Blockchain technology solves the need for this duplication-and-reconciliation process by creating a distributed ledger: a single record of financial transactions that are shared among multiple institutions.

5 The author of this article would be happy to make referrals to attorneys with blockchain experience.
6 This excellent article explores the governance deficiencies of ICOs.
7 This section borrows heavily from Adam Krellenstein’s excellent blog post which can be found here.
One solution might be to appoint a single entity to maintain a master set of records for the entire market to use. However, this third party would then be trusted to keep all records accurately, securely and confidentially. A blockchain, by contrast, allows multiple parties to share records in a manner that all can trust as valid. For a distributed ledger to work, a distributed, decentralized system is needed, one that multiple, independent parties can use to share information – but where there is a single source of truth.

Investment management company Vanguard announced in December 2017 that it is collaborating with the Center for Research in Security Prices and Symbiont to simplify the index data sharing process through blockchain. Investment managers will be able to use the blockchain-enabled platform to instantly distribute, receive, and process index data, to achieve better benchmark tracking and cost savings.

Blockchain solutions are also being developed for structured finance. Blockchain technology in the securitization market could lower risk and lead to greater investor interest, according to a study conducted by Deloitte, resulting in improved prices, volume, and spreads. The report explains that “[w]ith better and more transparent information, regulatory compliance could also be simplified and market failures would become less likely.”

**General Business Advice, Advising Boards**

Many attorneys act as sounding boards for their clients on general business issues. Other attorneys serve as directors on their clients’ corporate boards or advise corporate boards of directors. Discerning attorneys add value when they assist their clients to consider all of the issues and opportunities that blockchain technology presents.

The business opportunities would include using blockchain technology to develop bold, new revenue streams, platforms, and ecosystems. The most concerning and prevalent risk that traditional companies face is that of disintermediation, especially for companies that create value for their customers by serving as the middlemen in business transactions.

Last year, overall funding for blockchain projects exceeded $6 billion. With each passing day, entrepreneurs and mainstream companies are considering how to use blockchain technology to monetize illiquid assets such as oil and gold ore, even the Rain Forest in Brazil, and leverage and revitalize assets which had long been dormant, such as the KodakCoin, which will allow token holders to store photos on a blockchain. Blockchain technology is being used to determine the provenance of diamonds; track vehicle titles; make supply chains more efficient; and healthcare more cost-effective with better outcomes for patients; and even address environmental risks such as biodiversity loss and ecosystem collapse; and the list goes on ad infinitum.

Attorneys need to recognize that blockchain technology has entered our daily consciousness. It is shaping the way we think and talk about not just business transactions, but everything that we touch that is relevant to our daily existence, from the food we eat, the products we consume, the way we interact with government, to the way we engage with social media. Attorneys who begin to explore blockchain and become part of the conversation will be ahead of the curve.

**In-house Applications**

Enterprising lawyers and law firms should explore how to deploy blockchain tech to create new efficiencies and revenue streams within and across their entire law practice. Attorneys across most law practices work on documents collectively with multiple parties. Reconciling versions can be a time-consuming and costly process. This is exactly the type of activity that blockchain technology addresses elegantly and efficiently.8

Here are additional blockchain applications that attorneys should take note of:

- The city of Berkeley plans to issue a public bond using blockchain technology.
- Burlington, Vermont is developing a blockchain-enabled land registry.
- Registries are being developed for the blockchain to establish ownership and management of intellectual property, including Ujo Music where musicians can publish their music on the blockchain and consumers pay to download the song with Ujo tokens. Another is KodakCoin for photographs.
- Innovative applications are in development to bring greater transparency, security and efficiencies to supply chains across many sectors.
- IBM and Maersk are developing an electronic shipping platform.
- Boeing is examining the use of blockchain for resolving aviation cybersecurity concerns.
- Real estate transactions are moving onto the blockchain. Greenbriar Capital, a Canadian real estate developer launched Realblock, a blockchain enterprise to address the complex legal, title, due diligence and escrow aspects of a complete transaction, solving a comprehensive solution by incorporating all the players in the transaction.
- A global public utility for self-sovereign identity is in development which will become a lifetime portable digital identity on the blockchain that does not depend on any central authority and can never be taken away.

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8 Cardozo Law professor and OpenLaw co-founder Aaron Wright is an innovator in this space. He has developed a toolbox for lawyers to create smart contracts. This video illustrates his work. You can check out his new book, “Blockchain and the Law: The Rule of Code” here.
Are regulators cracking down on virtual currencies? How will cryptoassets such as virtual currencies and tokens be regulated?

Questions like these abound. There is fresh news daily from around the world. Virtual currencies are on the G20 agenda in Argentina, at the behest of the Finance Ministers and Central Bank Governors of France and Germany. The European Commission is establishing a “blockchain observatory” and forum. Chairman of the U.S. Securities and Exchange Commission (SEC) and the U.S. Commodity Futures Trading Commission (CFTC) chairs testify on virtual currencies before the Senate Banking Committee, while the White House says the U.S. is nowhere near to establishing a regulatory regime for bitcoin.1 Abu Dhabi and Switzerland set forth their frameworks for token regulation. South Korea prohibits anonymous accounts for bitcoin trading. China bans everything (again). Arizona legislators propose accepting bitcoin as legal tender for taxes. The European Central Bank says Estonia cannot issue its own virtual currency.2 How does one make sense of all this?

I believe 2018 will see significant progress on an arc toward greater legal and regulatory certainty for virtual currencies, tokens and blockchain. Like the price of bitcoin, this will not be linear. It will appear to move in fits and starts, as if regulators are both tightening and loosening their grip. Why this appearance? Because virtual currencies, tokens and blockchain are such powerful innovations that they require regulators to balance important core missions. For example, the SEC is balancing its missions of investor protection (coupled with robust enforcement) and promoting capital formation and investor access to markets. Regulators are approaching the balancing act thoughtfully; they do not proceed at the “fail fast” speed startups and some pundits would like.

Will virtual currencies be banned? I would be surprised to see that happen (other than in a handful of countries with tight exchange controls, authoritarian governments or spiraling economies). In the U.S., the Marshals Service recently auctioned off another batch of bitcoins it had seized, as it has been doing for the last 5 years. To me this suggests that bitcoin is more like a motorboat or car than it is like narcotics or other contraband – which do not get auctioned by the U.S. government. A primary concern of governments will, however, be to ensure that robust anti-money laundering, know-your-customer and anti-financial-crime measures are in place for the on-ramps and off-ramps between virtual currencies and fiat currencies. This is what was just put in place in South Korea; to me the biggest surprise is that anonymous accounts were tolerated for so long.

I also expect heightened regulatory attention to suspected fraud or manipulation in the trading platforms and cash markets for virtual currencies and tokens. This is a stated priority for the CFTC – which has enforcement jurisdic-

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CRYPTOASSETS 2018

The arc toward great legal certainty should continue

My perspective on regulation of bitcoin, tokens and blockchain by Jeff Bandman

>> Continued on Page 12
of no-action letters or guidance; as fact patterns vary, there may be no one-size-fits-all solution, and I believe issuers may wish to engage directly with the SEC. Much industry dialogue is underway. I am hopeful that the SEC will continue to distinguish between the ICO fraudsters or “pump-and-dump” schemes that are rightfully the target of their new Cyber Crimes Unit, as compared to well-meaning innovators who are trying to do the right thing under new regulatory clarity.

In the E.U., meanwhile, regulators such as the Autorité des Marchés Financiers (AMF) in France have expressed the view that most tokens do not fall under the technical definition of financial instruments or securities under the existing framework. A change in law would be necessary for tokens to fall under the E.U. securities framework, such as the European Prospectus Regulation under the Capital Markets Union initiative. Another option E.U. regulators may consider is a dedicated framework for digital token assets. Financial regulators are nevertheless concerned today about consumer protection and fraud, and have issued numerous warnings. Efforts are underway to develop an international code of conduct as well.

In 2018, we will see industrial-strength blockchain-based platforms put into mainstream production in financial market infrastructure. While the bitcoin blockchain is recognized for its decentralized and permissionless framework, interestingly, these distributed ledger technology initiatives will be centralized and permissioned, launched by regulated entities. Examples include the Australian Stock Exchange (ASX) replatforming of its Clearing House Electronic Subregister System (the CHESS system) for post-trade processing for Australia’s cash equity market, DTCC’s replatforming of its Trade Information Warehouse, which automates the record keeping, lifecycle events, and payment management for more than $11 trillion of cleared and bilateral credit derivatives, and CLS Bank's launch of CLSNet, which will allow participants to submit foreign exchange payment and netting instructions to CLSNet for spot, next day, forwards, non-deliverable forwards (NDFs), swaps and same-day trades for more than 140 currencies (all currencies outside the regular CLS Settlement group).

I am excited to see what 2018 will bring – no doubt with surprises along the way. I am optimistic that greater legal and regulatory certainty will promote a healthier ecosystem of innovation.

Jeff Bandman
Principal, Bandman Advisors
@bandmanjeff

I BELIEVE 2018 WILL SEE SIGNIFICANT PROGRESS ON AN ARC TOWARD GREATER LEGAL AND REGULATORY CERTAINTY FOR VIRTUAL CURRENCIES, TOKENS AND BLOCKCHAIN. LIKE THE PRICE OF BITCOIN, THIS WILL NOT BE LINEAR

The rise of initial coin offerings (ICOs) in 2017 has led to discussion of them displacing venture capital as a means of financing blockchain startups. With ICO investments totaling over $6.5 billion in 2017 – a small fraction of the $148 billion in venture capital investments during the same year but representing a significant share of investments in blockchain startups – some analysts have asserted that in that area, ICO fundraising has displaced traditional venture capital investments. ICOs have unresolved legal and regulatory issues that make ongoing growth uncertain, however. Moreover, there may be benefits for startups, venture capital firms and other investors in considering crossovers between the two financing methods.

ICO ADVANTAGES AND PROBLEMS

ICOs offer significant advantages as a fundraising method for blockchain startups. Also called “token sales” or “token generation events,” they enable a startup to create and sell a cryptocurrency directly to investors, avoiding the costs and other complications of raising capital through financial intermediaries. They offer lower costs of raising capital and greater rapidity compared to traditional venture capital or initial public offerings. Company founders avoid surrendering control to outside investors, which would be a consequence of selling equity to a venture capital firm or to IPO investors.

ICOs also can help to attract developer and user interest necessary for a project to grow. These advantages contributed to the rapid rise in the amounts invested in ICOs which grew by a factor of 65 between 2016 and 2017 (from a total of approximately $100 million in 2016 to over $6.5 billion globally in 2017).

However, unresolved regulatory issues that emerged in 2017 have created uncertainty that the growth of ICOs will continue into 2018. Since issuing its report of examination on ICOs in July 2017, the U.S. Securities and Exchange Commission (SEC) has repeatedly warned ICO issuers and investors that ICOs with the characteristics of securities must be registered as securities or offered under an exemption from registration. ICO issuers have attempted to characterize their cryptocurrencies as “utility tokens” that are not securities, but the SEC has warned that most so-called utility tokens are securities and that it may take enforcement action against unregistered offerings and sales of securities. The SEC’s enforcement actions would be in addition to actions against fraudulent ICOs that the SEC and state regulators are already conducting. ICOs also face regulatory issues under the commodities and anti-money laundering laws administered by the U.S. Commodity Futures Trading Commission (CFTC) and FinCEN, respectively. Hong Kong, Singapore and other major financial centers have issued guidance similar to that of the SEC, subjecting ICOs to existing securities laws, and China and South Korea have banned ICOs outright. These developments may restrict the number and size of ICOs in 2018 and beyond.

In addition to government securities regulation, private class action lawsuits emerged in late 2017 as a problem for ICOs. Beginning in November 2017, numerous ICOs became the subjects of investor lawsuits alleging the offering and sale of unregistered securities. The first and most prominent of them has been the Tezos ICO, which in July 2017 had raised a then-record $232 million, but whose project stalled when a dispute over control of the funds developed between the U.S.-based founders of the project and the Swiss nonprofit organization, the Tezos Foundation, which controlled the funds.

VENTURE CAPITAL-ICO CROSSOVER

Venture capital and ICOs often are discussed as mutually exclusive, but they may...
instead turn out to be complementary methods for raising and investing funds that venture capital firms can use as part of a strategy of investing in blockchain startups.

An early example is the ICO conducted by Blockchain Capital in 2017. Founded in 2013 as a venture capital firm specializing in blockchain projects, Blockchain Capital used an ICO to raise $10 million for a new investment fund in April 2017. It created an Ethereum-based token called BCAP that it declared to be a security exempt from U.S. registration under the Securities Act of 1933, offered to U.S. investors under Regulation D and to foreign investors under Regulation S. Issued by a Singapore company, the BCAP token was a for-profit investment granting holders a portion of the profits (after management and performance fees) of the Blockchain Capital III Digital Liquid Venture Fund, named for the ability of investors to liquidate their investments by reselling BCAP through digital currency exchanges. Possibly the first ICO to issue a security under an exemption from registration, it showed how a venture capital firm can use an ICO compliant with U.S. securities laws to raise funds from cryptocurrency investors.

A venture capital firm could also participate in an ICO as an investor, in a way that resembles its role in a conventional venture capital investment. For example, a venture capital firm could agree to invest in an ICO while offering its expertise in addressing the unresolved regulatory issues that present potential problems for the start-up company and its ICO, and negotiating a degree of control over the company. The investment in the ICO could be through the purchase of a specified number of tokens in a “pre-sale,” a token sale done before the ICO becomes open to the public.

These scenarios are only a few examples of how a venture capital firm could use ICOs to invest in blockchain startups, and there may be many other possible permutations. Whether any of them will actually be useful to a venture capital firm will depend on whether blockchain startup investments are of interest to the firm, and if suitable potential deals emerge. It remains to be seen whether these conditions are fulfilled in 2018 and beyond.

TO OUR GENEROUS SPONSORS

We have a fantastic event planned for the Private Equity and Venture Capital Subcommittee Dinner on Thursday April 12, 2018 at 7:15 p.m. The dinner will be held at The Tranquilo Private Dining Room, Four Seasons Orlando. This is a ticket event and spaces are selling fast - be sure to get yours today!

Please join us in thanking our sponsors, without whose assistance this event would not be possible.
The aim of this article is to provide insight to choice of entity considerations based on the new tax rules and updates choice of entity considerations discussed in “A Tale of Two Entities” in 2015.

Below, we revise the impact of certain factors that may have changed as a result of the material tax changes adopted in the Tax Cuts and Jobs Act (P.L. 115-97), which was enacted on December 22, 2017, and became primarily effective in January, 2018.

INTRODUCTION
The primary considerations for choosing the appropriate legal entity for a new venture or existing business include:

- Minimizing overall income taxes to the entity and its owners
- The availability of tax losses
- Management compensation (including incentive compensation)
- Taxation of distributions
- Financing of the entity’s operations
- Conversion of the entity to a different tax status
- Exiting the investment

Our personal perspective remains that partnerships (including LLCs taxed as partnerships) generally provide the most efficient and flexible tax structure for commencing a new investment. This is because the partnership:

- May provide the lowest overall taxes to the entity and its owners
- May provide the owners with current access to tax losses from the venture
- Allows the structuring of incentive compensation that may be taxed to individual owners at a lower tax rate
- Allows for the tax-free distribution of cash
- Allows for the tax-free conversion to C-corporation status
- May provide the seller with additional proceeds by giving the buyer a tax basis step-up

CORPORATIONS
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 then taxed again when the corporation’s earnings are distributed to its shareholders in the form of dividends. As a result, the owner’s overall tax burden for corporate earnings consists of federal and state taxes at the corporate level plus the shareholders’ federal and state tax rates on the dividends.

>> Continued on Page 16
Under the new tax rules, the effective tax rate of double taxation (39.8% federal, including the 21% corporate-level tax and the 23.8% individual rate on dividends) inches closer to the tax rate of the single level of tax on individuals (37% federal) on income from partnerships and S-corporations, which is not taxed at the entity level but rather at the owner level. To complicate the analysis of a corporate versus partnership operating vehicle, this 37% rate may be as low as 29.6% (federal) under a special deduction. However, the individual rate returns to 39.6% in 2026 (with no special deduction), while the 21% corporate rate was enacted as permanent.

As an illustration, the effective federal tax rate on $100 of corporate earnings is 39.8% as a result of the new tax laws, which is down from 51% prior to tax reform. This results from the new 21% federal tax on $100 of corporate earnings, leaving $79 to be distributed as dividends. That $79 is then taxed at 23.8% (federal and ACA 3.8%), or $18.8, so the total taxes on the $100 come to $39.8 ($21 corporate level and $18.8 individual shareholder level). Figure 1 is an illustration based on assumed tax rates and excludes state taxes.

If a corporation generates tax losses, a common occurrence in the beginning years of a new or highly leveraged venture, those tax losses can now be carried forward indefinitely to offset future earnings of the corporation. However, there is a new limitation on the use of net operating losses (NOLs) so that NOLs can only offset 80% of taxable income in any year. 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 the 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 will be limited under the loss limitation rule (IRC Section 382).

In this case, the losses would generally be subject to the lower of the two limitations (the Section 382 loss limitation rule and the new 80% annual limitation).

The new tax law also introduced a limitation on deducting interest expense. Now interest expense can only be deducted up to 30% of earnings before interest, tax, depreciation & amortization (EBITDA). We use EBITDA as shorthand for a more tax-technical definition. As a result, tax losses may be lower in the early years of the investment. However, interest expense that is disallowed in any year can be carried forward indefinitely. Although we are waiting for additional guidance from the IRS, this “deferred interest” appears to be treated similarly to an NOL after an ownership change.

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. One material benefit for C-corporation shareholders is the reduced gain on the sale of a qualified small business under Section 1202, which is often overlooked. Non-corporate shareholders who have owned qualified small business stock for more than five years can substantially reduce tax upon sale of the stock (this rule excludes 50%, 75%, or 100% of the gain from tax, depending on when the stock was acquired). This should definitely be taken into account for a startup business.

**THE PARTNERSHIP/LLC**

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, an LLC would be treated as a division of the corporation for income tax purposes.

Generally, partnerships/LLCs 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 $50 in earnings to each of 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 37% federal tax (down from 39.6% as the highest federal rate on individuals), 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 (49.7%). 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. As noted above, the 39.8% effective federal rate on corporate earnings that are distributed to owners is closer to the 37% tax rate on flow-through income from a partnership.

This comparison is complicated by the fact that the highest individual rate reverts to 39.6% in 2026 and the 37% may be as low as 29.6% under a special deduction for LLCs/partnerships.

<table>
<thead>
<tr>
<th>Prior Law</th>
<th>Current Law</th>
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<tbody>
<tr>
<td><strong>Corporate Earnings</strong></td>
<td>$100</td>
</tr>
<tr>
<td><strong>Tax Rate</strong></td>
<td>35%</td>
</tr>
<tr>
<td><strong>Corporate Tax</strong></td>
<td>$35</td>
</tr>
<tr>
<td><strong>Cash Available for Dividends</strong></td>
<td>$65</td>
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<tr>
<td><strong>Shareholder Tax</strong></td>
<td>$15.5</td>
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<tr>
<td><strong>Total Taxes</strong></td>
<td>$50.5</td>
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<tr>
<td><strong>Overall Effective Tax Rate</strong></td>
<td>50.5%</td>
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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.

While limited partners (LPs) have historically been quiet about tax and relied on the general partners (GPs) to handle tax matters, GPs will likely face additional inquiries from LPs regarding how the tax law changes impact their ROI. In addition, management at portfolio companies that are structured as partnerships are negotiating with PE owners to reduce the annual cash tax distributions based on determinations that the owners who are individuals are entitled to the special lower rate. 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 that may impact their tax-exempt status, and foreign investors do not want direct U.S. partnership income that would require them to file U.S. tax returns. With this limitation, private equity investors often invest in LLCs through “Blocker Subs,” which are corporations that hold LLC investments.

We 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 is similar to the taxation of LLCs/partnerships, they are not the same. We would generally choose an LLC over an S-corporation, as S-corporations have several limitations. Among others, there is a maximum number of shareholders (100), shareholders must generally be individuals (not corporations or partnerships, though certain estates and trusts are allowed), and there is 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 Schedule 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 appreciation in the value of the equity, known as stock appreciation rights (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 unvested profits interest can elect to be taxed currently (treating the taxable value as zero) and not be taxed when the interests subsequently vest. By doing so, all future appreciation would be taxed at the much lower capital gains rate (if held for at least 12 months). 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 as well as self-employment taxes related to the choice between a corporation and an LLC that should also be considered.
As practitioners, we 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 (as these 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, we 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. We also recommend waiting until there is a written commitment to provide the financing.

EXITING THE INVESTMENT

One of the most important decisions regarding 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 only once on the difference between the consideration and their tax bases in the stock. The shareholders’ tax bases likely will be the same as they were 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). Shareholders selling stock in a C-corporation may also be able to reduce the tax on exit if the investment qualifies under Section 1202. Qualification under Section 1202 should be carefully considered, especially if the business will include self-created intangibles (e.g., patents, know how, or processes). That is because the sale of those intangibles is now taxed at ordinary income rates rather than at the capital gains rate under the new tax law.

If the corporation has tax losses and/or deferred interest, the advisors should consider whether a sale of assets could be negotiated. If the NOLs and/or deferred interest are insufficient to offset all of the corporate-level tax, the buyers may have to consider the consideration so that the sellers’ net after-tax amount from the asset sale is the same as if they had just sold the stock (single level of tax on stock sale at capital gains rate).

Even with no or limited NOLs/deferred interest, advisors should consider whether an asset sale is viable with the new 21% corporate tax rate. This is especially true for 2018 through 2022, when the buyer can fully deduct the amounts allocated to fixed assets (under the temporary 100% expensing or bonus depreciation rule). This may enable the completion of an otherwise difficult deal, for example if the target has contingent liabilities that buyers do not want to inherit.

On the other hand, the sale of LLC units may be 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 the buyer of an LLC (either in whole or in part) to step up the tax basis of the assets to fair market value. If the tax benefit is material, the sellers may be able to negotiate additional consideration (there is no step-up on the purchase of Blocker Sub stock 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 less tax to the sellers because of the increase to their tax bases over time.

SUMMARY

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. In addition, a corporation may also offer a buyer the benefit of tax losses.
that have accrued over the startup phase of the business. Moreover, corporations now have an extremely low federal income tax rate—21%—and may provide a lower tax on gain if the corporation qualifies under Section 1202. The disadvantages of a corporation are that earnings are subject to double taxation if they 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 bases 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. An LLC is also very flexible and may be easily converted to corporate status, if required for equity or debt financing. Owners of partnerships enjoy a lower 37% rate through 2025 (which reverts to 39.6% thereafter) and may even be eligible for the 20% deduction for flow-through income, bringing the tax rate to 29.6%—though this 20% deduction also expires after 2025.

As you know, each situation has its own specific facts, and we recommend that you consult a tax advisor before deciding which legal entity to use. This is even more important now that tax rates have been reduced. For long-view investors, the rate reductions need to be considered. Individual rates (the 37% rate and the 20% deduction for flow-through income) expire after 2025. Although the 21% corporate tax rate is permanent, we understand anecdotally that investors and M&A attorneys are concerned that this rate will increase. In all events, there is no substitute for modeling the results for a partnership and corporate investment, taken with a grain of salt. While not discussed at length above, state taxation may play an important role in any analysis. The federal tax changes were enacted very quickly, and states are still determining how to address these changes. Some states may view this as an opportunity to increase rates.

Statements and opinions expressed herein are solely those of the authors and may not coincide with those of Houlihan Lokey.

PRIVATE EQUITY M&A SUBCOMMITTEE

The Private Equity M&A Joint Subcommittee met at the Mergers & Acquisitions Committee standalone meeting in Laguna Beach, California on January 26, 2018.

We commenced with our “The Experts Speaks” segment with The Honorable Leo Strine, Chief Justice of the Delaware Supreme Court, sharing his insights on Delaware law as it related to a number of topics of interest to Private Equity M&A practitioners. I was joined by Lisa Stark of the Wilmington, Delaware office of K&L Gates in asking the Chief Justice to comment on various topics, including the recent and much discussed Dell decision dealing with appraisal rights. Next, as our “Nuts and Bolts” segment, we had a panel discussion of “The New Deal Points Private Company Study — what it means to Private Equity M&A Attorneys.” I was joined on the panel by Wilson Chu of McDermott Will & Emery, Dallas, Texas, one of the creators of the Deal Points surveys, Jessica Pearlman of K&L Gates, Seattle, Washington, and Dennis White of the Boston, Massachusetts office of Verrill Dana.

The Private Equity M&A Joint Subcommittee will meet next on Friday, April 13th at 10:30 a.m. as part of the Business Law Section’s Spring Meeting in Orlando, Florida. For those of you who, like me, live in the northeastern part of the United States, the Spring Meeting can not come soon enough. At our meeting, we will have two major segments. As part of our “Recent Developments” series, we will have a panel discussing on “Trump Tax Reform and Private Equity M&A.” I will be joined on a panel by an investment banker, Rachel Regenstein of Houlihan Lokey, New York, New York, a U.S. tax lawyer Cristin Keane of Carlton Fields, Tampa, Florida, and a Canadian tax lawyer, John Lorito of Stikeman Elliot in Toronto, Ontario, to discuss the recent changes to our tax code and how they might effect Private Equity M&A and our practices. Then, as part of our “The Experts Speaks” series, Glenn West of Well, Gotshal & Manges LLP in Dallas, Texas will discuss “Private Equity Deal Issues that keep Recurring – Why are we not learning the lessons from Caselaw.” Finally, time permitting, I will discuss some recent case law developments.

I, along with my Vice Chairs (Mireille Fontaine of BLF in Montreal, Quebec and Samantha Horn of Stikeman Elliot in Toronto, Ontario) continually seek YOUR feedback as to the meetings and the Joint Subcommittee, either by talking to one of us in Orlando or reaching out to one of us afterwards. We are always looking for ideas for future programs, presentations and projects, as well as volunteers for all of them. And, as I’ve said before, if you don’t know me and you are at the Orlando meetings, please feel free to come by and introduce yourself.

I look forward to seeing many of you in Orlando on Friday the 13th at 10:30 a.m. If you are unable to be there, please feel free to dial in and listen using the instructions set forth elsewhere in Deal Points or Preferred Returns.

David Albin
Chair, Finn Dixon & Herling LLP
dalbin@fdh.com
Blockchain is increasingly recognized as a technology that has the potential to disrupt the private equity and venture capital (“PE&VC”) industry. It also is gaining an increased level of attention as a technology that has the potential to transform, and thereby reduce the level of cost associated with, the provision of legal services to the PE&VC industry. This article briefly outlines select publicly known use cases of blockchain technology that have been implemented into the operations of established players in the PE&VC industry. It also discusses some of blockchain’s potential impacts on PE&VC legal practice.

I. FUND ADMINISTRATION

PE&VC fund managers have historically addressed their fund administration needs internally. In recent times, however, PE&VC funds have increased their use and reliance upon third party service providers for fund administration, and the trend is projected to continue. Due in part to post-financial crisis regulation, including the Foreign Account Tax Compliance Act, the EU Alternative Investment Fund Managers Directive and cross-border anti-money laundering rules, as well as increased demand from institutional investors for transparency with respect to management fees and disclosure of expenses paid to General Partners, PE&VC funds of all sizes have begun to outsource their fund administration needs in order to avoid audits, regulatory compliance violation sanctions, and related litigation. The types of fund administration matters that have been outsourced to third party administration service providers include accounting, calculation of capital calls and distributions, investor relations and regulatory compliance. Given the increased pressure on PE&VC fund managers to outsource fund administration to increase transparency, as well as the proliferation of new technologies available to make fund administration and operational processes more efficient, fund administration has been a prime target for experimentation with blockchain technology.

The first publicly known application of blockchain technology to private equity fund administration was launched in February 2017 by Northern Trust Corporation, in collaboration with IBM and Switzerland-based asset management firm Unigestion. Using the Hyperledger Fabric blockchain platform (a collaborative open source software research and development project hosted by the Linux Foundation that consists of a permissioned blockchain system, which among other things, allows for the execution of smart contracts), Northern Trust developed a pilot blockchain system for managing the record keeping functions of a Guernsey-domiciled Unigestion fund. The Northern Trust private equity blockchain system, which operates as
a cloud-based private permissioned blockchain that is secured by hardware-assisted cryptography, provides fund managers, investors, service providers, and regulators with a shared and immutable record keeping platform upon which authorized users can upload and transfer fund transactional documents in real-time throughout the lifecycle of an investment, rather than rely upon e-mail or written correspondence. With the blockchain system, a fund’s contractual, financial and regulatory records can be accessed and managed directly by authorized users, each of which is provided with a unique node. Once authorized users upload data on the blockchain, the data is recorded on the immutable blockchain ledger and, as a consequence, users are provided with a single immutable shared source of transactional data upon which fund administration matters, such as capital calls and transfers of ownership, can be managed. In other words, rather than having multiple versions of fund documents located in multiple locations (including, potentially, multiple jurisdictions) and edited separately by multiple parties at separate times (sometimes leading to competing versions of the same document), the blockchain system eliminates this inefficient fragmentation of data by providing authorized fund users with a single encrypted “version of the truth” for each document that is uploaded to the distributed database.

The Northern Trust private equity blockchain system is considered disruptive to PE&VC fund administration because of the time efficiencies and cost savings that the system offers. It is also considered disruptive to the PE&VC legal services industry because it could replace legal documentation management, which is routinely handled by law firms, with an online system in which changes to transactional and/or regulatory documents can be made and shared instantaneously with all permissioned parties. As a result of the low cost and high speed with which information can be shared and modified between fund managers, investors, administrators and regulators on the blockchain system, there is projected to be less of a need in the future for law firms or other third parties to manage the flow of information. This provides PE&VC fund managers with a reduced time to market, which includes less time and less cost associated with traditional legal services. Although some opine that a more wide-scale adoption of blockchain technology by the PE&VC industry “will not necessarily cut lawyers when needed for more value-added input,” the overall potential for disruption to the PE&VC legal services industry is significant, and law firms should prepare to adapt to these changes accordingly.

Building upon its experience with blockchain-based private equity fund administration, Northern Trust has recently expanded its private equity blockchain system to the private equity audit domain. Working in collaboration with IBM, PwC and an undisclosed Guernsey-based audit firm, Northern Trust has enhanced its private equity blockchain system by allowing audit firms to have their own node on the Northern Trust blockchain system, thereby enabling auditors to directly access a “golden copy” of fund data and carry out audits of specific private equity lifecycle events in real-time, rather than on a periodic basis. Fund auditors can choose to either import fund data directly from the blockchain into their existing audit applications or can perform audits on the blockchain itself in conjunction with smart contract technology that is currently being developed by Northern Trust. Northern Trust is expected to expand its private equity blockchain system to other functions and to other existing clients by mid-2018 or early 2019.

II. FUND DISTRIBUTION

Cross-border private equity fund distribution is another area in which there has been a significant level of PE&VC industry experimentation with blockchain technology. In December 2016, a blockchain-enabled fund distribution platform known as FundsDLT was created in Luxembourg through a collaborative initiative between Fundsquare (a wholly-owned subsidiary of the Luxembourg Stock Exchange), InTech (an information technology consulting division of Luxembourg’s state-owned POST Luxembourg telecommunications corporation), and KPMG Luxembourg. The FundsDLT platform was designed to reduce costs associated with cross-border fund distribution transaction settlement processes by creating direct links on a blockchain between various actors in the fund distribution supply chain. It enables fund shares to be issued directly to investors, for example, by way of a secure distributed ledger that uses smart
contract technology to generate an immutable and searchable record of transactions, thereby eliminating the time and cost associated with obtaining approvals from multiple actors in what would otherwise be a fragmented supply chain. European fund managers have been quick to experiment with the FundsDLT platform.

In July 2017, Natixis Asset Management, an affiliate of Paris-based Natixis Global Asset Management, became the first global asset manager to execute a fund distribution transaction using the FundsDLT platform. In the Natixis transaction, a pilot investor used the FundsDLT platform to purchase shares in Natixis’ funds using fiat currency. From an operational standpoint, a fund distribution transaction on the FundsDLT platform takes place as follows: an investor uses the FundsDLT mobile app to submit a subscription order for shares, which is then routed to fund managers and other permissioned parties on the FundsDLT platform. Afterward, a transfer agent (such as, in the case of the Natixis transaction, Crédit Agricole’s CACEIS Investor Services division) approves or declines the transaction. If approved, clearing and settlement processes are triggered across all parties on the FundsDLT platform. From a payments perspective, payment processing occurs using S-money, an electronic wallet created by the Banque Populaire and Caisse d’Epargne (BPCE) Group that allows for peer-to-peer transfers of fiat currency on smartphones. The Natixis transaction was considered the first “real” blockchain fund distribution transaction because a “real fund’s shares” were purchased using “real cash” on a blockchain platform.

In January 2018, BNP Paribas Asset Management experimented with blockchain-driven fund distribution by executing an end-to-end fund distribution transaction using both the FundsDLT platform and Fund Link, BNP Paribas’ own blockchain-enabled fund distribution platform, which it co-developed with AXA Investment Management. The BNP Paribas transaction, which included “each part of the fund trade process, from the delivery of the order to the processing of the trade,” is regarded as a milestone in the development of blockchain-enabled fund distribution because it demonstrates the interoperability of various blockchain fund distribution platforms thanks to Fund Link’s ability to interconnect with FundsDLT’s blockchain. The recent success of the FundsDLT platform has led to increased demand for experimentation with the technology, and fund managers from the U.S., UK and Germany are said to be in discussions with FundsDLT to test the platform in the future.

III. FUND PAYMENTS & DIGITAL IDENTITY SECURITY

In addition to fund administration and fund distribution, blockchain technology has been experimented with in the context of fund payments and digital identity security. In September 2017, Partners Group, a Zug, Switzerland-based private equity firm, acted in cooperation with inacta AG, a Zug, Switzerland-based information technology consulting firm, to implement an Ethereum blockchain-based smart contract system to verify the authenticity of documents exchanged between fund counterparties in the execution of payment orders. The Partners/inacta document verification system was designed to increase the security and process efficiency of electronic payment order requests, which are typically exchanged between fund counterparties in the form of PDF files and Excel spreadsheets sent via vulnerable electronic means, such as e-mail. In order to verify the identity of fund bankers who request payment from Limited Partners, for example, the system utilizes timestamping and digital fingerprinting using cryptographic hash values. Only after their identity is authenticated can fund counterparties gain access to the ledger in order to obtain confidential details needed to execute payment orders. This helps to ensure that a mega fund payment of over $1 billion USD, for example, is not sent to the account of a cybercriminal posing as a legitimate fund counterparty. According to Partners Group, the document verification system is being used for various transactions per day and is being tested for future smart contract-based use cases in other areas of their private equity business. The Partners/inacta document verification system is a key example of the many financial services-related blockchain technology use cases that are being developed in Switzerland’s Crypto Valley ecosystem.

PE&VC fund managers around the world are experimenting with blockchain technology to increase the efficiency, transparency and security of their operations. From fund administration to fund distribution and payments, blockchain is clearly regarded as a technology that has the potential to disrupt the status quo in the PE&VC industry. Like any other area of technology, only some blockchain technology use cases will reach fruition. Nevertheless, the potential for a long-term transformation of the PE&VC industry is real, and law firms, in particular, should pay close attention to how blockchain-driven PE&VC disruption could lead to blockchain-driven PE&VC legal services disruption.
HOW TO GET STARTED:
THE BLOCKCHAIN TOOLKIT

USE THESE RESOURCES TO GET UP TO SPEED ON BLOCKCHAIN TECHNOLOGY AND APPLICATIONS, AND TO FOLLOW THE LATEST DEVELOPMENTS.

BOOKS

ORGANIZATIONS AND CONSORTIUMS
Enterprise Ethereum Alliance. The Enterprise Ethereum Alliance connects Fortune 500 enterprises, startups, academics, and technology vendors with Ethereum subject matter experts, in order to define enterprise-grade software capable of handling complex, applications at the speed of business.
Wall Street Blockchain Alliance. The WSBA describes itself as a neutral, unbiased steward of education and cooperation between Wall Street firms whose mission is to guide and promote comprehensive adoption of distributed ledger technology across financial markets.

NEWSLETTERS
“Bandman Advisors.” Monthly newsletter from Fintech and Regtech expert Jeff Bandman.
“Blockchain News.” CoinTelegraph’s blockchain blog featuring news, prices, breakthroughs and analysis.
“Blockchain News.” The latest news and opinion on blockchain and distributed ledger technology, now owned and operated by Token Report.
“CoinDesk.” A digital media, events and information services company covering the crypto asset and blockchain technology community.
“CrowdCrypto Newsletter.” Weekly newsletter published by securities attorney Robin Sosnow, whose focus is on equity crowdfunding, startups, legal innovation, and blockchain technology.
“Medici.” Newsletter from Medici, an independent newswire and information source for the worldwide financial technology community covering payments news and industry trends.

R3 is a consortium of more than 200 financial institutions that has assembled a team of 10 law firms to create the Legal Center of Excellence (LCoE), a platform for educating lawyers around the world on the fundamentals of blockchain technology and the ecosystem that’s grown up around it.

PODCASTS
Blockchain Insider by 11:FS. A dedicated podcast specializing in Bitcoin, Blockchain and distributed ledger technology (DLT) hosted by Simon Taylor and Colin G Platt.
CryptoRadio. A podcast about all things blockchain, bitcoin and crypto investing, created by CoSyndicate, a gamified platform for blockchain investors.
UnChained. Host Laura Shin, an independent journalist covering all things crypto, talks with industry pioneers about how crypto assets and blockchains will change the way we earn, spend and invest our money.

THOUGHT LEADERS

Follow these blockchain thought leaders for insightful commentary, links to resources, and to join in the conversation.

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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.

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