

Presentation Material at Stanford University

# STRUCTURING VENTURE CAPITAL AND ENTREPRENEURIAL TRANSACTIONS

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**Ruth Jin, Esq.**

The Jin Law Group

Tel: 646-863-5903

Fax: 646-862-9620

Email: [rjin@jinlex.com](mailto:rjin@jinlex.com)

**Michelle Shao, Esq.**

The Jin Law Group

Tel: 408-273-4560

Fax: 408-273-4665

Email: [mshao@jinlex.com](mailto:mshao@jinlex.com)

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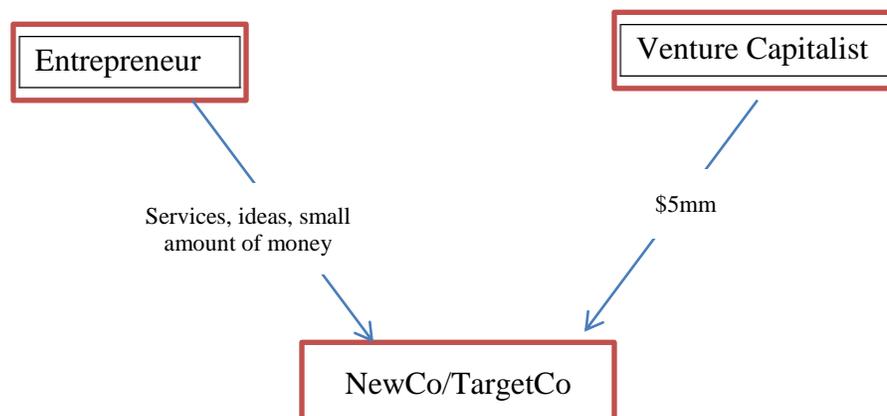
## 1. Premise:

An entrepreneur (“E”) wishes to start a business. E may have a new high-tech invention or a low-tech improvement on an existing product, or E may have a new no-tech approach to the manufacture or marketing of an established product or service.

E’s concept may require substantial research, development, and/or other activities before the proposed business will be ready to begin actual sales of goods or services, so E is seeking “seed money.” Or E may have passed the “seed money stage” and may now need “early stage venture capital” to begin producing goods or providing services.

In either event, E is seeking \$1mm from VC for the proposed business. E and VC decided to form NewCo as a C corporation (or as an LLC, or S Corp. --- We will discuss the proper business form, pros and cons of each type of corporate form, in Section 3 below). Or E already has formed a company (“TargetCo”) and VC will invest in TargetCo in exchange for certain equity and/or debt or a combination of both.

This presentation focuses only on a start-up investment and growth-equity investment, and not on buyout, industry consolidation or troubled company restructuring.



## 2. Exit Strategies

PE/VC does not invest in a transaction with the intent of holding and operating NewCo or TargetCo (each, a “Portfolio Company”) into the indefinite future. Rather, PE/VC’s goal is to liquefy its investment as a substantial profit when Portfolio Company’s value has been maximized through good management, VC/PE supervision and add-on values, and the like, typically 3-7 years after PE/VC’s initial investment in Portfolio Company.

When structuring NewCo or by the time of negotiating the term sheet with E, PE/VC is already planning its ultimate exit strategies. Hence, E too should take into consideration a

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variety of exist strategies when structuring NewCo as well as PE/VC's position in the Portfolio Company.

PE/VC's exit strategies may include:

- (1) Sales of Portfolio Company stock to the public in an IPO or a post-IPO registered offering or pursuant to SEC Rule 144; or
- (2) Sale of Portfolio Company to a large company ("BuyerCo") in exchange for BuyerCo stock (in a tax-free reorganization), for cash, or a combination of cash and debt instruments;
- (3) Redemption/repurchase: VC may have Portfolio Company buyback the stock at some future time either at a formula price or at appraised fair market price (FMV).

## **2.1 Initial Public Offering**

### 2.1.1. Generally

PE/VC and others acquire Portfolio Company securities without SEC registration in a private placement (such as Reg D). Therefore, these types of securities are "restricted securities" and a holder of such restricted securities can only resell:

- (a) in a subsequent private sale (Ex: a sale to qualified institutional buyers under SEC Rule 144A), or
- (b) in a public offering registered with the SEC under the 1933 Act; or
- (c) in a public sale under SEC Rule 144; or
- (d) in a public Reg A offering, where Portfolio Company is already a 1934 Act reporting company (and with certain other offering conditions);
- (e) in an offshore transaction to persons who are not US persons pursuant to SEC Reg. S.

### 2.1.2. IPO-1933 Act Registration Statement on Form S-1

The most likely method for effectuating an IPO for a privately held Portfolio Company is a full-blown 1933 Act Registration Statement on Form S-1.

### 2.1.3. Underwritten Offering

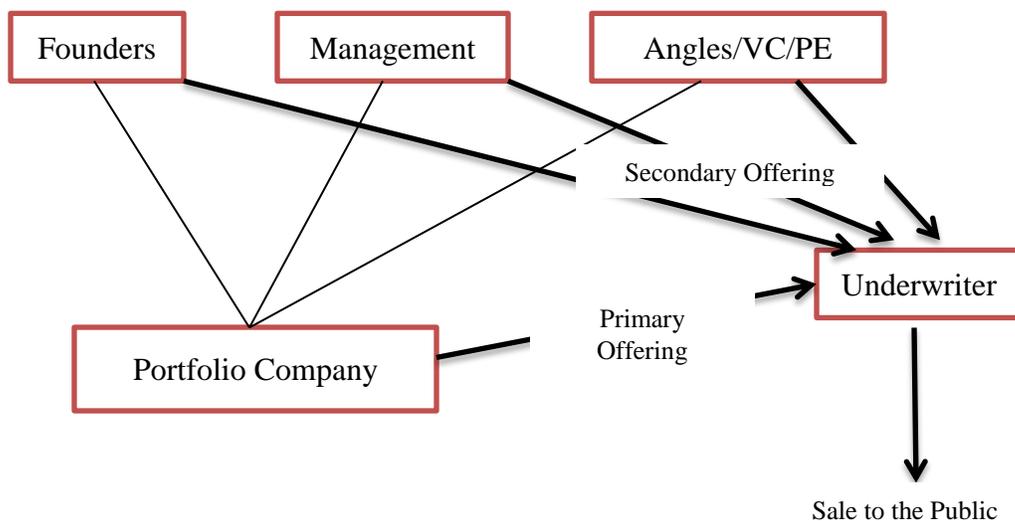
The most common approach to an IPO is to arrange an underwriter (or a group of underwriters) to buy the securities when the 1933 Act registration statement becomes effective and resell them to the public. The lead underwriter would place a limit on the number of securities that can be sold in the IPO. It would also require that Portfolio Company and each major shareholders agree to not sell additional company shares for a specified period of time (ex: 90 – 180 days or even longer) period after the underwritten offering ("Holdback Period"). Often the registration rights agreement obligates holders offered the opportunity to take part in the offering not to sell, other than in the underwritten offering, during the hold-back period.

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2.1.4. Primary v. Secondary Sale

If the Portfolio Company is merely seeking new money for expansion, redemption of PE/VC owned stocks and other business purpose, the IPO is offering “primary securities” by Portfolio Company. If VC/PE and other shareholders are seeking to liquefy their holdings of Portfolio Company securities, the IPO include “secondary” securities to be sold by existing shareholders.

An underwriter often insist that all or substantially all of the offering consist of primary securities – demonstrate that the Company is improving its finances and business; and that a very small portion of the offering is secondary securities – to demonstrate that the existing holders, founders and management in particular, are not bailing out but are committed to the business.



2.1.5. Stock Exchange Listing v. Nasdaq Stock Market

Each market, NYSE, AMEX, NASDAQ, has different requirements for the issuers, such as net tangible asset and net income thresholds. If an issuer can’t meet any of these requirements, it may be able to be traded on the OTC market.

2.1.6. Special Form for Small Business Issuer – simpler than S-1 registration

A “Small Business Issuer” is: (1) a US or Canadian entity; (2) with revenues of less than \$25 million; and (3) a public float (the aggregate FMV of voting stock held by non-affiliate) is less than \$25 million.

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Form SB-1 or Form SB-2 is used. (Detailed deleted)

2.1.7. Short-Form 1993 Act Registration Statement for Subsequent Offering (Omitted)

2.1.8. Blue Sky Compliance: comply with each applicable state's securities laws.

2.1.9. Post-IPO Obligations (omitted). Ex: 8K, 10b (5).

2.1.10. Rule 144 Sales after IPO

2.1.10.1. Once Portfolio Company has completed its IPO, PE/VC and other shareholders can begin to sell their restricted securities without filing an SEC registration statement for those securities, so long as (1) it's after the expiration of any hold-back period; and (2) all Rule 144 requirements are met (see below).

2.1.10.2. Rule 144 A Requirements are mainly:

- (i) Portfolio Company must have been a 1934 Act reporting company for at least 90 days prior to the sale and have filed all the required reports with the SEC during the preceding 12 months;
- (ii) Volume: Each holder can sell, in any 3 month period, no more than the greater of 1% of Portfolio Company's outstanding securities of the same class or 1 week's average trading volume over the past 4 weeks in securities of the same class (excluding from the reported trading volume any shares sold by the holders during that period). – Details omitted
- (iii) Manner of sale: Portfolio Company securities must be sold through a broker-dealer. Other requirements are under SEC's review for potential elimination (Ex: holding period requirement).

## **2.2. Sale of Portfolio Company to BuyerCo**

2.2.1. BuyerCo Stock as Principal Consideration

- (a) Tax: Under the tax-free reorganization rules, Portfolio Company shareholders can generally receive BuyerCo Stock (other than Non-Qualified Preferred Stock) tax free, and any assets/boot received in the reorganization is generally taxed as Long Term Capital Gain.

There is no tax impediment if Portfolio Company shareholders immediately sell BuyerCo stock received in a tax-free reorganization, so long as they don't sale the stock too quickly back to BuyerCo.

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- (b) SEC: If BuyerCo Stock issued in acquisition of Portfolio Company was not registered with the SEC, Portfolio Company shareholders can resell BuyerCo stock (i.e., restricted stock) under Rule 144 (same requirements: public disclosure; holding period requirement; volume requirement, manner of sale, notice). Therefore, if BuyerCo is not registered with the SEC, it is desirable to obtain registration rights from BuyerCo before such acquisition.
- (c) BuyerCo Stock was registered with the SEC: Portfolio Company shareholders are free to resale, except that:
  - a. If BuyerCo's acquisition of Portfolio Company was structured as an asset sale or merger requiring a shareholder vote, so that it fell within SEC Rule 145, a Portfolio Company shareholder who was a member of the Company's control group is subject to certain Rule 144 restrictions.
  - b. A former Portfolio Company shareholder who is a member of BuyerCo's control group at the time of resale is subject to Rule 144 volume and certain other restrictions.

2.2.2. BuyerCo Debt Instrument as Part of Consideration

- (a) Tax: Omitted
- (b) SEC: Rule 144 and 145 restrictions of stock sale apply to the sale of debt instruments by Portfolio Company shareholders.

2.2.3. BuyerCo purchases Portfolio Company's Asset:

In an asset sale, where Portfolio Company's assets are transferred to BuyerCo, the transaction is generally subject to double taxation, unless Portfolio Company is a pass-through company (S Corp., Partnership or LLC) and the transaction is structured with sophisticated tax and capital structure.

2.2.4. Representations and Warranties and Indemnifications

BuyerCo seeks extensive reps and warranties regarding undisclosed liabilities, inventories, IPs, receivables, financial statements, among other things. These R&W normally survive the closing and are coupled with indemnification against breaches of reps and warranties.

2.2.5. Assumption of Liabilities: Only certain liabilities are assumed by BuyerCo (all subject to negotiation).

### **3. Business Structure**

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3.1. S corporation

- (1) Limited liability and pass-through company (meaning, no entity level tax)
- (2) Must Avoid Veil Piercing:
  - Undercapitalization of NewCo;
  - NewCo's failure to observe corporate formalities;
  - Commingling of the Shareholder's and NewCo's funds;
  - Failure to maintain arms-length relationship between NewCo and Shareholder;
  - Common business enterprise between NewCo and the Shareholder, i.e., both engaged in portions or segments of an integrated business activity; and
  - The shareholder's fraudulent intent to avoid liability.
- (3) Pension Plan and Other ERISA Liabilities (Omitted)
- (4) Tax compared to C Corp: No entity level tax
- (5) Compared to LLC or Partnership: All are pass-through entities. The differences are significant however; they are mainly: (i) S Corp must comply with arbitrary rules limiting the number and identity of its shareholders; (ii) S Corp can only issue a single class of plain vanilla common stock; (iii) when S Corp distribute appreciated assets to shareholders, such recognized gain flows through and is taxes to its shareholders (no such tax in LLC or partnership).

3.2. Limited Liability Company

- (1) Limited liability and no entity level tax.
- (2) Must Avoid Veil Piercing: Same as S Corp.
- (3) Pension Plan and ERISA Liabilities (Omitted)
- (4) Tax compared to C Corp: No entity level tax – Note: It can elect to be treated as corporation for tax purposes.
- (5) Compared with S Corp: (i) No limitations on number and identity of shareholders/members; (ii) can issue different classes of equity and debt; (iii) no appreciation tax; (iv) cannot use tax-free reorganization in an acquisition.
- (6) Compared with C Corp: can discriminate shareholders of same class (with management power).

3.3. C Corporation

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- (1) Limited liability
- (2) Double taxation: entity level and shareholder level
- (3) Must Avoid Veil Piecing: Same as S Corp and LLC
- (4) Pension Plan and ERISA liabilities: Same
- (5) No limitation on number and identity of shareholders; can issue different class of equity and debt; and can use tax-free reorganization in acquisition.
- (6) More easily transferable in public, so most ideal in an IPO

Thank you. To discuss these matters further, please contact me or any of our attorneys.

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