Perhaps the most fundamental role of a business tax advisor is to recommend the optimal entity choice for nascent business enterprises. Nevertheless, even in 2018, the choice-of-entity analysis remains highly muddled. Most tax practitioners across the United States consistently recommend flow-through entities, such as LLCs and S corporations, to their clients. In contrast, a discrete group of highly sophisticated tax professionals, those who advise start-ups in Silicon Valley and other hotbeds of start-up activity, prefer C corporations.

Prior commentary has described and tried to explain this paradox without finding an adequate explanation. These commentators have noted a host of superficially plausible explanations, all of which are not wholly persuasive. For example, some have cited the presence of tax-indifferent investors, such as foreigners and tax-exempt organizations, in venture capital funds, but blocker structures solve that problem. Thus, despite the extensive commentary, the puzzle remains.

Two important factors have been either vastly under-appreciated or completely ignored in the existing literature. First, while previous commentators have briefly noted that flow-through structures are more complex and administratively burdensome, they did not fully appreciate the source, nature, and extent of these problems. In the unique start-up context, the complications of flow-through structures are exponentially more problematic, to the point where widespread adoption of flow-throughs is arguably infeasible.

>> Continued on Page 9
Message from the Chair

I am looking forward to seeing many of you in Austin shortly. We have a great slate of meetings lined up. For those who will not be able to attend in person, this issue of Preferred Returns contains dial in information for all of our committee and subcommittee meetings.

Special thanks to our sponsors for this meeting, Houlihan Lokey, Andersen Tax Corporation and CT Corporation. As a result of their generous sponsorship, we have a great dinner planned at the Vince Young Steakhouse on Thursday night. Representatives from each of our sponsors will be present both at our main Committee meeting and at our dinner; please join me in thanking them for their support.

Our mini-theme for this meeting is “alternative entities.” As you know, historically the vast majority of investments made by venture capital firms have been made in corporations, not limited liability companies. At several of our meetings (and an article in this edition of Preferred Returns), we will explore various aspects of investing in LLCs instead of corporations. To that end, our Committee is sponsoring a CLE entitled: “Should Venture Capital Take Another Look at the Use of Alternative Entities.” The CLE, moderated by our own Jon Gworek, will feature panelists Dave Czarnecki, (Morse Barnes-Brown & Pendleton), Tarik Haskins (Morris Nichols), and Jack Helfand (VantagePoint Capital Partners).

This meeting marks the first meeting at which Justice Randy Holland will serve as our Committee’s judicial liaison. Justice Holland, who retired from the Delaware Supreme Court last year and is now senior of counsel at Wilson Sonsini, was both the youngest person to serve on the Delaware Supreme Court and the longest tenured member. He wrote many of the seminal cases on Delaware corporate law, and is one of the most respected members of the Delaware legal community. Justice Holland will speak both at our main Committee meeting and our Academic Subcommittee meeting.

Welcome, Justice Holland!

Responding to feedback from you – our members – we have rejiggered our meeting schedule. The meetings will kick off with a Welcome Breakfast meeting on Thursday morning. Please grab some food and come on in to meet with the leadership of our Committee – we would love to get to know you and solicit your thoughts (and volunteer efforts) as we continue to grow the Committee and make membership more responsive to your needs and goals.

Immediately following the Welcome Breakfast will be our main Committee meeting. At this meeting, each subcommittee chair will briefly mention what will be discussed at their subcommittee, and so help set the stage for the rest of the conference and help you decide which meetings you would like to attend. In addition to that introduction, and presentations from each of our sponsors, (i) Tricia Vella will interview Justice Holland as a way to introduce him to our Committee, (ii) Lisa Murison, Executive Vice President, and Chief Legal and HR Officer of Edmunds, will speak with the Committee about the needs of inside counsel when working with outside counsel, in particular when thinking about making investments and strategic partnerships and (iii) John Mark Zeberkiewicz of Richards, Layton & Finger will discuss practice surrounding Delaware’s ratification statute.

Austin also marks the second meeting of our Academic Subcommittee. The subcommittee, which meets once a year, is designed to bring together academics, practitioners and members of the judiciary to discuss issues relevant to Private Equity and Venture Capital. At its successful inaugural meeting last year in Chicago, the subcommittee hosted a substantive meeting, attended by Vice Chancellor Laster, on Klaasen v. Allegro, a case dealing with governance of venture-backed companies and issues arising when terminating a CEO. In addition, the subcommittee sponsored a CLE in which academics presented papers on various cutting-edge issues in PEVC, and practitioners commented on those papers. The subcommittee
is reprising both in Austin. This year, Justice Holland will participate in a discussion on recent Court of Chancery opinions related to controlling stockholder obligations and their implications for venture capital. The Academic Subcommittee’s CLE will have presentations on (i) Choice of entity decisions by Silicon Valley start-ups (Gregg Polsky, University of Georgia School of Law presenting and Jason Breen from Goodwin commenting), (ii) Fiduciary obligations with multiple classes of stock (Sarath Sanga from Northwestern University School of Law and Eric Talley from Columbia University School of Law presenting and Russ Denton from Sherman & Sterling commenting), and (iii) A study of data regarding terms used in seed stage financing agreements (including SAFEs) (John Coyle, University of North Carolina Law presenting and Emily Yukich from Fox Rothschild commenting).

In addition to the two CLE’s our Committee is sponsoring, and our typical slate of subcommittee meetings, we are cosponsoring eight CLE’s in Austin that may be of interest to you, and that are listed in this issue of Preferred Returns. Please note two changes from the initially posted schedule: (i) Our Dictionary Task Force will not be meeting in Austin and (ii) Our International Subcommittee meeting will now be meeting from 4:30-5:30 on Friday, September 14.

I end, as usual, with a thank you to Brett Stewart, our editor of Preferred Returns. Putting together this publication is no easy task, particularly as volunteer work on top of a very busy schedule. Thanks to Brett for yet another excellent job.

Happy reading and I look forward to seeing many of you soon.

Eric Klinger-Wilensky
Chair
Looking Ahead to Austin
→ What the Committee Has in Store → Continued on Page 5

PRIVATE EQUITY AND VENTURE CAPITAL COMMITTEE MEETING
Thursday, September 13, 2018
(9:00 AM – 11:00 AM)
Convention Center, Ballroom B, Level 1

At our main committee meeting, we will have an interview of Justice Holland by Tricia Vella, an interview of Lisa Murison, General Counsel of Edmunds.com, by Josh Geffon, a presentation by John Mark Zerberkiewicz of Richards Layton on stockholder ratification, and presentations by each of our sponsors – Houlihan Lokey, Andersen Tax and CT Corp.

Toll-free dial-in number (U.S. and Canada): (866) 646-6488
International dial-in number: (707) 287-9583
Conference code: 5170670679

ANGEL VENTURE CAPITAL SUBCOMMITTEE MEETING
Friday, September 14, 2018
(10:00 AM – 11:00 AM)
Convention Center, Ballroom B, Level 1

The Angel Venture Capital Subcommittee will host a presentation titled “Austin's Startup Community Global Impact: Featuring SXSW and Central Texas Angel Network” consisting of a panel featuring Claire England (Executive Director of the Central Texas Angel Network (CTAN)) and Chris Valentine (SXSW Pitch Event Producer). The panel will provide unique insights regarding Austin's early stage investment community gleaned from CTAN's 160+ angel investment deals and SXSW's tenured status as an annual gathering for the world's startup community.

Toll-free dial-in number (U.S. and Canada): (866) 646-6488
International dial-in number: (707) 287-9583
Conference code: 5170670679

INTERNATIONAL VC & PE SUBCOMMITTEE MEETING
Friday, September 14, 2018
(4:30 PM – 5:30 PM)
Convention Center, Ballroom B, Level 1

Our International Subcommittee will have presentations on international topics of interest from our members.

Toll-free dial-in number (U.S. and Canada): (866) 646-6488
International dial-in number: (707) 287-9583
Conference code: 5170670679
The Private Equity M&A Joint Subcommittee is planning two presentations for their meeting. First, as part of their “Recent Developments” series, chair David Albin (Finn Dixon & Herling LLP) will be chairing a panel with The Honorable Justice Collins J. Seitz of the Delaware Supreme Court, Leigh Walton (Bass Berry & Sims) and Pamela Millard (Potter Anderson Corroon LLP) for a program entitled “Negotiating the Governing Law Clause post Eagle Force.” Then, continuing their “The Experts Speak” series, Matt Sachse, (Pagemill Partners) will moderate a panel including Margaux Knee (Protocol Labs), Daniel Goldman (Gunster Dettmer) and Todd Bissett (Miller Thomson) that will discuss “The Movement of Private Equity into Technology.”

See page 10 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 Venture Capital Financing Subcommittee will be hosting a panel discussion entitled “An Analysis of the State of the Venture Capital Market and Current Deal Term Trends”. The goal of the discussion is to provide practitioners from around the country a general understanding of deal-term intelligence and identify unique trends (possibly differing based on geography) in the marketplace. Panelists will include:

Danielle Naftulin (Cooley, Palo Alto), Scott Craig (Wilson Sonsini Goodrich & Rosati, Austin), Ed Pease (WilmerHale, Boston).

| Toll-free dial-in number (U.S. and Canada): (866) 646-6488 |
| International dial-in number: (707) 287-9583 |
| Conference code: 5170670679 |

The Fund Formation Subcommittee will discuss the use of alternative investment vehicles used in fund formation and a regulatory update regarding investment funds.

| Toll-free dial-in number (U.S. and Canada): (866) 646-6488 |
| International dial-in number: (707) 287-9583 |
| Conference code: 5170670679 |

The Private Equity and Venture Capital Jurisprudence Subcommittee will be joined by panelists Nathan Emeritz (Wilson Sonsini), Sophia Dai (Goodwin), Jacqueline A. Brooks (Saul Ewing) and Ernie Holtzheimer (Montgomery McCracken) to discuss recent judicial developments relating to private equity and venture capital during this subcommittee meeting. Topics to be discussed include recent case law involving fiduciary challenges to venture backed exits and dilutive down round financings, as well as the ratification of defective corporate acts under Delaware law. The panel will provide practical drafting and structuring tips for practitioners. Please join us.

| Toll-free dial-in number (U.S. and Canada): (866) 646-6488 |
| International dial-in number: (707) 287-9583 |
| Conference code: 5170670679 |

The Task Force will continue its work on a book focused on the Top 10 issues in governance of contractual business entities. 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: 1786332268 |
We have 2 fantastic CLE panels planned!

**PERSPECTIVES ON CUTTING-EDGE ISSUES IN VENTURE CAPITAL AND PRIVATE EQUITY**
Thursday, September 13, 2018 (2:30 PM – 4:30 PM) | Convention Center, Room 6B, Level 3

Panelists, including Brady Bohrman of Avalon Ventures, Rob May, CEO of Talla Inc., 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:** Brian Broughman, Indiana University Maurer School of Law

**Co-sponsoring Committee:** Business Financing, Federal Regulation of Securities, Young Lawyers

**SHOULD VENTURE CAPITAL TAKE ANOTHER LOOK AT THE USE OF ALTERNATIVE ENTITIES?**
Friday, September 14, 2018 (2:30 PM – 4:30 PM) | Convention Center, Room 6B, Level 3

This CLE will examine the various factors and considerations that startups and venture capitalists should weigh in the decision as to whether LLC’s may present a viable and attractive alternative to corporations.

**Co-Chairs:** Jon Gworek

**Co-sponsoring Committee:** Federal Regulation of Securities, LLCs, Partnerships and Unincorporated Entities, Middle Market and Small Business

... and are co-sponsoring 8 more!

**DRAFTING SERIES LLC PROVISIONS UNDER THE DELAWARE, TEXAS AND UNIFORM ACTS**
Thursday, September 13, 2018 (8:00 AM – 10:00 AM) | Convention Center Room 5BC, Level 3

**Chair:** Daniel J. Sheridan

**Sponsoring Committee:** LLCs, Partnerships and Unincorporated Entities

**Co-sponsoring Committee:** Business Financing, Middle Market and Small Business, Private Equity and Venture Capital

**SPOTTING IP ISSUES IN BUSINESS TRANSACTIONS – A BUSINESS LAWYER’S GUIDE DEAL RISKS — ISSUES, TRENDS AND DEVELOPMENTS**
Thursday, September 13, 2018 (10:30 AM – 12:00 PM) | Fairmont, Indigo, 4th Floor

**Chair:** Sarah A. Gatti

**Sponsoring Committee:** Intellectual Property

**Co-sponsoring Committee:** International Business Law, International Coordinating, Private Equity and Venture Capital, Young Lawyer

**PRIVATE EQUITY INVESTMENTS IN THE INTERNATIONAL OIL AND GAS SECTOR: A COMPARATIVE ANALYSIS OF U.S., U.K. AND NORWEGIAN PRACTICES**
Thursday, September 13, 2018 (10:30 AM – 12:00 PM) | Convention Center, Room 5BC, Level 3

**Chair:** Brad Squibb

**Co-sponsoring Committee:** Business Financing, International Business Law, International Coordinating, Private Equity and Venture Capital, Project Finance and Development

**SIX SIMPLE RULES FOR IN-HOUSE COUNSEL TO AVOID MOST HIDDEN INSOLVENCY RISKS IN COMMERCIAL TRANSACTIONS**
Friday, September 14, 2018 (8:30 AM – 10:00 AM) | Convention Center, Room 6A, Level 3

**Co-Chairs:** Matt Ochs and Sheryl Toby

**Sponsoring Committee:** Business Bankruptcy

**Co-sponsoring Committee:** Business Financing, Corporate Counsel, Private Equity and Venture Capital

**LEVERING-UP: IDENTIFYING AND UNDERSTANDING THE UNIQUE REQUIREMENTS OF PRIVATE EQUITY FUNDS AS BORROWER AND AS LENDER**
Friday, September 14, 2018 (10:30 AM – 12:00 PM) | Convention Center Room 6A, Level 3

**Chair:** Mat Rotenberg

**Sponsoring Committee:** Commercial Finance

**Co-sponsoring Committee:** International Coordinating, Private Equity and Venture Capital, Uniform Commercial Code, Young Lawyer, Association of Commercial Finance Attorneys (ACFA), American College of Commercial Finance Lawyers (ACFL)

**BLOCKCHAIN BASICS FOR THE BUSINESS LAWYER – SMART CONTRACTS, CRYPTO OFFERINGS AND OTHER TRANSFORMATIVE APPLICATIONS**
Friday, September 14, 2018 (10:30 AM – 12:00 PM) | Fairmont, Park View A, 7th Floor

**Co-Chairs:** William R. Denney and Brian Castro

**Sponsoring Committee:** Cyberspace Law

**Co-sponsoring Committee:** Business Financing, Commercial Finance, Credit Unions, Energy Law, International Business, International Coordinating, Middle Market & Small Business, Private Equity & Venture Capital, Young Lawyer

**GOING (TO THE) PUBLIC: RAISING CAPITAL FROM MIDDLE CLASS AMERICA – WHEN IT WORKS, AND WHEN IT DOESN’T**
Friday, September 14, 2018 (11:00 AM – 12:30 PM) | Fairmont, Lantana, 4th Floor

**Chair:** Elizabeth Bleakley

**Sponsoring Committee:** Middle Market & Small Business

**Co-sponsoring Committee:** Federal Regulation of Securities, Private Equity and Venture Capital, Young Lawyer

**A FAMILY AFFAIR: REPRESENTING THE FAMILY-OWNED BUSINESS – ETHICALLY**
Thursday, September 13, 2018 (10:30 AM – 12:00 PM) | Fairmont, Lantana, 4th Floor

**Co-Chairs:** - Michael Connolly

**Sponsoring Committee:** Middle Market and Small Business

**Co-sponsoring Committee:** LLCs, Partnerships and Unincorporated Entities, Private Equity and Venture Capital, Professional Responsibility, Young Lawyer
## Schedule of Events

**→ Business Law Section’s Fall Meeting | Austin | September 2018**

### Dial-in codes listed below
- Toll-free dial-in number (U.S. and Canada): (866) 646-6488
- International dial-in number: (707) 287-9583

### Thursday, September 13, 2018

<table>
<thead>
<tr>
<th>Event Description</th>
<th>Location / Dial-in Code</th>
<th>Time</th>
</tr>
</thead>
<tbody>
<tr>
<td>Welcome Breakfast – Private Equity and Venture Capital Committee</td>
<td>Convention Center, Ballroom B, Level 1</td>
<td>8:00 AM – 9:00 AM</td>
</tr>
<tr>
<td>Co-sponsored CLE Program: Drafting Series LLC Provisions Under the Delaware, Texas and Uniform Acts</td>
<td>Convention Center, Room 5BC, Level 3</td>
<td>8:00 AM – 10:00 AM</td>
</tr>
<tr>
<td>Private Equity and Venture Capital Committee Meeting</td>
<td>Convention Center, Ballroom B, Level 1</td>
<td>9:00 AM – 11:00 AM</td>
</tr>
<tr>
<td>Co-sponsored CLE Program: A Family Affair: Representing the Family-Owned Business - (Ethically)</td>
<td>Fairmont, Lantana, 4th Floor</td>
<td>10:30 AM – 12:00 PM</td>
</tr>
<tr>
<td>Co-sponsored CLE Program: Private Equity Investments in The International Oil and Gas Sector: A Comparative Analysis Of U.S., U.K. And Norwegian Practices</td>
<td>Convention Center, Room 5BC, Level 3</td>
<td>10:30 AM – 12:00 PM</td>
</tr>
<tr>
<td>Private Equity and Venture Capital Committee Leadership Lunch (Ticketed Event – Open to Committee Leadership Only)</td>
<td>Convention Center, Room 2, Level 1</td>
<td>12:00 PM – 1:30 PM</td>
</tr>
<tr>
<td>Private Equity and Venture Capital Funds Subcommittee Meeting</td>
<td>Convention Center, Ballroom B, Level 1</td>
<td>1:30 PM – 2:30 PM</td>
</tr>
<tr>
<td>Sponsored CLE Program: Perspectives on Cutting-Edge Issues in Venture Capital and Private Equity Developments and Practical Implications</td>
<td>Convention Center, Room 6B, Level 3</td>
<td>2:30 PM – 4:30 PM</td>
</tr>
<tr>
<td>Academic Subcommittee Meeting</td>
<td>Convention Center, Ballroom B, Level 1</td>
<td>4:30 PM – 5:30 PM</td>
</tr>
<tr>
<td>Private Equity and Venture Capital Committee Dinner (Ticketed Event)</td>
<td>Vince Young Steakhouse 301 San Jacinto Blvd.</td>
<td>7:30 PM – 10:00 PM</td>
</tr>
</tbody>
</table>

1 Note: CLE Programs are not accessible by Dial-in.
## Schedule of Events

<table>
<thead>
<tr>
<th>Event Description</th>
<th>Location / Dial-in Code1</th>
<th>Time</th>
</tr>
</thead>
<tbody>
<tr>
<td>Co-sponsored CLE Program: Six Simple Rules for In-House Counsel to Avoid Most Hidden Insolvency Risks in Commercial Transactions</td>
<td>Convention Center, Room 6A, Level 3</td>
<td>8:30 AM – 10:00 AM</td>
</tr>
<tr>
<td>Private Equity and Venture Capital Jurisprudence Subcommittee Meeting</td>
<td>Convention Center, Ballroom B, Level 1 Conference code: 5170670679</td>
<td>9:00 AM – 10:00 AM</td>
</tr>
<tr>
<td>Contractual Governance of Business Entities Joint Task Force Meeting</td>
<td>Fairmont, Firewheel, 4th Floor Conference code: 1786332268</td>
<td>9:00 AM – 10:00 AM</td>
</tr>
<tr>
<td>Angel Venture Capital Subcommittee Meeting</td>
<td>Convention Center, Ballroom B, Level 1 Conference code: 5170670679</td>
<td>10:00 AM – 11:00 AM</td>
</tr>
<tr>
<td>Private Equity M&amp;A Joint Subcommittee Meeting</td>
<td>Fairmont, Manchester Ballroom AB, 5th Floor Conference code: 4027564183</td>
<td>10:30 AM – 12:00 PM</td>
</tr>
<tr>
<td>Co-sponsored CLE Program: Levering-Up: Identifying and Understanding the Unique Requirements of Private Equity Funds as Borrower and as Lender</td>
<td>Convention Center, Room 6A, Level 3</td>
<td>10:30 AM – 12:00 PM</td>
</tr>
<tr>
<td>Co-sponsored CLE Program: Blockchain Basics for the Business Lawyer - Smart Contracts, Crypto Offerings and Other Transformative Applications</td>
<td>Fairmont, Park View A, 7th Floor</td>
<td>10:30 AM – 12:30 PM</td>
</tr>
<tr>
<td>Co-sponsored CLE Program: Going (to the) Public: Raising Capital from Middle Class America – When It Works, and When It Doesn’t</td>
<td>Fairmont, Lantana, 4th Floor</td>
<td>11:00 AM – 12:30 PM</td>
</tr>
<tr>
<td>Venture Capital Financing Subcommittee Meeting</td>
<td>Convention Center, Ballroom B, Level 1 Conference code: 5170670679</td>
<td>1:30 PM – 2:30 PM</td>
</tr>
<tr>
<td>Sponsored CLE Program: Should Venture Capital Take Another Look at The Use of Alternative Entities</td>
<td>Convention Center, Room 6B, Level 3</td>
<td>2:30 PM – 4:30 PM</td>
</tr>
<tr>
<td>International Subcommittee Meeting</td>
<td>Convention Center, Ballroom B, Level 1 Conference code: 5170670679</td>
<td>4:30 PM – 5:30 PM</td>
</tr>
</tbody>
</table>

1 Note: CLE Programs are not accessible by Dial-in.
The decision to use a flow-through structure practically has to be made extremely early in the company's life because converting from a C corporation to a flow-through after the company has appreciated will be prohibitively tax expensive. Yet, it is at this point that the complexity and compliance burdens of the flow-through structure will be the most problematic. In the earliest stages, a large number of investors will make relatively small investments in a very speculative enterprise. This means that a large number of K-1 forms will need to be prepared and issued to the company's (direct or indirect) taxable investors to properly file their tax returns. This is challenging enough for mature, sophisticated businesses, not to mention early-stage start-ups. And when a large percentage of these highly speculative enterprises inevitably go up in smoke, the likelihood of K-1 compliance is even more remote. These compliance problems are absent in the C corporation context because the operations of C corporations do not affect the tax returns of their owners.

In addition, the nature of flow-through taxation necessarily results in greater transactional complexity. While early-stage corporate forms can be relatively “cookie cutter,” LLC organizational documents are much more complicated precisely because of flow-through taxation. For example, flow-through taxation requires (as a practical matter) provisions for minimum tax distributions, which are completely unnecessary for C corporations. Similarly, subchapter K of the Internal Revenue Code (which governs the taxation of LLCs) necessitates tax jargon that only experienced tax lawyers can understand. In the fast-paced, low-cost start-up environment, these are particularly burdensome problems.

Likewise, flow-through taxation results in additional state and local tax compliance burdens for investors in organizations that operate across state lines. While these burdens are often quite manageable for mature businesses, they are not so easily managed by start-ups. Finally, equity compensation—the coin of the compensation realm for start-ups—is far more unwieldy for LLCs compared to corporations.

Second, the existing literature has not appreciated the effect of perplexing, yet pervasive, asset valuation problems in the public company context. One huge advantage of flow-through status is that these organizations can sell assets to buyers. C corporations, on the other hand, are effectively forced to sell stock, because assets sales would result in a prohibitively large tax bill. Buyers generally prefer buying assets because they receive a stepped-up basis in seller’s assets, which reduces the buyer’s future tax burdens. As a result, buyers are generally willing to pay a stepped-up basis (SUB) premium for assets. Under reasonable assumptions, the premium can equal about 20 percent of the purchase price of a stock purchase.

Despite the incontrovertible mathematical logic of the SUB premium, the conventional wisdom is that tax assets, such as SUBs, are ignored or severely undervalued in public company stock valuations. In theory, most significant benefit of flow-through status for start-ups is that it can result in the creation of valuable tax assets upon exit. However, the conventional wisdom makes this moot when the exit is through an initial public offering or sale to a public company, which are the desired types of exits for start-ups. Thus, the most significant benefit of using a flow-through (at least in theory) is eliminated because of the tax asset pricing problem.

In short, while the compliance and complexity costs of flow-through taxation have been underappreciated, while the most significant benefit (the SUB premium) is much smaller than it appears. Recent developments, however, could dramatically affect the choice-of-entity decision going forward. The so-called Up-C IPO structure, whose popularity has grown exponentially over the past few years, allows LLC owners to directly monetize the SUB, instead of relying on the public markets to price it. And, of course, the 2017 Tax Cuts and Jobs Act, while dramatically reducing corporate tax rates and sweetening the qualified small business stock exclusion, lowered individual rates and created the brand new pass-through deduction.

**WHILE EARLY-STAGE CORPORATE FORMS CAN BE RELATIVELY “COOKIE CUTTER,” LLC ORGANIZATIONAL DOCUMENTS ARE MUCH MORE COMPlicated PRECISELY BECAUSE OF FLOW-THROUGH TAXATION.**
The Private Equity M&A Joint Subcommittee met at the Business Section’s spring meeting in Orlando, Florida on March 28, 2018. We commenced with our “Recent Development” series with a panel discussion on “Trump Tax Reform and Private Equity M&A.” I was joined on the 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 of Toronto, Ontario, to discuss how the recent changes to the U.S. tax code are effecting and might effect Private Equity M&A and our practices.

Then, as part of our “The Experts Speaks” series, Glenn West of Weil, Gotshal & Manges LLP in Dallas, Texas discussed “Private Equity Deal Issues that keep Recurring – Why are we not learning the lessons from Caselaw.” Finally, to end our meeting, Jonathan Cardenas, as introduced the new Private Equity and Venture Capital Dictionary Taskforce.

The Private Equity M&A Subcommittee will meet next on Friday, September 14th at 10:30 a.m. local time, in Austin, Texas, as part of the Business Law Section’s Annual Meeting. We are planning two presentations for our meeting. First, as part of our “Recent Developments” series, I will be chairing a panel with The Honorable Justice Collins J. Seitz of the Delaware Supreme Court, Leigh Walton, a partner at Bass Berry & Sims in Nashville, Tennessee and a former chair of the Mergers and Acquisitions Committee, and Pamela Millard, a partner at the Wilmington, Delaware law firm of Potter Anderson Corroon LLP. The program will be entitled “Negotiating the Governing Law Clause post Eagle Force.” The panel will discuss the Delaware Supreme Court’s decision in Eagle Force Holdings, LLC v. Campbell (Del. 2018) and how it might and should effect Private Equity M&A lawyers in negotiating governing law clauses in acquisition agreements. Then, as part of our “The Experts Speak” series, a panel that will be moderated by Matt Sachse, a Managing Director of Page Mill Partners in Palo Alto, California, and will also include Margaux Knee, Assistant General Counsel at Protocol Labs, Daniel Goldman, a partner of Gunderson Dettmer in New York, New York and Todd Bissett, a partner in the Kitchener-Waterloo, Ontario, office of Miller Thomson, will discuss “The Movement of Private Equity into Technology.” It should be an informative 90 minutes.

As I keep sincerely saying, but to little effect, I, along with my Vice Chairs (Mireille Fontaine of BLF in Montréal, Québec 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 Austin 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 Austin meetings, please feel free to come by and introduce yourself.

I look forward to seeing many of you in Austin on Friday, September 14th at 10:30 a.m. local time. 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

THANK YOU TO OUR GENEROUS SPONSORS

We have a fantastic event planned for the Private Equity and Venture Capital Subcommittee Dinner on Thursday, September 13, 2018 at 7:00 p.m. The dinner will be held at the Vince Young Steakhouse. 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.
Lawmakers have placed private equity firms in the political crosshairs following the liquidation of Toys ‘R’ Us over the summer. The company’s demise represents the end of a highly-publicized death march as the world’s largest standalone toy store spent more than a decade trying to climb to safety in a hyper-competitive retail market – a climb made all the more difficult by the massive debt resulting from its buyout in 2005 by Bain Capital, KKR & Co., and Vornado Realty Trust in a highly leveraged deal which saw the retailer take on $5 billion in new debt, leaving it ill-equipped and ultimately unable to withstand fierce competition from retail behemoths Amazon and Walmart. In the wake of the liquidation, many in Congress, including Senators Elizabeth Warren and Minority Leader Chuck Schumer, have called for a strong legislative response. Among the most vocal members of this cohort is Rep. Bill Pascrell, Jr., representing New Jersey’s 9th District, just minutes from the former location of the Toys ‘R’ Us national headquarters in Wayne, New Jersey. In addition to publicly reprimanding the private equity group in June for its failure to protect the company’s employees – 33,000 of whom were fired abruptly without severance during bankruptcy proceedings – Rep. Pascrell has voiced support for first-of-its-kind federal legislation that would limit the debt burden private equity firms can place on target companies in leveraged buyouts (LBOs).

Leveraged lending is currently governed primarily by federal regulation, not legislation, and the prevailing regulatory regime has its genesis in the financial crisis. A substantial contributor to the 2008 collapse of the U.S. banking system was a years-long period of snowballing leverage at the consumer, institutional, and national economy levels. Leveraged buyouts were no exception – according to Thomson Reuters LPC, the mean leverage ratio of large LBOs reached an all-time high of 7.4 times EBITDA in the second quarter of 2007, a metric of credit risk considered well above “safe” levels for lenders in most industries.

To forestall future systemic collapse after the financial crisis, Congress passed the Dodd-Frank Act in 2010, and bank regulators promulgated a host of risk-management rules and guidance designed to complement the baseline obligation of banks to maintain their safety and soundness. Among these prophylactic measures was the Interagency Leveraged Lending Guidance (ILLG) jointly issued in March 2013 by the OCC, FDIC, and Federal Reserve Board (FRB), establishing new standards for leveraged finance activities that significantly impacted the leveraged loan market in two ways: (1) It limited lenders’ ability to originate, refinance, and modify loans to borrowers unable to demonstrate free cash flows sufficient to repay 100% of secured debt or 50% of total debt within 5 to 7 years; and (2) It subjected loans to borrowers having post-closing debt exposure greater than six times EBITDA to heightened regulatory scrutiny. While the ILLG was not accompanied by statutory notice and comment procedures for formal rulemaking and was thus technically not a “rule” at the time it was issued, it was understood by the compliance industry as de facto regulatory disapproval of the origination, modification, or refinancing of any loan causing a borrower company to carry debt exceeding six times EBITDA. Indeed, the guidance appears to have had the effect intended by the agency.

Jacob W. Stasny
Of Counsel, Sumner Schick LLP

Continued on Page 12
cies, as average debt/EBITDA on U.S. buyouts fell from their pre-crisis levels to below six in both 2015 and 2016.

Nevertheless, due in large part to a sustained period of quantitative easing, average leverage ratios have ticked up in 2017 and 2018, even as the incidence of leveraged buyouts ending in highly visible bankruptcies has also increased. In addition to the liquidation of Toys ‘R’ Us, which was leveraged at 7.5x EBITDA following its buyout in 2005, several other leveraged acquisitions filed high-profile bankruptcies in the last two years, including Claire’s Stores, Inc., Gymboree Group, Payless ShoeSource, The Limited Stores, and True Religion Apparel. This glut of post-LBO bankruptcies has likely not seen its end, as many analysts believe bankruptcy filings are imminent for other debt-saddled retailers such as Neiman Marcus and Guitar Center. Despite abundant evidence of the potentially destructive consequences of over-leveraging, risk tolerance in private equity remains high, as funds raised a record $453 billion last year and closed 2,247 deals in the first half of 2018 alone, according to Preqin and Pitchbook, respectively. Moreover, continued access to credit and unprecedented fundraisin-

ning success has resulted in a build-up of over $1 trillion in dry powder in the market, making a slowdown in deal activity unlikely as fund managers feel pressure to deploy capital.

Notwithstanding many legislators’ concerns regarding these risk factors, and their justified indignance over the Toys ‘R’ Us liquidation as the most recent example in a long line of companies hobbled by massive post-LBO debt, it is unlikely that the leveraged loan market will be negatively impacted by compliance concerns in the near term. Ironically, the sentiments expressed by lawmakers come on the heels of three key developments over the past year that will likely improve the legal climate for leveraged buyouts.

CONFIRMATION OF TRUMP APPOINTEES TO KEY BANK REGULATOR POSITIONS

President Trump campaigned on a promise to deregulate the financial industry, and his appointments, while more deliberate and less bank-friendly than many anticipated, have largely been seen as a means to fulfill that pledge. Three recently confirmed appointments are especially important to the private equity market. Randal Quarles, a former partner at the Washington, D.C.-based private equity firm The Carlyle Group and former Treasury Department undersecretary during the George W. Bush administration, was confirmed in October 2017 as the Federal Reserve Board’s Vice Chairman for Supervision, a post created by the Dodd-Frank Act to oversee supervision and regulation of Board-regulated financial firms. Joseph Otting, a former employee of Treasury Secretary Steven Mnuchin at OneWest Bank, was sworn in as Comptroller of the Currency (OCC) in November, and Jelena McWilliams, formerly the chief legal officer at Fifth Third Bancorp, was sworn in as Chairman of the FDIC in June.

GAO RULING: INTERAGENCY LEVERAGED LENDING GUIDANCE IS SUBJECT TO THE CONGRESSIONAL REVIEW ACT

In March 2017, Sen. Pat Toomey asked the Government Accountability Office (GAO) to determine whether the ILLG rose to the level of a formal rule subject to review under the Congressional Review Act (CRA), a statute allowing Congress to roll back certain regulations by issuing a joint resolution of disapproval. Typically, Congress has only 60 days following the enactment of a rule to act under the CRA, but since the 2013 ILLG was issued as “guidance” rather than a “rule,” it was considered outside the Act until Senator Toomey’s unorthodox intervention, which resulted in the GAO’s October 19, 2017 ruling that the ILLG is a rule subject to the CRA because it meets the tripartite definition of a “rule” under the Administrative Procedure Act, in that it is (1) An agency statement, (2) Of future effect, (3) Designed to implement, interpret, or prescribe law or policy. 1

Significantly, congressional disapproval under the CRA effectively forever nullifies a rule by prohibiting agencies from re-proposing regulation to take its place. Because of this salttheearth effect, reversal of the ILLG under the Act would render bank regulators unable to police leveraged lending in any manner – whether by guidance or by rule. Instead of risking permanent loss of authority in this area due to the current anti-regulation political climate, the recently appointed leadership of the agencies responsible for the jointly-issued ILLG responded to the GAO ruling first by stating that they would revisit the guidelines, and ultimately by reiterating that the ILLG is merely “guidance” and was never intended as hard and fast rules, a reaction widely viewed as a political response intended to conciliate a Republican Congress, and to carry out the agency leaders’ mandate to roll back regulation while still maintaining their current authority to influence how regulated lenders manage credit risk associated with leveraged loans.

LOAN SYNDICATION AND TRADING ASSOCIATION V. SECURITIES EXCHANGE COMMISSION

With the intent to align the economic interests of securitizers and investors, the Dodd-Frank Act required securitizers of asset-backed securities to maintain “skin in the game” by retaining at least five percent of the credit risk for any asset the securitizer delivers to a third party. The resulting Credit Risk Retention Rule issued jointly by the SEC and FRB, according to its express terms, applied to managers of “collateralized-loan obligations” (CLOs). CLOs are securities backed by pools of debt often including high-risk corporate loans such as those involved in leveraged buyouts, and CLO managers are the biggest buyers of risky corporate loans. Under the Loan Syndication ruling 2, the Credit Risk Retention Rule does not apply to CLO managers, which should make it easier for managers to pool CLOs, and in turn increase investor demand for loans that fund LBOs and other highly leveraged acquisitions.

---

The story is rather common – an early stage company (the “Company”) wants to create and launch an exciting new business. They have an idea, and a plan on how to bring the idea to life, however, they do not have the capital to bring this idea into existence. The Company decides to pitch the idea to friends, family, angel investors, venture capitalists, etc. in hopes one (or all) of these people will invest in the Company and allow them to bring this idea to life.

Fortunately for the Company, some of these potential investors see the vision and are willing to invest in the concept to help this move forward. A snag then occurs when the investor asks the Company what the valuation of the Company is. The Company doesn’t know – they do not even have a product yet – but they know enough that if they gave away a large amount of the business today, they might be less incentivized to operate the Company moving forward. In light of this scenario, and the need for quick and easy early financing, early stage companies have begun using alternative forms of financing to equity issuances to keep the parties aligned at this early stage. This post will focus on an increasingly popular method of alternative financing which is called a SAFE, or a Simple Agreement for Future Equity.

By way of background, the SAFE was created in 2013 by Y-Combinator to create a simple and efficient way for early stage businesses to raise capital. In its purest form, a SAFE is a contract between a company and the investor that will grant the investor equity in the future, upon the occurrence of triggering events. The triggering events contained in a SAFE include: Equity Financing, Liquidity Event, or Dissolution Event. This article will focus on the triggering event of an Equity Financing, or in other words, when the Company sells preferred stock to later investors, as this event provides for a conversion of the SAFE into preferred stock.

Upon the Equity Financing, the SAFE will convert to a series of preferred equity, nearly identical to those of the equity securities sold in an Equity Financing, with the significant difference being the liquidation preference and dividend rate calculation (which will be based on SAFE conversion price per share rather than the Equity Financing investor’s price per share). The SAFE will convert to equity.

> Continued on Page 14
BY WAY OF EXAMPLE:

Company 1 has 1,000,000 shares outstanding and $50,000,000 in SAFE investments, with a Valuation Cap of $5,000,000.00 and a Discount Rate of 20%. The Equity Financing has a pre-investment valuation of $10,000,000.00 dollars. This means that at the Equity Financing, the per share price will be $10.00 per share ($10,000,000.00 pre-investment valuation/1,000,000 shares outstanding).

In this case, a Discount Rate on the price per share will not net the SAFE investor much of a percentage of the Company. Instead, using a Valuation Cap provides for the SAFE investors to convert as if the Company were valued at $5,000,000.00, or $5.00 per share ($5,000,000 pre-investment Valuation Cap/1,000,000 shares outstanding) thus giving a larger discount to fairly compensate the SAFE investor.
“Nobody cares how good your case is if you don’t have the money to prove it.” As harsh as this sounds, it’s often true in post-closing M&A disputes. The selling shareholders may have a great claim against the buyer for an earnout payment (or a rock-solid defense to the buyer’s indemnification claims), but if the shareholders have not reserved enough in their post-closing expense fund, they may have brought a knife to a gunfight.

This shareholder expense fund plays a critical role in post-closing strategy and dispute management, and may even present some advantages for buyers. However, with legal billing rates increasing over the past several years, it is important that shareholder expense funds keep pace.

For those that cannot, the market has responded by providing an alternative to traditional expense accounts. A burgeoning sector of litigation financiers has emerged to provide contingency-like funding that can allow sellers to pursue meritorious offensive litigation. While litigation finance creates new opportunities for some, its applications and benefits are limited. The best way to adequately protect merger parties’ rights post-closing is (still) to adjust the expense fund to the cost of anticipated issues.

WHY AN EXPENSE FUND?

On most M&A transactions, there is work to be done after closing. Most deals have escrows, holdbacks, or at least tax matters that extend for several years after the signatures dry. A sizeable percentage of deals also have earnouts or milestones where over 50% of the deal consideration may be contingent on future events.

For these reasons, SRS Acquiom (“SRSA”) advises shareholders to reserve a portion of the deal value in a shareholder expense fund to be used as needed for counsel, tax experts, or other costs. At minimum, we recommend at least $250,000 on deals without earnouts or other known issues.

Several factors warrant larger-than average expense funds. Deals with earnouts, multiple escrow releases, or post-closing payouts are prime examples.

>> Continued on Page 16
THE BEST WAY TO ADEQUATELY PROTECT MERGER PARTIES’ RIGHTS POST-CLOSING IS (STILL) TO ADJUST THE EXPENSE FUND TO THE COST OF ANTICIPATED ISSUES.

Risk is also a key variable, so expense funds should be larger on deals with ongoing litigation, significant intellectual property assets, or specifically indemnified matters. International deals present similarly expensive post-closing challenges and should have expense funds to match.

Notwithstanding the critical importance of shareholder expense funds, they are generally an afterthought. The parties have often spent months on the details of the M&A transaction, and the expense fund is given little consideration, both literally and figuratively. However, failure to set aside enough can prove to be a very costly mistake for all.

SIZE MATTERS

The presence of an adequate expense fund presents a number of strategic advantages, regardless of whether or how much is spent. In fact, our experience suggests that a larger expense fund is less likely to be depleted than a smaller one based upon the additional leverage it provides.

The expense fund amount is typically determined at the time of closing and held by the shareholders’ representative “to be used for the purposes of paying directly, or reimbursing the shareholder representative for, any third-party expenses...” The absence of adequate expense fund can make sellers extremely vulnerable. Here’s why:

- **Money is Power.**
  There are many instances after closing where the sellers are entitled to money, either from an earnout or an escrow, or need to be able to assume or assist in the defense of a third-party claim. It can be very challenging to adequately protect rights unless the other party knows the sellers are able escalate to litigation. Even absent any disputes, the financial ability to pay expenses of third-party advisors can cause things to move more smoothly on routine processes like purchase price adjustments, tax return reviews, and escrow releases.

- **Control Saves Costs.** Many merger agreements give the shareholders the option to assert control over certain third-party claims. Exercising this right is generally advisable because it allows the sellers to select counsel, keep close tabs on legal fees, and dictate the most cost-effective strategy for resolution. Of course, the ability of the sellers to make this choice is directly dependent on the expense fund. If the expense fund is inadequate, sellers can find themselves having to defer to the buyer or to proceed with the defense of a claim.

- **Mutually Assured Depletion.** In many cases, having the money to sue reduces the likelihood that you’ll ever have to do it. Litigation is expensive for everyone, and if the claiming party knows that the sellers have a trial-sized expense fund, they have significantly more incentive to be reasonable early so as to save themselves the cost of that fight. Even if the merits are grey, the prospect of an expensive legal battle usually gets savvy parties to consider early resolution. Conversely, the claiming party loses some incentive to settle if they know the sellers can’t afford to go the distance.

BEST FOR BOTH SIDES?

In addition to the more obvious shareholder advantages described above, buyers may also benefit from an adequate shareholder reserve. For example, shareholders who are able to control third-party claims can alleviate much of the burden from buyers by handling the claims on their own time and dime. When the shareholders are paying, buyers can also trust that they will be motivated to resolve the claims as efficiently and effectively as possible.

Funding defensive litigation from the shareholder expense fund rather than the escrow also ensures that more escrowed funds will be available for other contingencies that can arise post-closing. This can prove especially valuable on deals where escrowed funds are limited or post-closing liabilities are greater than anticipated. In light of these potential positives, buyers may be wise to devote more consideration to the size of the shareholder expense fund.

>> Continued on Page 17
Finally, many buyers prefer that the sellers be represented by sophisticated legal counsel both with respect to the negotiation of the merger agreement and any post-closing disputes. These buyers know that good opposing counsel will understand the issue and will be able to have a reasonable discussion to drive to a sensible resolution. Having a properly sized expense fund can help ensure this.

THE RISING COST OF GOOD REPRESENTATION

Despite the strategic advantages of an adequate expense fund, rising legal costs have made “having enough” more difficult. According to Thomson Reuters’ 2018 Report on the State of the Legal Market, law firms raised their standard rates by approximately 3.1% in 2017 (after increasing 2.9% in 2016 and 2.5% in 2015). For the Am Law 100 firms, Thomson Reuters’ Q1 2018 Executive Report indicates that billing rate growth has jumped from 3.3% to 4.5% since Q1 2016, after a 2.7% increase in 2015.

The 2018 CounselLink Enterprise Management Report issued by LexisNexis confirms the same trend. In 2017, LexisNexis observed a 8% rate increase from 2016 among the largest law firms. Among legal sectors, M&A and IP-Patent have seen some of the largest growth in partner hourly rates, with M&A growing at over 4% year-over-year for the past three years (almost 13% since 2015) and IP-Patent growing almost of representation can be provided going forward.

NEW FINANCING OPTIONS

For many years, an inadequate expense fund meant that shareholders would either have to accept their fate or seek replenishment through an arduous “pass the hat” process. However, a new market of expect more to follow.

In exchange for their infusion of capital, litigation financiers are taking roughly 10-20 percent of recovery following return of their initial investments. Although terms vary by deal, most investors do not require repayment in the absence of recovery. This means that shareholders have the opportunity to

A NEW MARKET OF LITIGATION FINANCIERS HAS RECENTLY EMERGED TO PROVIDE THIRD-PARTY FUNDING FOR OFFENSIVE SHAREHOLDER LAWSUITS.

As an initial matter, litigation financiers are primarily interested in cash payouts. On deals where sellers are after additional shares (especially if illiquid) or equitable remedies, it may be difficult or impossible to negotiate financing. Even if cash is available, financing also requires the sellers to forfeit a decent slice of their proverbial pie. More importantly, financing is simply not available for any litigation defense because there is no potential payout. Since defense work (either directly against buyer, or against third-party claims) comprises a significant percentage of post-closing disputes, litigation finance is not a reliable substitute for an adequate shareholder expense fund.

To achieve the most bang for their buck on post-closing matters, shareholders are best served by establishing a well-stocked expense fund at closing. Any amount not used will be distributed back to sellers after the dispute period has ended, but having enough to meaningfully engage with either the buyer or third-parties is likely to result in better post-closing outcomes across the board.
A carve-out transaction involves the sale or divestment of a division or assets comprising a specific business line, subsidiary or other unit of a larger business enterprise. Carve-out transactions create a path for sellers to discard businesses least aligned with core business strategies while also generating additional capital for the seller. There is anecdotal evidence that private equity buyers have obtained superior returns from investments made as a result of such carve-out transactions which are typically consummated at favorable valuations that come with ready managerial talent.

Carve-out transactions invoke unique challenges compared to standard M&A transactions. Being experienced in executing carve-outs and/or utilizing experienced representation is vital to identifying and resolving the distinct issues that carve-outs pose. Below is a list of key issues that private equity firms should consider when planning and executing a carve-out transaction and navigating the post-closing exit and integration process. This list is based on Koley Jessen’s experience in closing carve-out transactions in a variety of industries, as well as from our extensive contribution to and review of the 2017 Carveout Transaction Deal Points Study published by the ABA Business Law Section Mergers & Acquisitions Committee’s Subcommittee on Market Trends (ABA Carve-out Study).

KEY CONSIDERATIONS IN PRIVATE EQUITY CARVE-OUT TRANSACTIONS

The considerations noted below are bucketed in three categories: (1) Structuring Issues, (2) Diligence Issues, and (3) Transition and Integration Planning Issues.

1. Structuring Issues
   a. Defining the Business and Determining True Cost of Operations
      If the target is not already an independent entity, the buyer and seller will need to determine the assets comprising the business and how to segregate these from the seller’s existing enterprise. If an equity deal structure is preferred, it may be preferable to spin off the target into a new subsidiary prior to closing. Anything that cannot be assigned to the new target entity or to buyer should be addressed in the TSA (see transition and integration planning issues below). Financial modeling implications of this issue are obvious, and a private equity buyer would typically spend significant time in determining the true-cost of operating the business as a stand-alone operation. See also, 2(a) below for diligence on financial statements.

b. Structuring the Transaction
   Multiple sub-issues need to be considered for appropriately structuring a carve-out: (i) Like all other transactions, tax structuring is important and depends on existing tax structures of both buyer and seller (also see (c) below); (ii) Seller must consider how the transaction may

>> Continued on Page 19
CARVE-OUT TRANSACTIONS CREATE A PATH FOR SELLERS TO DISCARD BUSINESSES LEAST ALIGNED WITH CORE BUSINESS STRATEGIES WHILE ALSO GENERATING ADDITIONAL CAPITAL FOR THE SELLER.

impact its remaining business (i.e., seller may not want to lose permits and licenses, general disruption of business, time and focus); (ii) Potential regulatory approvals and contract consents (i.e., assignment versus change in control provisions); and (iv) contractual consents required for assignment or if contract defaults are triggered by an assignment. Although many buyers favor asset transactions versus equity transactions to reduce liability, private equity buyers at least consider whether the target business unit ought to be spun off into a separate entity because it simplifies integration and better packages the business for a future sale. This is reflected in the available deal studies data: 58% of deals in the ABA Carve-out Study were structured as equity transactions, whereas 41% of sellers in the ABA Carve-out Study provided a representation and warranty that the target business’s financials were audited.

2. Diligence Issues
a. Financial Statements
In carve-out transactions, the seller often has financials for the parent/seller level, but not separate financials for the relevant business unit(s) or lines of business(es). Lack of separate financials can inhibit buyer’s assessment of the target, leading to delays in closing and impeding buyer’s ability to obtain financing to fund the transaction. To streamline this process, private equity buyers seller should identify the scope of the target business and its specific revenue and expenses as quickly as possible, although this may be difficult when these items are commingled throughout seller’s effective tax rate after closing. Buyer can consider reflecting future tax benefits in the purchase price valuation, as applicable.

b. Books and Records
Sellers typically maintain books and records on a consolidated basis, so the parties need to coordinate their efforts to determine how to most efficiently assemble and organize due diligence materials of the target, so that buyer may evaluate the transaction and comply with recordkeeping requirements going forward. In addition, sellers need to have a plan in advance to ensure that they do not disclose significant information of other separate business units that is not relevant to the transaction. This is commonly handled through extensive redaction of documents or nuanced confidentiality agreements.

c. Intellectual Property
Whether seller, the target business unit or a third party owns relevant intellectual property (IP) is a crucial distinction in a carve-out transaction. The parties should consider how to

>>> Continued on Page 20
effectively preserve these favorable pricing structures as part of the transaction while also noting that a seller may face penalties for decreases in volume under its existing licenses.

d. Customers/Suppliers
In addition to usual steps to get comfortable that the target business unit’s customers will continue to do business with the target after closing without material interruption or reduction, it may be necessary to disclose the deal to key customers prior to closing to make sure they are aligned with the goal of separating out the business from the mothership. When valuing customer relationships, buyers should take into account that calculations may be compounded due to existing cross-selling arrangements for seller’s other products or services. Buyer should also review customer information to learn if any new relationships would cause conflicts with its current customers (i.e., one loyal customer might not want buyer to do business with one of that customer’s competitors). Buyer should consider its operations goals as well and whether the target’s suppliers and distributors are appropriate for larger (or smaller) orders.

3. Transition and Integration Planning Issues

a. Transition Services
Negotiating an effective transition services agreement (TSA) early in the deal process must be a priority for both the buyer and seller. 96% of deals in the ABA Carve-out Study utilized a TSA in the transaction. The TSA should contemplate key services that buyer requires from seller in order to turn assets into a standalone business as well as any services of the business unit that seller requires to continue its go-forward operations. TSAs commonly provide buyer with access to IT-related items that cannot be unwound from seller’s infrastructure, such as enterprise resource planning (ERP) and other hardware as well as the assistance of seller’s IT team to migrate information to buyer’s network. TSAs can grant access to interim services for a set period of time, until post-closing covenants from the purchase agreement have been satisfied (for example, access to IP until assignments are completed or use of bank accounts until control is transferred) or until cancelled by one or both parties. The parties can also utilize the TSA as an alternative to a supply agreement to capitalize on favorable pricing arrangements and relationships of seller, which can eliminate the need to transfer any such contracts to buyer or terminate and start from scratch. Thinking creatively about ancillary items that are not traditionally included in the purchase agreement can also add significant benefits, such as considering value-added tax (VAT) implications (whether it is recoverable and if, who is responsible for the cost) and other go-forward operations.

b. Employees and Benefits
The parties should take the time to identify key employees and management who will work for buyer after the transaction. This is especially important when there are employees with responsibilities that overlap between seller and the target business unit’s operations. Aside from inclusion in the TSA, a limited-term consulting agreement could help ease such transition period as well. Early identification of employees who will work for buyer and involvement of such employees in the deal process can be a major advantage to buyer: such employees essentially serve as an “inside man” for buyer with regard to seller’s and target’s operations. With key employees, buyer may be required to negotiate new employment contracts, providing buyer with an opportunity to establish the terms and conditions of the employment relationship without an obligation to adhere to the original terms seller agreed to.

CONCLUSION
As carve-out transactions become increasingly prevalent, private equity buyers and sellers need to do more than merely be aware of the existence of carve-out opportunities. Private equity firms must also understand and prepare for the key issues described in this article in order to capitalize on potential carve-out prospects as they arise and minimize the execution risk of the post-closing exit and integration process. The ABA and other programs will continue to collect and publish data on carve-out transactions, which will allow private equity firms to better seek out, investigate and incorporate such information into their financial and risk assessments.
The Committee is collecting articles for future newsletters which are circulated to our members worldwide. Please send your submissions to Brett Stewart at brett.stewart@mcmillan.ca. 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.

HOW TO REACH OUR LEADERSHIP

Eric Klinger-Wilensky  
Chair  
Morris, Nichols, Ariste & Tunnell LLP  
ekwilensky@mnat.com

Steve Wilson  
Vice Chair  
Osborne Clarke  
steve.wilson@osborneclarke.com

Brett Stewart  
Editor, Preferred Returns  
Membership Director  
McMillan LLP  
brett.stewart@mcmillan.ca

William Bratton  
Co-Chair, Academic Subcommittee  
University of Pennsylvania Law School  
wbratton@law.upenn.edu

Brett Stewart  
Editor, Preferred Returns  
Membership Director  
McMillan LLP  
brett.stewart@mcmillan.ca

How to reach our leadership

PRIVATE EQUITY & VENTURE CAPITAL COMMITTEE

Thomas Mullen  
Co-Chair, Jurisprudence Subcommittee, Liaison to the Joint Task Force on Contractual Governance of Business  
Potter Anderson & Corroon LLP  
tmullen@potteranderson.com

Lisa Stark  
Co-Chair, Jurisprudence Subcommittee  
K&L Gates LLP  
lisa.stark@klgates.com

David Albin  
Chair, Private Equity M&A Joint Subcommittee  
Finn, Dixon & Herling LLP  
dalbin@fdh.com

Mireille Fontaine  
Vice Co-Chair, Private Equity M&A Joint Subcommittee  
BCF LLP  
mireille.fontaine@bcf.ca

Samantha Horn  
Vice Co-Chair, Private Equity M&A Joint Subcommittee  
Stikeman Elliott LLP  
sghorn@stikeman.com

Scott Bleier  
Co-Chair, Venture Capital Financing Subcommittee  
Morse Barnes-Brown & Pendleton, PC  
sbleier@mbbp.com

Jonathan Gworek  
Chair, Programs Subcommittee & Immediate Past Chair  
Morse Barnes-Brown & Pendleton, PC  
jgworek@mbbp.com

Ernest Holtzheimer  
Technology Director  
Montgomery McCracken Walker & Rhoads LLP  
eholtzheimer@mmwr.com

Jonathan Cardenas  
Co-Chair, PE & VC Dictionary Task Force  
Visiting Fellow, Yale Law School  
jonathan.cardenas@yale.edu

Jenna Nand  
Co-Chair, PE & VC Dictionary Task Force  
Fortuna Law PLLC  
jnand@fortuna-law.com

AMERICAN BAR ASSOCIATION  
321 N Clark  
Chicago, IL 60654-7598  
Tel: 312-988-5522  
Toll Free: 800-285-2221  
www.americanbar.org