BUSINESS PLANNING

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2013 SUPPLEMENT

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BUSINESS
PLANNING

PREFACE – SUPPLEMENT

We are very pleased to release this Supplement to the First Edition of Business Planning. In the three years since the book was first published there have been some significant changes in the law of business planning.

In this Supplement you will find the following:

1. Corrections to the First Edition.
2. Important developments in the law of taxation (Chapter 3), securities exemptions (Chapter 4), and buy-sell agreements (Chapter 8).
3. Additional information for Chapters 2, 5, 6 and 7.

We encourage you to contact us with any comments, observations or suggestions you may have.

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Corrections to BUSINESS PLANNING (Ehrlich & Michael)				
Chapter	Page	¶	Line	Change
1	35	2	11	"documenet" to "document"
3	83	1	12	insert "for" after 15%
3	90	2	2	insert space after question mark in phrase "contributions? Section 385"
3	110	6	9	change "$300,000" to "$250,000" in the last line.
3	115	1	6	insert "Once cash " after "1984."
3	123	4	3	Insert "-" after "distribu"
4	140	7	3	Insert "." after "Exchange Act"
4	169	8	1	Delete "to" in "Would it be possible for sales to"
4	177	5	6	Change "Only then can evaluate" to "Only then can you evaluate"
5	203	2	4	change "corporation" to "entity"
5	254	2	2	change "three" to "five
5	258	1	3	insert "better position" after "partnership be in a "
5	260	2	2	change "depending on the ULLCA" to "depending on the version of the ULLCA"
5	266	3	8	delete "some of "
8	385	3	1	delete "extremely"
8	390	2	8	change "$1.8 loan" to "$1.8 million loan"
8	402	5	3	change "of if its " to "or if its "
8	409	3	13	delete "it" from phrase "it may actually have "
10	596	6	7	insert the word "who" after the phrase "departing partner," so that it reads: "departing partner, who receives the same cash amount "
10	603	6	6	change $900,000 to $1.9 million

e. Conflicts of Interest and Informed Consent

As discussed in detail earlier in this chapter, it is essential that "informed consent" be obtained when representing multiple clients. The adequate disclosure and informed consent can be included in the attorney client agreement or as a separate document bundled with the attorney client agreement.

f. Summary — The Attorney Client Agreement

The relationship between attorneys and clients can be productive and mutually satisfying, particularly in business entity formation. The lawyer provides the client with the legal advice and guidance to get the business formed and fulfill the objectives of the clients. However, a good relationship is based on a mutual set of expectations regarding the nature of the attorney's services, the charges related to those services, the scope of the attorney's work, the obligations of the clients and other matters discussed above. In the case of new clients or the renewal of a relationship with former clients, it is *always* best to put those expectations in writing. The submission of the attorney client agreement to the clients creates an opportunity to double-check that the parties expectations are in synch. If those expectations are not in synch, the written documenet will help to flush out any areas of the relationship that need to be discussed, negotiated and resolved *prior* to the commencement of the relationship. As you will see below, once entered into, the relationship is not easily terminated, even though the lawyer is losing money or the client is causing frustration and stress for the attorney.

The ABA Model Rules of Professional Conduct do not expressly *require* a written attorney client agreement, although the Rules recommend that the agreement between lawyer and clients be in writing. Many states require, by statute or professional rule, that the agreement be in writing in many circumstances. Below are some excerpts from the Model Rules, as well as California statutes, that will help to understand the importance and preferred contents of an attorney client agreement.

ABA Model Rules of Professional Conduct (2009)

Rule 1.2 Scope Of Representation And Allocation Of Authority Between Client And Lawyer

(a) Subject to paragraphs (c) and (d), a lawyer shall abide by a client's decisions concerning the objectives of representation and, as required by Rule 1.4, shall consult with the client as to the means by which they are to be pursued. A lawyer may take such action on behalf of the client as is impliedly authorized to carry out the representation . . .

(2) * * *

(c) A lawyer may limit the scope of the representation if the limitation is reasonable under the circumstances and the client gives informed consent.

(d) A lawyer shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent, but a lawyer may discuss the legal consequences of any proposed course of conduct with a client and may counsel or assist a client to make a good faith effort to determine the validity, scope, meaning or application of the law.

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2. Some Temporary Relief from the Double Taxation Problem

In 2003, The Jobs and Growth Tax Relief Reconciliation Act of 2003[23] provided capital gains and dividends tax relief to individual taxpayers by lowering rates on most capital gains and dividends. The Tax Increase Prevention and Reconciliation Act of 2005[24] extended these lower rates to 2010. Together, the Acts accomplished two goals. First, the capital gains tax rates for individuals were dramatically reduced to 15% for most long-term capital gains.[25] In addition, there was a temporary reduction in the tax rate applied to dividends distributed by corporations. Rather than paying taxes at the normal income tax rates for individuals, the rates for dividends received from domestic corporations and certain qualified foreign corporations were substantially reduced. Rather than dividends being taxed at the ordinary income rates (as high as 39.6% by 2008) the *maximum tax* rate for qualifying dividends was reduced to 15% most people — and less for individuals in the lower income brackets.

The reduction of the rate of taxes paid on dividends has caused a substantial reduction in the "double-taxation problem." Nevertheless, the problem is not eliminated and remains worthy of discussion for several reasons. First and foremost, the 15% dividend rate merely *reduces* the impact of double taxation but does not eliminate it. If the corporation has substantial income, it will be taxed at the rate of 35% prior to distribution and taxed again at the 15% rate when distributed to individual stockholders. The double taxation will still cause the taxpayer to end up with less after-tax cash in his or her pocket than if the income was taxed only once (as it is in partnership type entities or Subchapter S corporations). In addition, there are other impediments to taking advantage of the reduced dividend rate:

(i) Sunset provisions: The lower tax rates on dividend income will expire at the end of 2011.[26] Unless made permanent by some future Congress, these new provisions will fade into the sunset, and the rules on the taxation of dividends will revert back to the old rules (ordinary income taxed at normal tax rates).

(ii) Qualifying Dividends: To receive the lower tax rate, the dividends must be received from a domestic corporation or a qualified foreign corporation.[27] Dividends paid to policyholders by insurance companies don't qualify, nor do dividends paid by several other types of entities such as dividends paid by cooperatives to their patrons, dividends taxpayers elect to take into account as investment income, dividends received from charitable, religious and scientific organizations exempt from tax IRC § 501, dividends paid by a mutual savings bank, dividends paid and held by

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[23] 108 P.L. 27 (2003).

[24] 109 P.L. 222 (2005).

[25] There are several rates for capital gains, ranging from 5% for lower income taxpayers, to 28% for certain "collectibles and some other properties. However, the 15% rate is the most common rate for middle class and upper class taxpayers disposing of long-term capital assets.

[26] The 2003 Act originally had a sunset date of 2008. The date was extended to 2011 by the 2005 Act.

[27] A qualified foreign corporation is incorporated in a U.S. possession or in a country that has a current tax treaty with the U.S., and meets several other qualifications.

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and interest payments may be determined by the IRS to be constructive dividends.[44]

When will the IRS honor stockholder loans as debt and, on the other hand, when will the IRS treat stockholder loans as equity contributions?Section 385 of the IRC, aptly titled "Treatment of certain interests in corporations as stock or indebtedness," helps to answer this question by granting the IRS the authority to prescribe regulations to help determine whether a debtor-creditor relationship exists or a corporation-shareholder relationship exists, based on factors including the following:

1. whether there is a written unconditional promise to pay on demand or on a specified date a sum certain in money in return for an adequate consideration in money or money's worth, and to pay a fixed rate of interest,
2. whether there is subordination to or preference over any indebtedness of the corporation,
3. the ratio of debt to equity of the corporation,
4. whether there is convertibility into the stock of the corporation, and
5. the relationship between holdings of stock in the corporation and holdings of the interest in question.[45]

In the early 1980s, proposed regulations were released by the IRS, but eventually withdrawn.[46] Nevertheless, the five factors listed in IRC § 385 and explained in the proposed regulations have evolved into generally accepted guidelines for answering the question of when debt owed to shareholders might be considered equity. No single factor is determinative or relevant in every case. One court explained the nature of the inquiry:

> The identified factors are neither equally significant nor is any single factor determinative or relevant in each case . . . The "real issue for tax purposes has long been held to be the extent to which the transaction complies with arm's length standards and normal business practice." *Estate of Mixon v. United States*, 464 F.2d 394, 403 (5th Cir. 1972). "The various factors * * * are only aids in answering the ultimate question whether the investment, analyzed in terms of its economic reality, constitutes risk capital entirely subject to the fortunes of the corporate venture or represents a strict debtor-creditor relationship." *Fin Hay Realty Co. v. United States*, 398 F.2d 694, 697 (3d Cir. 1968). We have stated that the ultimate question is, "was there a genuine intention to create a debt, with a reasonable expectation of repayment, and did that intention comport with the economic reality of creating a debtor-creditor relationship?" *Litton Business Systems, Inc. v. Commissioner*, 61 T.C. 367, 377 (1973).[47]

Cases are "all over the map" on when debt will be considered equity. However, looking at the five factors in § 385, for shareholder loans to survive scrutiny by the IRS, at a minimum the terms of the loans must be similar to those that would be

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[44] Even if the face terms of the promissory notes are "straight" in format, if the debt is convertible into equity or otherwise part of a direct or indirect plan to tie payments to equity interests, the "interest" is generally not deductible. IRC § 163(l).

[45] IRC § 385(b).

[46] The proposed regulations can be found at 47 F.R. 163 (Jan. 5, 1982).

[47] Calumet Industries, Inc. v. Commissioner, 95 T.C. 257, 286 (1990).

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risk basis by their proportional share of qualified "nonrecourse"[95] mortgage financing that is secured by the real property used by the entity. This means that the limited partners and LLC members can use the debt incurred by the *entity* to increase the amounts held to be at risk for the investor (and, therefore, deductible by the investor) beyond the amounts which the investor has invested. To take advantage of this benefit there are some essential qualifications that must be satisfied:

(i) the activity of the entity must be the developing and/or leasing of real estate
(ii) the debt must be mortgage financing secured by the real estate
(iii) the debt must be nonrecourse with no person personally liable for payment of the debt (the lender must agree to resort only to the collateral for repayment of the loan in the event of a default in payment by the entity)
(iv) the lender must a qualified, third-party lender such as an institutional mortgage lender.[96]

In the context of a real estate venture, this can be very productive. Suppose a limited partnership or limited liability company has ten investors. Each investor is contributing $50,000 in equity capital, for a total capitalization of $500,000. The entity borrows another $2 million from a commercial bank to purchase an apartment building for approximately $2.5 million. The debt to the bank will be secured by a mortgage lien on the apartment building and the bank has agreed that the loan will be nonrecourse. The nonrecourse debt will result in the at-risk basis for each investor to be increased by one-tenth of the amount of the loan ($250,000) from $50,000 to $300,000.

For *limited liability companies*, the non-recourse aspect of the mortgage loan is easier to establish. All loans to the LLC are nonrecourse since no member is personally liable for the debts incurred by the LLC. There is no need to have the lender specifically agree to make the loan non-recourse. Of course, the lender will *treat* the loan as non-recourse for the very same reasons. So long as no member personally guarantees the loan or offers security for repayment of the loan, the non-recourse nature of the loan is easily satisfied. For limited partnerships, the lender will have to agree in writing to make the loan on a non-recourse basis.

As a result, for general partnerships, as well as limited partnerships and LLCs that meet the qualification requirements, the at-risk basis of *all* partners or members can be increased by the member's allocable share of losses in the partnership or LLC operating agreement.[97]

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[95] In a "nonrecourse" loan the lender agrees that no person other than the entity will be liable for payment of the debt, including the general partners of a partnership. Normally, nonrecourse loans are made in connection with real estate mortgage loans, with the lender looking to a mortgage lien in the entity's property to satisfy its claim in the event of a default by the entity. Why would a lender be willing to make a mortgage loan on a nonrecourse basis? Prior to forming the entity, the promoters will work closely with the proposed lender to assure the nonrecourse nature of the loan so that the venture can gain the advantages of increased at risk basis for its investors. The lender will agree if it determines that the loan is likely to be repaid by the entity and that there is sufficient equity in the collateral to assure repayment in the event of a default. The lender is likely to charge higher fees and interest as a condition to making the loan on a nonrecourse basis.

[96] IRC § 465(b)(6).

[97] IRC §§ 465(b), 705, 752.

Twenty Class A interests were sold by December 31, 1979, and the remaining fifteen were sold by December 31, 1980. Each unit sold for $99,250. Resale of partnership units was subject to approval by the general partner, which could withhold approval arbitrarily. The partnership did not anticipate cash distributions to the Class A limited partners until 1982 and to the special limited partners and the general partner until 1984. became available for distribution, the Class A limited partners were given priority. They were also entitled to return of their capital investment upon the sale or refinancing of the hotel. The first $30,000 of any additional proceeds from such a transaction were allocated to the general partner as return of capital. The special limited partners were each entitled to a share of any remaining proceeds.

Diversified Financial Services, a member of Summa T. Group, received three percent of the Phillips House offering proceeds as reimbursement for expenses incurred in the offering. Realty Properties, and other members of the group, received 42.5 percent of the proceeds for "expense allowances, consulting fees, and management fees." Campbell provided services in the formation and syndication of the partnership. However, the record does not reveal what part of these fees were paid to Summa T. Group for services actually performed by Campbell, nor does it reveal what part of Campbell's partnership interest, if any, was received as compensation for services for which his employer was compensated.

The other two limited partnerships at issue here were formed under similar agreements. Campbell received a one percent interest in The Grand partnership, which was formed in 1980 to purchase and operate the Howard Johnson's Motor Lodge in Myrtle Beach, South Carolina. Also in 1980, the Airport partnership was formed to purchase and operate the Northwest Airport Inn in St. Louis County, Missouri. Campbell received a one percent interest in Airport. As in Phillips House, Realty Properties was the general partner, Campbell and Kane were special limited partners, and thirty-five Class A limited partnerships were sold in both The Grand and Airport. Realty Properties and its affiliates, including Diversified Financial Services and Summa T. Realty, received 30.2 percent of the proceeds of The Grand's offering of limited partnership interests, and 38.5 percent of the proceeds of Airport's offering. These payments were made for expense allowances, consulting fees, management fees and financing fees. Again, Campbell provided some of these services, and the record does not reveal the capacity in which he performed them. The offering memoranda for The Grand and Airport projected taxable losses for the first several years of operations. As with Phillips House, however, the memoranda warned that any of the deductions and credits might be disallowed by the Internal Revenue Service.

On May 10, 1983, the Commissioner issued a notice of deficiency for the tax years 1979 and 1980, alleging that Campbell should have included the value of his interests in these partnerships in ordinary income.[103] The Commissioner valued Campbell's interests in Phillips House, The Grand and Airport at $42,084, $16,968 and $20,683, respectively. amendment to his answer, the Commissioner alleged that Campbell was liable for additions to tax for, *inter alia*, negligently failing to include these interests in his ordinary income.

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[103] [1] The notice contained other adjustments to Campbell's income. However, the only remaining dispute is in regard to the inclusion of the partnership interests in ordinary income.

Campbell's tax returns. Campbell was trying to postpone the tax realization event from the time that he actually received the property interest in the entity, to some time in the future when the profits were actually paid to him. Campbell and his tax advisors did some smart work. By classifying his interest as a *future* profits interest, rather than a current capital interest in the entity, Campbell argued that although he rendered services to the entities in the year of formation, he didn't receive any compensation until the profits were paid to him. This argument was successful with the court, which relied on IRC § 83(a), Property transferred in connection with performance of services:

> (a) General rule: If, in connection with the performance of services, property is transferred to any person other than the person for whom such services are performed, the excess of —
>
>> (1) the fair market value of such property . . . at the first time the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier . . .

Campbell was successful in convincing the court that a "profits interest" was significantly different from a capital interest in the partnership. Unlike partners receiving capital interests, he argued, Campbell had no right to current distribu tions, nor any right to participate in management or other aspects of owning partnership interest. The court was also swayed by the arguments that Campbell had not really received any transferable property interest because the profits interest lacked transferability and might never be paid if profits weren't received. Therefore, the court concluded that the profits interest lacked any current value.

Was the court correct? Is a "profits interest" really any different than a capital interest in the partnership with regard to its recognition as property capable of valuation? In 2005, the IRS issued proposed regulations that sought to overrule the outcome in *Campbell*.[111] Excerpts from the IRS "Explanation of Provisions" provide some insight as to whether or not there is really a difference between a "profits interest" and some other interest exchanged for services by someone like Campbell:

> The proposed regulations apply section 83 to all partnership interests, without distinguishing between partnership capital interests and partnership profits interests. Although the application of section 83 to partnership profits interests has been the subject of controversy, see, e.g., Campbell v. Commissioner, . . . 943 F.2d 815 (8th Cir. 1991), . . . the Treasury Department and the IRS do not believe that there is a substantial basis for distinguishing among partnership interests for purposes of section 83. All partnership interests constitute personal property under state law and give the holder the right to share in future earnings from partnership capital and labor. Moreover, some commentators have suggested that the same tax rules should apply to both partnership profits interests and partnership capital interests. These commentators have suggested that taxpayers may exploit any differences in the tax treatment of partnership profits interests and partnership capital interests. The Treasury Department and the IRS agree with these comments. Therefore, all of the rules in these proposed

[111] 70 F.R. 29675 (2005).

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the certificates of deposit in *Marine Bank, supra*, at 557–558, which were insured by the Federal Deposit Insurance Corporation and subject to substantial regulation under the federal banking laws, and unlike the pension plan in *Teamsters v. Daniel*, 439 U.S. 551, 569–570 (1979), which was comprehensively regulated under the Employee Retirement Income Security Act of 1974, 88 Stat. 829, 29 U.S.C. § 1001 *et seq.* (1982 ed.), the notes here would escape federal regulation entirely if the Acts were held not to apply.

The court below found that "[t]he demand nature of the notes is very uncharacteristic of a security," 856 F.2d, at 54, on the theory that the virtually instant liquidity associated with demand notes is inconsistent with the risk ordinarily associated with "securities." This argument is unpersuasive. Common stock traded on a national exchange is the paradigm of a security, and it is as readily convertible into cash as is a demand note. The same is true of publicly traded corporate bonds, debentures, and any number of other instruments that are plainly within the purview of the Acts. The demand feature of a note does permit a holder to eliminate risk quickly by making a demand, but just as with publicly traded stock, the liquidity of the instrument does not eliminate risk altogether. Indeed, publicly traded stock is even more readily liquid than are demand notes, in that a demand only eliminates risk when, and if, payment is made, whereas the sale of a share of stock through a national exchange and the receipt of the proceeds usually occur simultaneously.

We therefore hold that the notes at issue here are within the term "note" in § 3(a)(10).

. . . .

Accordingly, we reverse the judgment of the Court of Appeals and remand the case for further proceedings consistent with this opinion.

So ordered.

[The concurring opinion of Justice Stevens and the concurring and dissenting opinion of Chief Justice Rehnquist (joined by Justices White, O'Connor, and Scalia) are omitted.]

NOTES AND QUESTIONS

1. In Chapters 1 and 2, we noted that a business, whether sole proprietorship or large corporation, often raises money by borrowing it. In Chapter 3, we noted that in many instances borrowing provides an advantage in deductibility of interest payments. Suppose a small partnership, corporation, or LLC were to borrow money from an investor. How would you determine if the note given by the business is a "security"?

2. This case did not involve the registration requirement of Section 5 of the Securities Act. Rather, the disappointed investors were suing Ernst & Young based on the antifraud provisions of the Exchange Act Note here that the definition of "security" is dealt with in virtually identical fashion in both acts, and Justice Marshall notes that the two statutory provisions will be construed as if identical.

3. Once something is determined to be a "security," there may be other hurdles before deciding it is subject to the provisions of the federal securities laws. In *Reves*, another issue faced by the Court was whether the notes, even if "securities,"

(1) *General conditions.* To qualify for an exemption under this section, offers and sales must satisfy all the terms and conditions of Rule 501 and Rule 502.

(2) *Specific Conditions*—

(i) *Limitation on number of purchasers.* There are no more than or the issuer reasonably believes that there are no more than 35 purchasers of securities from the issuer in any offering under this section.

(ii) *Nature of purchasers.* Each purchaser who is not an accredited investor either alone or with his purchaser representative(s) has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment, or the issuer reasonably believes immediately prior to making any sale that such purchaser comes within this description.

A SHORT QUIZ AND WORKSHEET ON REGULATION D

1. Notice that there are no requirements in Rule 501; it is simply a "dictionary" of terms used elsewhere in Regulation D. Go through the rest of Regulation D now and note where these defined terms are used. This will be important in answering questions on Regulation D later in these exercises.

2. Rule 502 presents four requirements which appear to apply throughout Regulation D: integration, information requirements, limitations on manner of offering, and limitations on resale. But appearances are deceiving. Actually, these rules do *not* apply throughout the Regulation D exemptions. Which of these four requirements of Rule 502 apply to offerings under Rule 504? Rule 505? Rule 506?

3. We said that Regulation D was promulgated under the SEC's delegated authority in § 3(b) of the Securities Act. Actually, this is not completely true. Which Rule is not a § 3(b) rule? (You may think this is picky, but it will be critically important later.) Note that the rule which is not a § 3(b) rule is a "safe harbor" rule.

4. What is the difference between Rule 505 and Rule 506? Or to put it another way, since Rule 505 has a $5 million limit and Rule 506 has no dollar limit, why is Rule 505 even here?

5. Would it be possible to for sales under Rule 504 or 505 to be made to more than 35 people? (Be sure to consult Rule 501 for how to count purchasers; it is trickier than you might think.)

6. Now that you are thoroughly familiar with Regulation D, you can compile your quiz answers in the following table.

	Statutory authority	Dollar limit on offering	Requirements from Rule 502 (√ if required):			Limit on no. of offerees	Purchaser qualification required?
			Information to offerees	Limits on advertising	Limit on re-sales		
Rule 504							
Rule 505							
Rule 506							

First, there is Rule 144, which is itself complicated and something we have not yet considered. Rule 144 is a safe harbor permitting resales of "restricted" securities. But two onerous requirements of that rule are (1) that there be "current *public* information" about the issuer,[73] and (2) that the sales be made through a broker.[74] Although these requirements lapse after one year,[75] they do so only in the case of resales by individuals who are not "affiliates" of the issuer, a condition not likely met by the investors who might now want to use Rule 144 for their resales.[76]

Second, Rule 144A is a "safe harbor" rule for resales, but only for resales to "qualified institutional buyers." These buyers include: insurance companies, investment companies, employee plans, charitable organizations, businesses, and investment advisers. These buyers must be purchasing for their own account or on behalf of other qualified institutional buyers.[77] These restrictions likely make the Rule of limited utility to the occasional seller of small business securities.

Third, Rule 504(b)(1) permits resales of securities, but only if the initial sale registered under at least one state's securities laws.[78] However, registration under state securities laws is not likely a feasible option for many of the same reasons that federal registration was not an option.

Finally, although Rule 147 explicitly notes that it does *not* cover resales,[79] § 3(a)(11) itself does *not* say that in so many words, raising the hope that perhaps the statute will exempt resales where the "safe harbor" rule does not. That hope is dashed by remembering that the statute exempts only securities which are "part of an *issue*," suggesting that the exemption is available only to an issuer.[80]

The generally-accepted solution to the "resale" problem is to have objective evidence of investment intent for the initial sale and evidence of sophistication-or-access for the resale. At the time of the initial sale, you will probably require each purchaser to affirm that he or she is purchasing for investment and not for resale. In addition, you as counsel must have the question of resale brought to you *at the time of the resale*. Only then can evaluate whether the initial purchaser likely did purchase for investment and whether the subsequent purchaser would meet the requirements for § 4(2) to apply. The mechanism for bringing the proposed sale before counsel is a transfer restriction imposed in the *original* sale (through a

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[73] *See* Securities Act Rule 144(c).

[74] *See* Securities Act Rule 144(f).

[75] *See* Securities Act Rule 144(d)(1)(ii).

[76] A resale *could* come within Rule 144(d)(1)(ii) if, for example, the insider has held the securities for one year, resigns his or her inside position such that he or she is no longer an "affiliate," waits three months, and then sells the securities. There are several problems here; (1) that is a long time to wait, especially the three months after surrender of insider status, and (2) there is no guarantee that such surrender will make the potential seller not an "affiliate." Rule 144(a)(1) defines affiliate in terms of "control," and the SEC resolutely refuses to assist issuers or counsel in determining control. *See generally* Loss & Seligman, *supra*, Ch. 5.

[77] Rule 144A(a)(1).

[78] For the details of state registration, see *infra* Section E.

[79] Rule 147(a) makes clear it is only an issuer exemption. The nine-month prohibition on interstate resales in Rule 147(e) does not exempt those resales, but is relevant only in determining whether the otherwise exempt issue has "come to rest" within the boundaries of the state. *See* Loss & Seligman, *supra*, at 442.

[80] This is the better but not universally-held view. *See* Hazen, *supra*, at 192 & n.3.

Chapter 5

FINANCING OF BUSINESS ENTITIES

A. INTRODUCTION

A primary cause of business failure is lack of adequate financing. The promoters, investors and managers of a business may have a unique and powerful idea that they work hard to implement but, without adequate resources, the business may stagnate or fail. Sometimes businesses fail because the financing obtained at the startup of the business was insufficient to meet the basic operating needs of the business during its early stages due to poor planning, delays, market changes or unforseen factors. Other times, financing may have been adequate to get the business off the ground and operating but additional funds may be needed as the business matures to propel the company into new markets, expand operations or outperform competitors. If there is insufficient cash to meet the operating or growth needs of the business, then problems will arise unless additional financing can be obtained.

An essential part of planning and implementing a new business entity is arranging for appropriate initial financing to acquire the capital necessary to meet the projected needs of the business. At the time of formation the promoters must assess how much capital the corporation will need to purchase or lease fixed assets; acquire equipment and goods; license, purchase or develop intellectual property; hire employees; and operate the business during the startup phase. It may be quite a while before the business spins off sufficient cash to meet operating expenses, so the financing plan must be based on realistic projections of future revenues and expenses. It also makes sense at the formation stage to plan for the possibility of *additional* financing if needed for survival or growth of the company.

The promoters and investors must choose the appropriate sources, amounts and timing of finance for the short and long range success of the business. The task of the *lawyers* is to draft appropriate documentation and advise clients regarding the tax and non-tax considerations that arise in connection with the financing plans being proposed for the entity. In this regard, the objective of this chapter is to provide students with a fundamental understanding of how business ventures are financed.

B. DEBT FINANCING

When forming a business there are two elemental sources of financing to fund the startup and operations of the business — equity and debt. What is the essential distinction between these two types of financing? Equity financing is the cash, property or services contributed to the venture in exchange for ownership rights. As owners, equity holders may be looking for distributions of income from profits, or they may be looking for appreciation of the value of their ownership interests as

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of the partnership agreement to alter the *distributional priorities* with respect to the distribution of cash from operations or upon final sale or liquidation of the entity. For instance, even though the general partners each own a 10% share of the profits and losses of the limited partnership, the limited partnership agreement might provide that the moneyed partners are entitled to a priority of distribution and any profits or proceeds from sale or liquidation must first be paid to limited partners according to a preferential distribution formula. For instance, the agreement might provide:

> *Distribution of Net Cash from Operations:* Cash distributions of profits shall be distributed according to following formula. For the first three years following commencement of operations, the limited partners shall share (in proportion to the amount that their percentage interest bears to the total percentage interest of all limited partners) 85% of the cash distributed from profits and the general partners shall share (in proportion to the amount that their percentage interest bears to the total percentage interest of all general partners) 15% of the cash distributed from profits. After five years of operations, the distribution of cash from profits shall be in proportion to the percentage interests set forth in Exhibit A.

Why would the above clause be structured this way? Do the distributional priorities seem fair? As a limited partner would you find the distributional scheme more attractive than if the distributions of cash from operations were based solely on the percentage interests of the general and limited partners?

In the next paragraph, the scheme for distribution of proceeds from sales or liquidations is discussed. Keep in mind that the original capital contributions of all partners in Exhibit A were $700,000 ($620,000 in cash and $80,000 in services), with most of the cash being provided by the limited partners. The next paragraph contemplates two possibilities. First, if the business is successful and sold for a substantial profit, how should the proceeds be distributed? In this regard, consider how proceeds would be distributed if the business was sold for $2 million. Second, if the business is sold or liquidated for a loss, how should the proceeds, if any, be distributed? In this regard, consider how proceeds would be distributed if the business was sold or liquidated for only $400,000.

> *Distribution of net cash from sale or liquidations:* The net cash from a sale or liquidation of the business shall be distributed according to the following formula.
>
> (i) If the net cash exceeds the amount of $620,000, then the first $600,000 shall be distributed first to the limited partners in proportion to the amount that their percentage interest bears to the total percentage interest of all limited partners and $20,000 shall be distributed to the general partners in proportion to the amount that their percentage interest bears to the total percentage interest of all general partners. For any amounts in excess of $620,000, the net cash shall be distributed shall be in proportion to the percentage interests set forth in Exhibit A.
>
> (ii) In the event that net cash from sale or liquidation of the business is less than $620,000, the net cash shall be distributed 96% to the limited partners in proportion to the amount that their percentage interest bears to the total percentage interest of all limited partners and 4% shall be distributed to

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iii. Contributions of debt

What impact do these rules have when considering the possibility of financing the limited partnership entity with a combination of equity and *debt* from the limited partners? Will partners who loan money to the limited partnership be in a as creditors rather than equity holders? The answer is undeniably yes. As creditors of the entity, partners who loan money to the limited partnership are entitled to be paid interest and principal in accordance with the terms of the loan documents, regardless of the cash flow position of the business and prior to any distributions of profits to partners.

In the event of a winding up of the limited partnership, partners who contributed part of their capital in the form of debt must be paid before there can be a distribution to any of the other partners. From the perspective of the *limited* partners, this means that those partners who make smaller equity contributions but larger debt contributions will be taking less risk in the event of a loss — and assured of a priority of distribution in the event that there is a profit. For instance, suppose that Ace, Bert and Clint are three limited partners in a limited partnership with each having a 25% share. Ace and Bert each contributed $250,000 in cash as their capital contributions. Clint contributed $100,000 in exchange for his capital contribution and *loaned* the limited partnership $150,000. The general partner is Gary who received a 25% share in exchange for his services.

Suppose the business fails, leaving $50,000 in cash after paying off all *outside* (non-partner) creditors. The remaining $50,000 must be distributed to Clint, since he is a creditor of the limited partnership with regard to the outstanding $150,000 loan. In addition, unless there is some kind of non-recourse agreement with the general partner, Gary will owe Clint another $100,000 (as a *creditor*, not as a *partner*). If, on the other hand, the business is successful, and eventually sold for $1 million, the $150,000 loan from Clint must be repaid first, before the remaining $850,000 will be split among the four partners, with the total distribution to Clint far in excess of the distribution to other partners.

In other words, there is danger in allowing the allocation of some portion of a limited partner's share to debt, rather than equity. From the perspective of the *limited* partners, unless *all* limited partners are making the same proportional allocation between debt and equity, then some limited partners will be receiving a priority with respect to distributions. From the perspective of the *general* partner, loans from limited partners place the general partner in a liability position. In the event that there is a default in payment of interest or principal, the general partner faces personal liability for repayment of any debt obligations, including loans from limited partners. Upon the dissolution and winding up of the limited partnership, the general partner would remain fully liable for repayment of these loans, plus unpaid interest, if partnership assets were insufficient to satisfy the loans. Few general partners are willing to personally guarantee the limited partner investors that their contributions, whether in the form of equity or debt, will be repaid by the general partner in the event of a business failure.

It is possible that some of the concerns of non-lending limited and general partners can be handled by drafting special provisions into the loan documents or partnership agreement. For instance, the promissory notes could be drafted as *non-recourse* documents that eliminate the ability of the lending partners to seek payment from the general partner. Or, the economic distributions upon liquidation

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Section 401. Form of Contribution.

A contribution of a member of a limited liability company may consist of tangible or intangible property or other benefit to the company, including money, promissory notes, services performed, or other agreements to contribute cash or property, or contracts for services to be performed.[62]

With regard to allocation of profits and losses, the default rules are a bit different depending on the ULLCA and statutes adopted in many states. The ULLCA provides for a default rule similar to general partnerships, with members sharing *equally* regardless of the amount of their capital contributions:

Section 405. Sharing of and Right to Distributions

(a) Any distributions made by a limited liability company before its dissolution and winding up must be in equal shares.

* * *

Section 806. Distribution of Assets in Winding Up Limited Liability Company's Business

(a) In winding up a limited liability company's business, the assets of the company must be applied to discharge its obligations to creditors, including members who are creditors. Any surplus must be applied to pay in money the net amount distributable to members in accordance with their right to distributions under subsection (b).

(b) Each member is entitled to a distribution upon the winding up of the limited liability company's business consisting of a return of all contributions which have not previously been returned and a distribution of any remainder in equal shares.

The comments to ULLCA § 405 explain the reasoning behind this default rule:

> Recognizing the informality of many limited liability companies, this section creates a simple default rule regarding interim distributions. Any interim distributions made must be in equal shares and approved by all members . . . The rule assumes that: profits will be shared equally; some distributions will constitute a return of contributions that should be shared equally rather than a distribution of profits; and property contributors should have the right to veto any distribution that threatens their return of contributions on liquidation. In the simple case where the members make equal contributions of property or equal contributions of services, those assumptions avoid the necessity of maintaining a complex capital account or determining profits. Where some members contribute services and others property, the unanimous vote necessary to approve interim distributions protects against unwanted distributions of contributions to service contributors. Consistently, Section 408(a) does not require the company to

[62] ULLCA § 401. See also Cal. Corp. Code § 17200(a) which provides: "The articles of organization or the operating agreement may provide for capital contributions of members. The contribution of a person may be in money, property, or services, or other obligation to contribute money or property or to render services."

> Capital Contribution") are necessary or appropriate for the conduct of the Company's business. The Manager shall provide written notice of such request for additional Capital Contributions (a "Capital Call") to each Member not less than ninety (90) days prior to the date such Optional Capital Contributions are due (the "Capital Call Due Date"). The notice shall set forth the aggregate amount of the Capital Call, the purposes for which such Capital Contributions will be used and the date on which Optional Capital Contributions are due. No Member shall be obligated to make any such Capital Contributions. However, each Member shall have the opportunity, but not the obligation, to participate in a Capital Call on a *pro rata* basis in accordance with the Member's Percentage Interest by making an Optional Capital Contribution. Immediately following any Optional Capital Contribution by a Member, the Percentage Interests shall be adjusted to reflect the new relative proportions of the Capital Accounts of the Members.
>
> (b) If a Member (a "Non-Contributing Member") does not make an Optional Capital Contribution equal to its *pro rata* share of the Capital Call by the Capital Call Due Date, the Company shall notify each Member that made an Optional Capital Contribution equal to its pro rata share of such Capital Call (each, a "Fully-Participating Member") that such Fully-Participating Member may, within the fourteen (14) day period from the date of such notice, increase its Optional Capital Contribution to the Company to cover amounts that the Non-Contributing Member declined to contribute on a pro rata basis, in which case the Percentage Interests of the Members shall be adjusted to reflect the new relative proportions of the Capital Accounts of the Members.

After reading these provisions regarding additional capital contributions, what are some of the concerns that promoters and investors might have? It's apparent that the promoters and early investors need to give considerable thought to any mechanism for raising additional equity from the original group of investors in the venture. Although the provisions above relate to a limited liability company, equivalent provisions could easily be drafted for general or limited partnerships. It is the role of the lawyers in drafting these types of provisions to make sure that some of the parties fully understand the issues that arise in connection with future capital contributions, and to draft the provisions to comprehensively cover all of the concerns that arise.

e. Future Contributions from New Equity Participants

One possible way to raise additional capital as the business matures is to seek equity contributions from new investors. In the case of corporations, this is done by selling additional shares of common or preferred stock. How can we accomplish this with an existing, *non-corporate* business entity?

In the case of a general partnership, in the absence of some provision in the partnership agreement to the contrary, the consent of all of the general partners is required for the admission of a new partner.[69] Similar rules exist for the admission

[69] See RUPA § 401(i) which provides: "A person may become a partner only with the consent of all of the partners." *See also* Cal. Corp. Code § 16401(i); Del. Ann. Code tit. 6, § 15-401(a).

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— If taxed as a sale: The partner will pay capital gains taxes on the excess of the price received over the adjusted basis which will be $225,000.[14] At the 2008 capital gains rate of 15%, the departing partner will pay $33,750 in taxes.[15]

— If taxed as a liquidation: The entire $300,000 will be considered ordinary income. Taxed at about the 30% rate applicable to high income tax payers, the departing partner will pay approximately $100,000 in taxes.[16]

The above example is extremely general and meant only to dramatize the extreme difference in tax consequences for the departing partner. The primary rules governing these tax consequences, IRC §§ 736, 741, 751 and 1014 are extremely complex and require input from a tax specialist.

2. Tax Considerations for Corporations and Stockholders

For tax purposes, the purchase by a C corporation of its shares is considered a redemption.[17] Regardless of the treatment of the *stockholder's* receipt of funds as capital gains, dividends, or the non-taxable return of capital, the impact on the C corporation is the same. The payments are not deductible to the corporation and there is no gain or loss recognized by the corporation in a cash buyout.[18]

With regard to the selling stockholder, a cross-purchase sale to other shareholders, or a *redemption* sale to the corporation, is usually treated as the sale of a capital asset, with the stockholder having to pay capital gains taxes only on the increase in value received over the basis in the shares of stock.[19] However, if a portion of the payment for the shares constitutes payment for services rather than stock redemption, that amount will be taxed as ordinary income.

There might be circumstances where a repurchase by a corporation may be classified as a dividend payment.[20] As of 2008, the tax rate for dividends and capital gains was the same (15%). However, if classified as a dividend, the *entire* amount of the buyout payment would be taxed rather than the difference between the price paid and the taxpayer's basis in the stock. Those circumstances where the buyout might be considered a dividend involve situations where the redemption is of less than all of the outstanding shares of stock of the departing stockholder. The purchase will still be treated as a stock redemption, rather than a dividend, even if the corporation uses an installment plan to repurchase the stock, or (ii) the corporation buys only some of the shares but the remainder of the shares are purchased by a subsequent cross-purchase by other stockholders, so long as there is a "firm and fixed plan" to buyout all of the shares of the departing stockholder.[21]

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[14] $300,000 (buyout price) − $75,000 (adjusted basis) = $225,000.

[15] IRC §§ 741, 751.

[16] IRC § 736.

[17] IRC §§ 162, 302(a).

[18] IRC § 311. The outcome might be different if the buyout is funded by a distribution of appreciated property. *See* IRC § 311(a).

[19] IRC § 301(c)(2)-(3). If there is a loss, the taxpayer may deduct the loss, subject to the usual passive activity loss limits discussed in Chapter 3.

[20] IRC §§ 301(c)(1), 316.

[21] IRC § 302(b); *see also* Merrill Lynch & Co. v. Comm'r, 386 F.3d 464, 470 (2d Cir. 2004).

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outsider occurs, that the transfer of non-economic rights cannot be consummated without the non-departing owners having the opportunity to approve the admission of the new owner.

3. Encumbrances

Ownership interests in business entities can be a valuable source of equity for borrowing money or guaranteeing obligations of the *equity holders*. Just like tangible property such as residences, office buildings and automobiles, the intangible property rights of the equity owner can serve as collateral for borrowing money or securing the performance of other obligations. Suppose an equity owner, Ann, has a 10% interest in a business venture, with the entire business valued at approximately $20 million. Ann might use her ownership interest (worth approximately $2 million) as collateral for a $1.8 loan from her bank. The bank will insist on a security interest in Ann's equity interest that gives the bank the right to resort to the collateral to help satisfy it's claim against Ann in the event that she defaults on the loan from the bank. The security interest will be an "encumbrance" on Ann's ownership interest and will give the bank the right to exercise the remedies available under Part 5 of Article 9 of the Uniform Commercial Code. In the event of a default under the note or security agreement, the ownership interest will either: (i) be sold to the highest bidder at a foreclosure sale,[33] or (ii) retained by the lender in strict foreclosure.[34] Either way, there may be a transfer of Ann's interest in the entity to some new partner, member or shareholder.

The ability to use equity interests in business entities as a source of collateral can be an important source of financing for owners who want to borrow money for other business or personal purposes. Indeed, as the business entity becomes more valuable, many investors will want to retain their rights of ownership (rather than selling their interests) and "pull out" cash from their equity holdings by using their ownership interest as collateral for loans.

However, the existence of a voluntary encumbrance creates the possibility that, in the event of default, there will be a transfer of the interest to some outsider. For this reason, buy-sell provisions may sometimes limit or condition the ability of owners to pledge their ownership interests as collateral for loans.

Some buy-sell provisions may simply prohibit the creation of voluntary encumbrances. This might make sense in some circumstances but such

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interest to only the economic portion until the transferee is admitted as a partner or member, in accordance with the voting or other approval mechanisms set forth in the statutes and/or documents. Until admitted as a partner or member, the new "owner" merely acquires the economic rights of the transferor. While this is more difficult to accomplish in corporate entities, similar restraints can be provided for in the documentation of closely held corporations.

[33] UCC § 9-504 gives the secured party the right to dispose of the debtor's interest in the property at a public or private foreclosure sale, extinguishing the debtor's rights in the collateral and transferring the debtor's interest in the collateral to the purchaser at the sale. Any surplus (amount received by the secured party in excess of the debt, interest and expenses) must be returned to the debtor. If the sale price is insufficient to satisfy the entire obligation to the secured party, the debtor will remain liable and the creditor may pursue a deficiency judgment against the debtor.

[34] UCC § 9-505(2) gives the secured party the right the right to accept the collateral in discharge of the obligation. Under § 9-505(2), the acceptance of the collateral in strict foreclosure results in a satisfaction of the entire obligation owed to the secured party and denies to the secured party the right to a deficiency judgment against the debtor.

similar neighborhoods in the vicinity to determine the price at which similar houses[52] have been sold in the last six to twelve months. In this way, the appraisers can determine a "fair market value" for the residence being appraised. It's important to notice that it takes the existence of a *marketplace* with frequent sales of similar properties to be able to easily determine a "fair *market* value."

Other examples of marketplaces for the determination of "fair market value" are the public securities and commodities exchanges. The exchanges serve as central marketplaces for the sale of property. The centrality and large volume of transactions yields a ready determination of "fair market value" for ownership interests in business entities (in the case of stock exchanges) and contracts for goods (in the case of commodities exchanges). The total value of the shares of stock of a listed corporation gives us the *market capitalization value* — the current amount of equity in the corporation. Simply multiple the current stock price by the number of shares.[53]

Notwithstanding that such marketplaces give us a fair market value for the market capitalization and the concomitant *fractional ownership* interests traded on the exchanges, they don't *necessarily* give us a fair market value for the sale of the *entire* business. The value of stocks traded on the public exchanges may change radically when there is a takeover bid for a listed company. This is sometimes caused by the fact that the company was "undervalued" by the stock market price and, indeed, is worth far more. Takeover specialists will attempt to buy the company at a price near to the current stock price, or pay a premium over the existing stock price, because the takeover purchaser anticipates that there is more value in the company than reflected on the stock exchange. The opposite may also be true. Companies may be "overvalued" with the stock price far in excess of the actual value of the company if the entire company was to be put up for bid to knowledgeable and informed buyers.

The types of business entities discussed in this book are closely held entities that are *not* traded on public exchanges. Valuing such closely held business entities, and the proportional value of the fractional ownership interests, can be extremely difficult. Parties to buy-sell agreements may sometimes refer to "fair market value." However, there is rarely a "marketplace" for the sale of investment interests in closely held businesses — nor is there a ready marketplace for the sale of the *entire* business (which would allow determination of the value of ownership interests by dividing the total market worth of the company among the owners in the same proportions as the ownership interests). One of the great errors made by drafters is the use of the phrase "fair market value" as a *standard* for determining value in connection with a buyout.

In addition to the absence of a marketplace for determining fair market value, the term can have different meanings depending upon whether the business is being sold as a going concern, of if its assets are being liquidated. A company that

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cushion also helps to cover the possibility of a decline in value of the property.

[52] The appraiser will do an inspection of the property being appraised to determine its size, the number of bedrooms, the quality of construction, the history of renovations, etc. He or she will then comb through the real estate records to find similar houses that have sold in the vicinity or in similarly situated residential communities.

[53] Note that the term used is *market* capitalization and the price of shares *publicly* traded. There may be privately held shares of stock in the corporation as well.

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Similar book value formulas could be used for a corporate entity. Consider the following:

> The purchase price per share shall be its book value calculated as of the end of the last calendar quarter prior to the event triggering the purchase. The corporation's book value shall mean the difference between the total assets and the total liabilities of the corporation as determined by the normal practices of the corporation and according to generally accepted accounting principles but shall not include goodwill. The per share book value shall be determined by dividing the book value by the shares outstanding as of the end of the last calendar quarter prior to the event triggering the purchase.

Book value of a corporation is based on the balance sheet account balance — the value of the assets of the corporation minus the liabilities of the corporation. It's important to understand that the corporation's bookkeeping or accounting records do not generally reflect the *market value* of assets and liabilities. The initial book value is usually the acquisition cost (or its actual cash value at the time of acquisition). Assets such as buildings, land and equipment may be further reduced in value on the books of the corporation based on depreciation formulas that may, or may not, accurately reflect the current market value of the assets. If the property was acquired several years in the past, the "book value" will not reflect upward (or downward) changes in the value of the property. This is particularly true when assets such as land or commodities have appreciated in value due to market forces. An office building shown on the corporation's books as worth $100,000 (it's acquisition cost less depreciation), it may actually have a market value of over a million dollars.

With regard to intangibles such as the corporation's goodwill, tradenames and trademarks, the value shown on the books of the corporation may show these amounts as "$0," unless they were *purchased* rather than *created* by the corporation.[57]Either way, the cost reflected on the books may be unrelated to the true value of these intangible assets.

As you can see, book value is a poor method for valuing the actual market worth of a departing owner's interest in a business. Some buy-sell agreements attempt to adjust for the difference between book value and market value by providing for percentage adjustments or adjustments keyed to market indexes. Such adjustments may, by pure chance, result in a value that is closer to true market value but that would be a serendipitous event.

b. Capitalized Earnings

One objective method of computing the value to be paid for a departing owner's interest is to use capitalized earnings. This type of valuation mechanism is sensible where the business is one with few capital assets, such as most service-based businesses. In asset-rich business ventures, such as real estate, the capitalized earnings approach may also be fair and objective, although there may be alternative valuation procedures that are equally objective and fair.[58] By looking at

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[57] Intellectual property that has been *purchased* will be listed at the purchase price. For instance, patents purchased by the company will be shown on the books. However, the going concern or goodwill value will not.

[58] See the Asset Valuation discussion below.

caused by the dissociation.[86] This means that the dissociating partner, whether rightful or wrongful, gets to participate in the full value of the partnership, including going concern value if the winding up of the company could be accomplished by a sale as a going concern in a non-forced-sale environment.

RUPA's statutory buyout provisions establish two interesting requirements. Let's take a look at them and see if they make sense — with the ultimate test of sensibility being whether or not you would include these requirements in a well-drafted buyout:

> (i) RUPA sets the valuation *date* as the date of the dissociation rather than the date of the completion of the undertaking or expiration of the term.
>
> (ii) RUPA § 701(d) requires that the continuing partnership indemnify the *departing* partner for any debts incurred before or after the dissociation.[87]

These provisions are reasonable. A partnership is a voluntary association of partners who share in the profits, losses and value of the business. The departing partner is exiting the partnership and *if the partnership was dissolved at that point* is entitled to the amount that would be distributed at the time of dissolution. That amount would be the value of the business (sold under normal winding up conditions), less payments to creditors, less any damages assessed to the departing partner if the dissolution was caused by a wrongful dissociation. If the remaining partners want to avoid dissolution and continue the business, they must pay the departing partner his/her/its fair share. If a well-drafted buy-sell agreement was prepared, this value would be the value that fair parties with equal negotiating power would agree to.

The indemnity provisions are also sensible. The departing partner is technically liable for all of the debts of the partnership prior to the partner's departure from the partnership. If the partnership was dissolved, these debts would be paid off prior to distribution, leaving the departing partner with a cash payment and no liability for outstanding debts of the partnership. However, if the partnership continues, the relative proportion of debt will be deducted from the payout to the the departing partner, receives the same cash amount as a dissolution — but the debts have *not* been paid off since the partnership is continuing. Unless the creditor agrees to release the departing partner (an unlikely event), this leaves the departing partner saddled with debt that has *already* been deducted from the partner's payout, subjecting that partner to double liability. For instance, suppose that a partnership with four partners is valued at $5 million and has debt of $1 million. Assuming equal capital accounts and equal rights to profits and losses then, upon dissolution, each partner would end up with $1 million in final distribution and no liability for debt, which has been paid. Now suppose that, instead of dissolution following a dissociation by one of the partner's, Danielle, the remaining three partners continue the business and buyout Danielle for $1 million ($5 million in value, less $1 million in debt, divided by four). Even though Danielle has $1 million

[86] Prior to adoption of RUPA in 1994, UPA § 38(2)(c)(II) punitively excluded the going concern value of the partnership from the valuation of the dissociating partner's interest.

[87] However, the continuing partners need not indemnify the departing partner for "liabilities incurred by an act of the dissociated partner under Section 702." UPA § 702 refers to acts of the dissociated partner following dissolution that creates a partnership liability.

§ 401. Partner's Rights and Duties.

(a) Each partner is deemed to have an account that is:

(1) credited with an amount equal to the money plus the value of any other property, net of the amount of any liabilities, the partner contributes to the partnership and the partner's share of the partnership profits; and

(2) charged with an amount equal to the money plus the value of any other property, net of the amount of any liabilities, distributed by the partnership to the partner and the partner's share of the partnership losses.

(b) Each partner is entitled to an equal share of the partnership profits and is chargeable with a share of the partnership losses in proportion to the partner's share of the profits.

Under the RUPA default rules, partners share *profits* equally — not in proportion to their capital contribution. If there's a profit after paying off creditors, the net result of §§ 807 and 401 is that the partners will be repaid their capital contributions and then the profits will be distributed equally. In part (i) of our hypothetical we asked what the result would be under RUPA if "the business is profitable and there is a surplus of $5 million after paying creditors." The answer is that the capital contributions of Anita and Ben ($2 million each) would be repaid, as would Cedric's contribution of $100,000. This would leave $900,000 to split evenly among the partners. The outcome under the RUPA default rules makes sense and is most likely what the three partners intended when they formed the partnership.

But what is the result under part (ii) of our hypothetical, if there's a net loss of $1.9 million? RUPA § 807 (which is no different than the rules under UPA) states that: "A partner shall contribute to the partnership an amount equal to any excess of the charges over the credits in the partner's account . . . " The *total* loss suffered by this partnership was $6 million. The capital contributions of $4.1 million are gone, and the partners remain liable for $900,000 in outstanding debt. Since the three partners share the loss equally, they should each contribute one-third of the $6 million loss. Each is responsible for $2 million of the *total* loss ($6 million ÷ 3). Since Anita and Ben have already contributed $2 million in the form of their original capital contributions, Ben is liable to contribute the entire $1.9 million since his initial contribution was only $100,000 and he is responsible for a $2 million share of the loss. This result is consistent with the concept that Anita, Ben and Cedric agreed to share losses equally and, so far, Cedric has only paid $100,000 of his share of the loss.

This result is a trap for the poorly informed partners who make uneven financial contributions to the equity of the partnership. It's probably *not* what Anita, Ben and Cedric intended at the startup of the partnership. The moneyed partners expected to have more money at risk in this venture than Cedric, who was contributing time and expertise instead. Do you think Cedric expected that, if there was a loss, he would have to contribute the lion's share towards payment of that loss? The comment to RUPA § 807 recognizes this potentially unfair result:

> It may seem unfair that the contributor of services, who contributes little or no capital, should be obligated to contribute toward the capital loss of the

Chapter 2 – Choosing and Forming the Entity

A. Types of Business Entities

5. The Limited Liability Company

Add at the top of page 49: Re-ULLCA has now been adopted in eight states and the District of Columbia.[1]

9. The Business Trust and other Variations

Add at the end of the first paragraph:

The pace expansion of the business trust is quickening. At least nine states and the District of Columbia have enacted specific business trust legislation.[2] The development of a uniform law on the subject[3] is a key improvement which may further hasten the appearance of business trusts in other states. The entity retains rather specialized uses for asset securitization and similar purposes,[4] but has greater potential for general use. The following is a basic summary.

> [A] statutory trust is structurally analogous to other business forms where management and control are separated from equity ownership. Similar to the limited liability company and limited partnership structures, the statutory trust offers significantly more contractual flexibility as compared to the corporation, while requiring less observance of formalities. With appropriate drafting, the same results in terms of risk sharing, management, voting rights, limits on duties and liabilities, and bankruptcy remoteness may be obtained whether using a statutory trust, a limited partnership, or a limited liability company. … .
>
> Generally speaking, there is greater flexibility as to internal structure than is available under business corporation laws. The rule on transferability of beneficial interests is the reverse of the default rule in other unincorporated association law. Uniquely, the law of trusts serves as the gap filler.[5]

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[1] www.uniformlaws.org/Act.aspx?title=Limited Liability Company (Revised)
[2] Nicholas G. Karambelas, Limited Liability Companies: Law, Practice and Forms § 11:3 (2013) lists eight states, and Kentucky was added to the list in 2012. *See* Thomas E. Rutledge, *The Kentucky Uniform Statutory Trust Act (2012): A Review*, 40 N. Ky. L Rev. 93 (2013).
[3] The Uniform Statutory Trust Entity Act was adopted by NCCUSL in 2009. See www.uniformlaws.org/shared/docs/statutory%20trust%20entity/ustea_final_09.pdf.
[4] Thomas E. Rutledge and Ellisa O. Habbart, *The Uniform Statutory Trust Entity Act: A Review*, 65 Bus. Law. 1055, 1057 (2010).
[5] *Id*. at 1057-58. This summary refers specifically only to the uniform act, which has been adopted to date only in Kentucky and the District of Columbia. http://www.uniformlaws.org/Act.aspx?title=Statutory Trust Entity Act. The USTEA was based primarily on the Delaware statute; see www.uniformlaws.org/shared/docs/statutory%20trust%20entity/ustea_final_09.pdf. at 2 (Prefatory Note).

One important remaining issue is the tax classification of a business trust, which was not conclusively dealt with in the “check the box” regulations described earlier in this chapter.[6]

[6] See section 5 of this Section A, and Chapter 3, Section F.2 for a background of the “check-the-box” entity tax classification rules. For a discussion of the remaining issues, see Carter G. Bishop, *Forgotten Trust: A Check-the-Box Achilles Heel*, 43 Suffolk U.L.Rev. 529 (2010).

Chapter 3 – Taxation and Business Entities

C. C-Corporation Entity Level Taxation

1. The Problem of Double Taxation
2. Some Temporary Relief form the Double Taxation Problem (pages 81-84)

U.S. corporations continue to pay income taxes on net income derived from all sources, including sales of goods and services – as well as dividends and capital gains received by the corporation. In the following chart, notice the difference between the *marginal* tax rates and the *effective tax obligation*. Marginal tax rates are the rates for that portion of net income. A corporation with profits over $100,000 pays 39% on amounts ***over*** $100,000 but lower rates on the portion of income less than $100,000. Thus, the effective tax obligation will be lower, since the corporation pays only 15% on the first $50,000 of income, 25% on income from $75,001 to $100,000, etc. Consequently, a corporation with net earnings of $335,000 pays a total of $113,900 in taxes – an *effective* tax rate of 34% of net profits, not the 39% *marginal* rate.

Federal Corporate Income Tax Rates 2013		
Net Income	**Marginal Tax Rate**	**Effective Tax Obligation**
$0-$50,000	15%	15% of net income
$50,001-$75,000	25%	$7,500 + 25% over $50,000
$75,001-$100,000	34%	$13,750 + 34% over $75,000
$100,001-$335,000	39%	$22,250 + 39% over $100,000
$335,001-$10,000,000	34%	$113,900 + 34% over $335,000
$10,000,001-$15,000,000	35%	$3,400,000 + 35% over $10,000,000
$15,000,001-$18,333,333	38%	$5,150,000 + 38% over $15,000,000
Over $18,333,333	35%	35% of net income

The Expiration of the "Bush Tax Cuts"

As of December 31, 2012, there was great uncertainty as to whether or not Congress would extend the "Bush Tax Cuts",[1] which were due to expire on January 1, 2013. Perhaps the most important aspect of the Bush Tax Cuts was the implementation of a lower rate for corporate dividends and capital gains which, for most taxpayers was fixed at 15%. This rate is a highly favorable rate for income earned from *investment*, when compared to income from *employment*. Individuals who earn their wealth from employment are taxed at much higher rates. Non-investment income earners also face the additional burden of paying social security and medicare taxes.

The Bush tax cuts, enacted in 2001 and 2003, were originally scheduled to expire for in January,

1. Economic Growth and Tax Relief Reconciliation Act of 2001 and the Jobs and Growth Tax Relief Reconciliation Act of 2003 commonly referred to as the "Bush Tax Cuts."

2011. However, President Obama signed legislation in late 2010 that temporarily extended the Bush tax cuts through the end December 31, 2012. If Congress failed to extend the Bush tax cuts, many substantive changes would have taken effect in 2013. Indeed, it was only on January 1, 2013 that Congress enacted the American Taxpayer Relief Act of 2012 ("ATRA"), which was signed into law by President Obama on January 2, 2013.

Below is a summary of tax matters of importance to a basic understanding of individual, corporate and partnership taxation, taking into account the tax "relief" afforded under ATRA.

Individual Income Tax Rates

Ordinary income tax rates remain the same for most taxpayers – but a hefty 39.6% tax bracket was added for taxpayers with taxable income of more than $400,000 (individuals) or $450,000 (married filing jointly). The following chart shows the tax brackets as of January 2013. Once again, notice the difference between the *marginal* tax rates and the *effective tax obligation*. A married couple with taxable income of $223,050 will pay 28% on amounts over $146,400 but lower rates on the portion of income less than $146,400. Such a couple will pay a total of $49,919.50 – an *effective* tax rate of 22.4% of taxable income, not the 28% *marginal* rate.

Tax Rates 2013 – Married Couples Filing Jointly		
Taxable Income	**Marginal Tax Rates**	**Effective Tax Obligation**
$0 – $17,850	10%	10% of net income
$17,851 – $72,500	15%	$1,785 + 15% over $17,850
$72,501 – $146,400	25%	$9,982.50 + 25% over $72,500
$146,401 – $223,050	28%	$28,457.50 + 28% over $146,400
$223,051 – $398,350	33%	$49,919.50 + 33% over $223,050
$398,351 – $450,000	35%	$107,768.50 + 35% over $398,350
$450,001 and over	39.6%	$125,846 + 39.6% over $450,000

Tax Rates 2013 – Single Individuals		
Single Individual	**Marginal Tax Rates**	**Effective Tax Obligation**
$0 – $8,925	10%	10% of net income
$8,926 – $35,250	15%	$892.50 + 15% over $8,925
$35,251 – $87,850	25%	$4,991.25 + 25% over $35,250
$87,851 – $183,250	28%	$17,891.25 + 28% over $87,850
$183,251 – $398,350	33%	$44,603. + 33% over $183,250
$398,351 – $400,000	35%	115,586.25 + 35% over $398,350
$400,001 and over	39.6%	$116,163.75 + 39.6% over $400,000

Long-Term Capital Gain Rates

The Internal Revenue Code continues to provide a far lower tax rate for income in the form of long term capital gains – income earned from the sale of capital assets such as corporate stock, real estate investments or other forms of equity investments.

Profit from long term capital gains[2] has been taxed at more favorable rates than taxes from other forms of income, such as salary, wages and earnings from self employment. Under the Bush Tax Cuts, individuals in the two lowest income tax brackets pay no taxes on capital gains. ATRA continues this policy and, once again, adds an extra bracket for high income earners. See the charts below for the tax rates on long term capital gains.

Income From Qualified Dividends

A potentially dramatic change resulting from the expiration of the Bush Tax Cuts would have been the return of true double taxation for corporate dividends. Prior to 2001, income from dividends was taxed within the same brackets as ordinary income from wages and earnings. However, in 2011 the Bush Tax Cuts dropped the dividend tax rate substantially for "qualified dividends". ATRA continues those reduced rates. For most taxpayers the dividend tax rate is only 15-20%, compared to the rates of up to 39.6% for ordinary income.[3] See the discussion in Section C.2 for a further explanation.

From the viewpoint of wealthy investors, profits from qualified dividends and capital gains will remain highly preferable to income from employment. Taxpayers who earn $1 million in *wages* will have to pay a marginal tax rate of 39.6% (and an overall effective tax rate of about 30%) Compare this outcome to taxpayers who receive qualified dividends or realize capital gains of $1 million. These taxpayers will pay a flat rate of 15% in on the first $400,000/$450,000[4] and 20% on the remaining $600,000/$550,000.

Dividend & Capital Gains Rates 2013 Single Individual or Married Filing Jointly	
Marginal Tax Bracket	**Qualified Dividend & Long Term Capital Gains Tax Rates**
10%, 15%	0%
25%, 28%, 33%, 35%	15%
39.6%	20%

2. Short term capital gains are taxed at the ordinary income tax rate.

3. These rates are for "qualified dividends" rather than "ordinary dividends." Qualified dividends include most corporate dividends paid by American corporations if the stock is held by the taxpayer for more than 60 days.

4. Single/Married Filing Joint Return

<u>Medicare Contributions</u>

In 2013, for the first time, income in the form of capital gains and dividends will require the payment of Medicare taxes of 3.8%.[5] This additional tax will require individuals who acquire wealth through investment, rather than employment, to pay into the Medicare system.

<u>Built-in Gains Tax Applicable to Certain S Corporations</u>

Businesses that have converted from a C corporation to an S corporation are potentially subject to a corporate-level 35 percent built-in gains tax ("BIG tax") on the disposition of their assets to the extent that the aggregate fair market value of the corporation's assets exceeded the aggregate basis of such assets on the conversion date. In the case of fiscal years beginning in 2011, the BIG tax does not apply if the five-year anniversary of the conversion date has occurred prior the beginning of the fiscal year. However, in the case of fiscal years beginning in 2012 or thereafter, the BIG tax will not apply only if the ten-year anniversary of the conversion date has occurred prior to the beginning of the fiscal year.

C. C-Corporation Taxation – Reducing the Impact of Double Taxation

b. Salaries vs. Dividends: Distributing Earnings to Shareholders in the Form of Salaries for Services (pages 85-88)

Section 162 of the Internal Revenue code, and Regulation 1.162, prohibit the payment of excessive salaries in attempts by corporate shareholders to escape double taxation of corporate profits. Prior to 1999, courts consistently applied a multiple factors test to determine if the compensation was, as required by Regulation 1.162 "reasonable and true compensation [in] such amount as would ordinarily be paid for like services by like enterprises under like circumstances."

As discussed in the text, in 1999, Judge Posner led the 7th Circuit Court of Appeals to hold that the re-classification of salaries as constructive dividends be based on an actual intent, with a presumption that salaries are reasonable – if the investors in the company are receiving a "higher" return than they had reason to expect.

It appears that no other circuit has jumped on Judge Posner's bandwagon. For an excellent discussion of the cases since 1999, see Stetson, Downs, Shough and Blake, *Courts Don't Follow: Reasonable Compensation Rulings and the Exacto Spring Approach,* 15 Chap. L. Rev. 343 (2011).

H. Tax Consequences: Contributing Services or Property

1. Employee Stock Options (Note 2 at page 124)

Employee stock options continue to grow as a means for compensating employees. Some types of stock options may have favorable tax consequences for employees. Startup entities often rely on stock options because there is no immediate cash payout. It also serves as an incentive for employees to work hard towards the success of the company, since significant wealth may be generated if the company is successful.

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5. Enacted as part of the Patient Protection and Affordable Care Act of 2010.

Stock options are contractual rights giving employees, officers, directors and/or consultants the right to buy the company's common stock at a specific price, usually after a certain vesting period. The price can be any price fixed by the company but is usually the market price at the time the options are granted or earned by the employee. However, some management employees may negotiate a price that is lower than the market price. The attractiveness of the options are that, if the market value of the company rises, exercising the option will allow the employee to acquire the stock at a lower-than-market price at the time it is exercised. Of course, if the market price is below the option price, the employee will not exercise the option. Consider the case of an employee of an internet startup who receives options to buy ten thousand shares of the entity at one dollar per share. Five years later, the startup is purchased by a large Internet company at a price of $25 per share. At the time of purchase, if the employee exercises the options, he/she will become the owner of ten thousand shares at a cost of $10,000. The employee can then turn around and sell the shares for $250,000 for a net profit of $240,000! What are the tax consequences of this event?

The IRC recognizes two classes of stock options:

<u>Qualified ("statutory") options</u>:

These types of options are afforded accorded favorable tax treatment if they meet the strict qualifications of IRC Sections 421-424. Generally, there are two types:

1. Incentive Stock Options, which are limited to $100,000 a year for any one employee. Incentive Stock Options may be confined to officers and highly paid employees.
2. Employee Stock Purchase Plans, which are limited to $25,000 a year for any employee. Employee stock purchase plans must be offered to all full time employees with at least two years of service.

Qualified options are not taxed as income to the employee when granted nor when they are exercised. Taxes are assessed only when the stock is *sold*. If the stock is held more than one year from the date of exercising the option (and two years from the granting of the option), the gain is taxed as long-term capital gain. As we know, the capital gains rate is currently at only 15% for most taxpayers. This means that employees can shift their compensation from *income from wages* to *capital gains*, significantly reducing their tax burdens. It also allows the taxpayer to postpone taxation into the future, which is always beneficial since the taxpayer gets to invest the full value of the compensation, without first paying taxes.

In our above example, the taxpayer does not pay taxes at the time the option is exercised and he/she becomes the owner of stock with a net value to the taxpayer of $240,000. This is wonderful news for the taxpayer and stunningly different than the result that would occur if the taxpayer *earned* a *salary* of $240,000. The salary would be taxed at about 30-35% leaving the taxpayer with only about $170,000. The taxpayer will pay no tax until the stock is sold. At that time, if the sale constitutes a long-term capital gain, the tax rate will be only 15% (under current Bush Tax Cuts) or 20% if the Bush Tax Cuts expire.

However, if the options are exercised and the stock is not held by the employee the required time before being sold, the employee will be taxed at ordinary income tax rates.

Impact on Corporate Employers

The employer is not allowed a deduction for Qualified Stock Options. Note that the inability to claim a deduction is irrelevant in terms of double taxation, since there is no taxable event to the employee at the time of the grant nor exercise of the option. However, if the option is exercised and the stock is not held by the employee the required time before being sold, the employer is allowed a deduction and the employee will pay taxes at ordinary income tax rates.

Nonqualified Options

There is no limit on the granting of Nonqualified Options. Typically, they are granted on a case-by-case basis to senior managers as part of their employment package and can generate fortunes for them. These options are taxed under IRC Section 83 *when exercised* and *all restrictions on selling the stock have expired*. Taxes will be computed based on the market value at the time the option is exercised, less the amount paid for the stock pursuant to the options agreement.

There is no favorable capital gains treatment for Nonqualified Options and any income will be taxed at regular income tax rates. However, there is some value to the employee in postponing the taxable event to some time in the future when the options become vested. For tax purposes, under IRC Section 83, vesting occurs when the options are no longer at risk of forfeiture and can be freely transferred.

At the same time that they vest in the employee and become subject to income tax, the corporation may deduct the difference in value, thereby reducing any double taxation.

Chapter 4 – Securities Law Considerations

B. Definition of a "Security"

Add the following at the end of the section.

In *Securities and Exchange Commission v. Merchant Capital, LLC* , 483 F.3d 747 (11th Cir. 2007), the Eleventh circuit faced the question of whether an interest in a Registered Limited Liability Partnership (RLLP) formed under Colorado law was an "investment contract" under the *Howey* test as described in the text. The court in *Merchant Capital* applied precedent from *Williamson v. Tucker*[1] to determine if the RLLP would be entitled to the "presumption" of investment contract status. *Williamson* endorsed a substance-over-form test, but stated that the following factors would raise a presumption that an RLLP interest is an investment contract, despite the investor's nominal control over the enterprise:

> (1) [A]n agreement among the parties leaves so little power in the hands of the partner or venturer that the arrangement in fact distributes power as would a limited partnership,
> (2) [T]he partner or venturer is so inexperienced and unknowledgeable in business affairs that he is incapable of intelligently exercising his partnership or venture powers, or
> (3) [T]he partner or venturer is so dependent on some unique entrepreneurial or managerial ability of the promoter or manager that he cannot replace the manager of the enterprise or otherwise exercise meaningful partnership or venture powers.[2]

This adds another method of analysis of the *Howey* test. In this case, because the court found that *all three* of the *Williamson* factors were present, any one of which is sufficient to render the investment a security, they did not need to reach the broader question of whether the Colorado RLLP might enjoy a base presumption that it is *not* an investment contract.[3]

C. Exemptions from Registration

1. Transaction Exemptions for Initial Sales

c. Small or Limited Offerings

i. Regulation A

As part of the Jumpstart Our Business Startups (JOBS) Act ,[4] Congress gave the SEC exemptive authority under a new Section 3(b)(2) of the Securities Act. This new exemption has tempting features:

- exemptions up to $50 million in a twelve month period
- public offerings permitted, no "restricted security" status for resales

[1] *See supra* note 28.
[2] *SEC v. Merchant Capital, LLC,* 483 F.3d at 755, *quoting Williamson v. Tucker*, 645 F.2d at 424.
[3] *SEC v. Merchant Capital, LLC,* 483 F.3d at 756.
[4] Pub. L. 112-106, 126 Stat. 306 (effective Apr. 5, 2012).

- “indications of interest” may be solicited prior to the filing of an offering statement

The less savory features are the ability of the SEC to require transactional and periodic disclosure from the issuer under this exemption.

Because of the similarity to Regulation A, this new § 3(b)(2) exemption is known colloquially as “Regulation A+.” However, before giving it such a high grade, business planners should note the following features reminiscent of the lower-grade Regulation A. First, it will require SEC implementing regulations to be effective, and the JOBS Act provides no timetable for those rules nor has the SEC volunteered a schedule. Second, and most importantly, the Regulation A+ securities will preempt state regulation only if exchange traded or if sold to persons designated by the SEC as “qualified purchasers” under Securities Act § 18(b)(4), a power the SEC has declined to exercise for over 16 years.

ii. Regulation D

Also as part of the JOBS Act, the SEC was directed to amend Rule 506 to permit solicitation and general advertising in offerings where all purchasers are accredited investors. Final rules so providing were issued in September 2012.[5] The main change from the proposed regulation was the addition of a non-exclusive list of examples of ways in which issuers can verify “accredited investor” status as required by the rule.[6]

In addition, as a partial response to so-called “crowdfunding” initiatives, where new businesses raise capital by obtaining small investments or contributions from many investors, Congress provided that any “platform” or place which permits the offer and sale of Rule 506-exempt offerings will not be subject to registration or regulation as a broker or dealer. To be exempt, the platform must not receive compensation nor take possession of customer funds or securities.[7]

Under this new rule, entrepreneurs may solicit and advertise for investors, but if they do so, *all sales must be to accredited investors.* The exemption permitting unaccredited investors still exists, but the general solicitation and advertising bans still apply there.[8] We will need to add a new line to the “Regulation D Worksheet” at the bottom of p. 169 of the textbook, replacing the line labeled “Rule 506” with two lines labeled “Rule 506(b)” and “Rule 506(c).”

iii. Other Small or Limited Offerings

Section 4(6) of the Securities Act as discussed in the text has been renumbered as Section 4(a)(5). Because of changes such as the amendments to Rule 506, it has become even less useful.

[5] Securities Act Release No. 9415, *Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings*, 78 Fed. Reg. 44771 (July 10, 2013).
[6] *Id.,* 78 Fed. Reg. at 44777-79.
[7] Securities Act §4(b), added by the JOBS Act. *See* main text Chapter 4, Section E.1.b for details of broker (and agent) registration. Curiously, Congress added this provision to the *Securities Act* while making changes to requirements of the *Securities Exchange Act*, probably a trivial oversight.
[8] Compare Rule 506(b) with proposed Rule 506(c).

In contrast, Congress in the JOBS Act added a new Section 4(a)(6),[9] which provides an exemption for offers or sales by an issuer which:

- Aggregate to no more than $1 million in sales in ay 12-month period
- Are limited to small amounts sold to each investor
- Are conducted through a qualified broker or "funding portal" which has taken specific measures to prevent fraud with respect to these transactions
- Are made by an issuer which meets certain disclosure requirements more limited than a Regulation D offering statement
- Are made with no advertising outside of the approved broker or funding portal
- Files simplified annual reports with the SEC.

This is what most individuals refer to as the "crowdfunding" exemption. It has important additional features. Like Rule 506 offerings, the new Section 4(a)(6) offerings will be "covered securities" so that state "blue sky" laws will be pre-empted.[10] These securities can be resold within one year, whereas securities sold under other exemptions face additional restrictions or longer holding periods.[11]

The crowdfunding exemption requires SEC rulemaking in order to implement it.[12] The SEC has taken the position that this legislation means that the exemption is not self-executing. Acting in reliance on the crowdfunding exemption or as a crowdfunding "portal" would be unlawful, according to the SEC.[13] The statutory deadline for the SEC to adopt implementing regulations has long since passed, but there is to date silence from the Commission on this exemption, other than the use of the "funding portal."[14]

D. Antifraud

Add after note 1 following *Wharf Holdings Ltd.*textbook p. 189:

In addition to *Wharf*, the Supreme Court has shown a resurgent interest in Rule 10b-5. In *Janus Capital Group, inc. v. First Derivative Traders*, 131 S.Ct. 2296 (2011), the Court trimmed the expansive reach of

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[9] The JOBS Act changed the numbering of Securities Act Section 4, adding subsections (a) and (b). Thus, what was previously known as the "Section 4(2) exemption" for transactions by an issuer not involving any public offering will now be known as a "Section 4(a)(2) exemption." That said, Congress was not consistent within the JOBS Act itself in following this new nomenclature. Whether it will catch on remains to be seen. Many texts and professionals refer to this new "Section 4(a)(6) exemption" by its old numbering as "section 4(6)," as does the rest of the JOBS Act.

[10] This new exemption is added to the list of "covered securities" in Securities Act § 18(b)(4). For the details of this provision, see the main text Ch. 4.E.2.

[11] See new Securities Act §4A(e). For general provisions governing resales, see the main text Ch. 4.C.2.

[12] JOBS Act §302(c) requires the SEC to "issue … rules as [it] determines may be necessary or appropriate for the protection of investors to carry out" the crowdfunding exemption.

[13] www.sec.gov/spotlight/jobsact/crowdfundingexemption.htm (Apr. 23, 2012): "The Act requires the Commission to adopt rules to implement a new exemption that will allow crowdfunding. Until then, we are reminding issuers that any offers or sales of securities purporting to rely on the crowdfunding exemption would be unlawful under the federal securities laws."

[14] See www.sec.gov/divisions/marketreg/tmjobsact-crowdfundingintermediariesfaq.htm.

Rule 10b-5 by holding that an investment adviser did not "make" a statement which was actually made by the mutual fund which was organized by and sponsored by the adviser. On the other hand, in *Matrixx Initiatives, Inc. v. Siracusano*, 13 S.Ct. 1309 (2011), the Court refused to restrict the standard of "materiality" required of allegedly false statements under the rule, holding that an omission by a pharmaceutical company of adverse side effects to its medication might be material even if not statistically significant.

Chapter 5 – FINANCING OF BUSINESS ENTITIES

D. Structuring the Financing of Business Entities (pages 216 *et. seq.*)

In this chapter, we tend to emphasize the benefits of *initial* entity formation as a partnership or LLC. For many startup businesses, the non-corporate entity is a much simpler mechanism for accomplishing the aims of the promoters and initial investors: (i) preferences and priorities of distribution; (ii) management and control; (iii) pass-through partnership taxation; and, (iv) flexibility without corporate formalities.

Successful startup business entities often go through subsequent rounds of financing as part of the growth and maturing of the business. As a result, the initial capital formation may also change over time. Business entities that start as partnerships or limited liability companies, may reorganize as a corporation to accommodate new investors. When the number of investors and employees increase, it becomes easier to use corporate stock as the means of financing the company, particularly when stock options are used to attract talented employees. While it is possible to structure a partnership or LLC to accomplish the same objectives, it is cumbersome to do so when compared to the ease of issuing corporate stock. Of course, depending on the deal negotiated with each new round of financing, the types and amounts of common and preferred stock will be structured to provide preferences and priorities to the financiers.

Two recent initial public offerings ("IPO's") reveal the reasons that venture capitalists and wealthy investors are willing to step in with the financing needed for second, third and more rounds of financing:

> Groupon, Inc.: Groupon is a "coupon-a-day" site that connects local retail merchants and local consumers by circulating heavily discounted (30%-50%) goods and services on behalf of the merchants. The first deal was a half-price offer for pizzas for the restaurant on the first floor of Groupon's building in Chicago in 2008. By 2011, Groupon had gathered sufficient momentum to undertake an IPO at a price of $20 per share. That pricing gave Groupon a market value of $12.7 billion. At the close of business on the first day on the NASDAQ Stock Exchange, the shares were selling at approximately $26 per share. The IPO revealed some of the investors and venture capitalists who were big winners:
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>> Groupon's two largest venture capital shareholders held a combined total of $3.13 billion. The New Enterprise Associates (NEA) held 87,453,072 shares valued at $2.27 billion, while Accel Partners' growth fund, Accel Growth Fund LP, held 33,203,928 shares valued at about $863 million. NEA paid $14.8 million for its shares, according to the securities registration materials. This amounts to a return of more than 153 times on its investment. Accel paid $20 million for its shares, giving it a return on investment of about 43 times. Digital Sky Technologies, which invested $151 million ended up with a $1.1 billion stake in Groupon. Battery Ventures, invested $58 million that grew to $417 million. Also notable investors were the three Sawmer brothers (the managers of the European Founders Fund in Germany), who made more than $1 billion.

Facebook, Inc. is a massive social media site that began life in the Harvard dorm room of Mark Zuckerberg in 2004. Facebook held its IPO on May 17, 2012, at $38 per share, establishing a market value for the the company $104 billion, the largest valuation in history for a newly listed public company. The fast-paced growth of the company was fueled by many rounds of financing. Once again, the registration materials filed with the SEC open the window for a view of who some of the pre-IPO investors were: Accel Partners, Russian investment firm DST Global, Goldman Sachs, Tiger Global Management, Russian Internet company Mail.ru, PayPal founder Peter Thiel, Greylock Partners, Meritech Capital Partners, Microsoft.

1. Financing of Corporations

c. Preferred Stock (pages 222-226)

An excellent example of using preferred stock to achieve financing and management objectives can be found in Facebook's articles of incorporation, included in the registration materials filed with the SEC in connection with Facebook's initial public offering. Facebook, Inc. I incorporated in Delaware. The provisions below are from the Eleventh Amended Articles of Incorporation, filed in Deleware in 2010. The provisions included in this Supplement have been substantially edited to give a flavor for the structure of the common and preferred stock of the corporation.

ELEVENTH AMENDED AND RESTATED
CERTIFICATE OF INCORPORATION
OF FACEBOOK, INC.[1]

ARTICLE IV

(A) Common Stock and Preferred Stock.

1. Classes of Stock. The Corporation is authorized to issue three classes of stock to be designated, respectively, "Class A Common Stock," "Class B Common Stock" and "Preferred Stock." The total number of shares which the Corporation is authorized to issue is 8,851,001,400 shares, each with a par value of $0.000006 per share. 4,141,000,000 shares shall be Class A Common Stock, 4,141,000,000 shares shall be Class B Common Stock and 569,001,400 shares shall be Preferred Stock.

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(B) Rights, Preferences and Restrictions of Preferred Stock. The Preferred Stock authorized by this Restated Certificate shall be divided into series as provided herein. The first series of Preferred Stock shall be designated "Series A Preferred Stock" and shall consist of 134,747,360 shares. The second series of Preferred Stock shall be designated "Series B Preferred Stock" and shall consist of 226,032,000 shares. The third series of Preferred Stock shall be designated "Series C Preferred Stock" and shall consist of 95,768,000 shares. The fourth series of Preferred Stock shall be designated "Series D Preferred Stock" and shall consist of 67,454,040 shares. The fifth series of Preferred Stock shall be designated "Series E Preferred Stock" and shall consist of 45,000,000 shares. The rights, preferences, privileges, and restrictions granted to and imposed on the Preferred Stock are as set

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[1]Facebook, Inc. Is incorporated in Delaware. The provisions below are from the Eleventh Amended Articles of Incorporation, filed in 2010. The provisions included in this Supplement have been substantially edited to give only a flavor for the structure of the common and preferred stock of the corporation.

forth below in this Article IV(B).

1. Dividend Provisions. The holders of shares of Preferred Stock shall be entitled to receive dividends, out of any assets legally available therefor, prior and in preference to any declaration or payment of any dividend (payable other than in Class A Common Stock, Class B Common Stock or other securities and rights convertible into or entitling the holder thereof to receive, directly or indirectly, additional shares of Class A Common Stock or Class B Common Stock of the Corporation, provided that an adjustment to the respective Conversion Price (as defined below) of such other securities or rights has been made in accordance with Section 4(d)(ii) below) on the Class A Common Stock or Class B Common Stock of the Corporation, at the rate of (a) $0.00036875 per share (as adjusted for stock splits, stock dividends, reclassification and the like) per annum on each outstanding share of Series A Preferred Stock, (b) $0.00456 per share (as adjusted for stock splits, stock dividends, reclassification and the like) per annum on each outstanding share of Series B Preferred Stock, (c) $0.02297335 per share (as adjusted for stock splits, stock dividends, reclassification and the like) per annum on each outstanding share of Series C Preferred Stock, (d) $0.593 per share (as adjusted for stock splits, stock dividends, reclassification and the like) per annum on each outstanding share of Series D Preferred Stock and (e) $0.3633264 per share (as adjusted for stock splits, stock dividends, reclassification and the like) per annum on each outstanding share of Series E Preferred Stock, payable quarterly when, as and if declared by the Board of Directors of the Corporation (the "Board of Directors"). Such dividends shall not be cumulative. After payment of such dividends, any additional dividends shall be distributed among the holders of Preferred Stock, Class A Common Stock and Class B Common Stock pro rata based on the number of shares of Class A Common Stock and Class B Common Stock then held by each holder (assuming conversion of all such Preferred Stock into Class B Common Stock).

2. Liquidation.

(a) Preference. In the event of any liquidation, dissolution or winding up of the Corporation, either voluntary or involuntary, the holders of the Preferred Stock shall be entitled to receive, prior and in preference to any distribution of any of the assets of the Corporation to the holders of Class A Common Stock or Class B Common Stock by reason of their ownership thereof, an amount per share equal to (i) $0.004605 per share (as adjusted for stock splits, stock dividends, reclassification and the like) for each share of Series A Preferred Stock then held by them, (ii) $0.0570025 per share (as adjusted for stock splits, stock dividends, reclassification and the like) for each share of Series B Preferred Stock then held by them, (iii) $0.2871668 per share (as adjusted for stock splits, stock dividends, reclassification and the like) for each share of Series C Preferred Stock then held by them, (iv) $7.412454 per share (as adjusted for stock splits, stock dividends, reclassification and the like) for each share of Series D Preferred Stock then held by them, and (v) $4.54158 per share (as adjusted for stock splits, stock dividends, reclassification and the like) for each share of Series E Preferred Stock then held by them, plus declared but unpaid dividends (each such amount being the "Applicable Liquidation Amount"). If, upon the occurrence of such event, the assets and funds thus distributed among the holders of the Preferred Stock shall be insufficient to permit the payment to such holders of the full aforesaid preferential amounts, then the entire assets and funds of the Corporation legally available for distribution shall be distributed ratably among the holders of the Preferred Stock in proportion to the preferential amount each such holder is otherwise entitled to receive.

(b) Remaining Assets. Upon the completion of the distribution required by Section 2(a) above, if assets remain in the Corporation, all of the remaining assets of the Corporation shall be distributed among the holders of the Class A Common Stock and Class B Common Stock pro rata based on the number of shares of Class A Common Stock and Class B Common Stock then held by them.

(c) Notwithstanding paragraphs (a) and (b) above, upon a liquidation, dissolution, or winding up of the Company, the holders of Preferred Stock shall receive at the closing (or upon the occurrence of such event if no closing is scheduled to occur) (and at each date after such closing (or such occurrence, if applicable) on which additional amounts (such as earnout payments, escrow amounts or other contingent payments) are paid to stockholders of the Company as a result of the event) in cash, securities or other property (valued as provided in Section 2(d)(ii)) below) an amount with respect to each series of Preferred Stock that, when added to all other amounts previously paid under this paragraph (c), is equal to the greater of: (1) the Applicable Liquidation Amount, and (2) the amount that the holders of such series of Preferred Stock would have been entitled to receive had they converted their shares of Preferred Stock into Class B Common Stock immediately prior to such event at the then effective Conversion Price for each such series (as defined below).

(d) Certain Acquisitions.

(i) Deemed Liquidation. For purposes of this Section 2, a liquidation, dissolution, or winding up of the Corporation, whether voluntary or involuntary, shall be deemed to occur if the Corporation shall either (1) sell, lease, convey, or otherwise dispose of all or substantially all of its assets or business or (2) (A) merge with or into or consolidate with any other corporation, limited liability company or other entity (other than a wholly-owned subsidiary of the Corporation) or (B) effect any transaction or series of related transactions in which the stockholders of the Corporation immediately prior to such transaction or series of related transactions (and prior to any acquisition of shares of stock of the Corporation effected in connection with such transaction or series of related transactions), own in the case of either subclauses (A) or (B) less than 50% of the Corporation's voting power (or the voting power of the surviving entity in such transaction or series of related transactions) immediately after such transaction or series of related transactions (any such transaction, a "Liquidation Transaction"), provided that none of the following shall be considered a Liquidation Transaction: (i) a merger effected exclusively for the purpose of changing the domicile of the Corporation or (ii) an equity financing in which the Corporation is the surviving corporation.

(ii) Valuation of Consideration. In the event of a deemed liquidation as described in Section 2(d)(i) above, if the consideration received by the Corporation is other than cash, its value will be deemed its fair market value. Any securities shall be valued as follows:

* * *

3. Redemption. The Preferred Stock is not redeemable.

4. Conversion. The holders of the Preferred Stock shall have conversion rights as follows (the "Conversion Rights"):

(a) Right to Convert. Subject to Section 4(c), each share of Series A Preferred Stock, Series B Preferred Stock, Series C Preferred Stock, Series D Preferred Stock and Series E Preferred Stock shall be convertible, at the option of the holder thereof, at any time after the date of issuance of such share, at the office of the Corporation or any transfer agent for such stock, into such number of fully paid and nonassessable shares of Class B Common Stock as is determined by dividing (i) $0.004605 in the case of the Series A Preferred Stock (as adjusted for stock splits, stock dividends, reclassification and the like), (ii) $0.0570025 in the case of the Series B Preferred Stock (as adjusted for stock splits, stock dividends, reclassification and the like), (iii) $0.2871668 in the case of the Series C Preferred Stock (as adjusted for stock splits, stock dividends, reclassification and the like), (iv) $7.412454 in the case of the Series D Preferred Stock (as adjusted for stock splits, stock dividends, reclassification and the like) and (v) $4.54158 in the case of the Series E Preferred Stock (as adjusted for stock splits, stock dividends, reclassification and the like) by the Conversion Price applicable to such share, determined as hereafter provided, in effect on the date the certificate is surrendered for conversion. The Conversion Price per share as of the Effective Time shall be $0.004605 for shares of Series A Preferred Stock, $0.056724 for shares of Series B Preferred Stock, $0.285764 for shares of Series C Preferred Stock, $7.320504 for shares of Series D Preferred Stock and $4.54158 for shares of Series E Preferred Stock. Such Conversion Price shall hereafter be subject to adjustment as set forth in Section 4(d) below.

(b) Automatic Conversion. Each share of Preferred Stock shall automatically be converted into fully-paid, non-assessable shares of Class B Common Stock at the applicable Conversion Price at the time in effect for such share immediately upon the earlier of (i) except as provided below in Section 4(c), the Corporation's sale of its Class A Common Stock and/or Class B Common Stock in a firm commitment underwritten public offering pursuant to a registration statement under the Securities Act of 1933, as amended (the "Securities Act"), the public offering price of which results in aggregate cash proceeds to the Corporation of not less than $100,000,000 (net of underwriting discounts and commissions) or (ii) the date specified by written consent or agreement of the holders of a majority of the then outstanding shares of Preferred Stock, voting together as a single class on an as-converted basis; provided however, that in the event of an automatic conversion pursuant to clause (ii) of this Section 4(b) in which either (A) the holders of a majority of the then outstanding shares of Series D Preferred Stock do not consent or agree or (B) the holders of a majority of the then outstanding shares of Series E Preferred Stock do not consent or agree, then in such case the conversion shall not be effective as to any shares of Preferred Stock until 180 days after the date of the written consent of the majority of the outstanding shares of Preferred Stock.

(c) Mechanics of Conversion. * * *

(f) Recapitalizations. If at any time or from time to time there shall be a recapitalization of the Class B Common Stock (other than a subdivision, combination or merger or sale of assets transaction provided for elsewhere in this Section 4 or in Section 2) provision shall be made so that the holders of each series of Preferred Stock shall thereafter be entitled to receive upon conversion of such Preferred Stock the number of shares of stock or other securities or property of the Corporation or otherwise, to which a holder of Class B Common Stock deliverable upon conversion would have been entitled on such recapitalization. In any such case, appropriate adjustment shall be made in the application of the provisions of this Section 4 with respect to the rights of the holders of such Preferred Stock after the recapitalization to the end that the provisions of this Section 4 (including adjustment of the Conversion Price then in effect for such series of Preferred Stock and the number of shares purchasable upon conversion of such Preferred Stock) shall be applicable after that event and be as nearly equivalent as practicable.

* * *

(i) Reservation of Stock Issuable Upon Conversion. The Corporation shall at all times reserve and keep available out of its authorized but unissued shares of Class B Common Stock, solely for the purpose of effecting the conversion of the shares of Preferred Stock, such number of shares of its Class B Common Stock as shall from time to time be sufficient to effect the conversion of all outstanding shares of Preferred Stock; and if at any time the number of authorized but unissued shares of Class B Common Stock shall not be sufficient to effect the conversion of all then outstanding shares of Preferred Stock, in addition to such other remedies as shall be available to the holder of such shares of Preferred Stock, the Corporation will take such corporate action as may, in the opinion of its counsel, be necessary to increase its authorized but unissued shares of Class B Common Stock to such number of shares as shall be sufficient for such purposes, including, without limitation, engaging in best efforts to obtain the requisite stockholder approval of any necessary amendment to this Restated Certificate.

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(k) No Impairment. The Corporation will not, except with the approval required by Section 6 hereof and applicable law, by amendment of its Certificate of Incorporation or through any reorganization, recapitalization, transfer of assets, merger, consolidation, dissolution, issue or sale of securities or any other voluntary action, avoid or seek to avoid the observance or performance of any of the terms to be observed or performed hereunder by the Corporation but will at all times in good faith assist in the carrying out of all the provisions of this Section 4 and in the taking of all such actions as may be necessary or appropriate in order to protect the Conversion Rights of the holders of the Preferred Stock against impairment.

5. Voting Rights.

(a) Generally. Except as expressly provided by this Restated Certificate or as provided by law, the holders of Series A, Series B, Series C, Series D and Series E Preferred Stock shall have the right to ten (10) votes for each share of Class B Common Stock into which such Series A, Series B, Series C, Series D and Series E Preferred Stock could then be converted, and with respect to such vote, such holder shall have full voting rights and powers equivalent to those of the holders of Class B Common Stock. In addition, such holder shall be entitled to notice of any stockholders' meeting in accordance with the Bylaws of the Corporation, and, except as expressly provided by this Restated Certificate or as provided by law, shall be entitled to vote together with holders of Class A Common Stock and Class B Common Stock (all voting together as a single class) on all matters upon which holders of Class A Common Stock and Class B Common Stock have the right to vote. Fractional votes shall not, however, be permitted and any fractional voting rights available on an as-converted basis (after aggregating all shares into which shares of Preferred Stock held by each holder could be converted) shall be rounded to the nearest whole number (with one-half being rounded upward).

(b) Directors.

(i) Election by Class. The directors shall be elected as follows:

(A) For so long as a minimum of 45,280,000 shares (as adjusted for stock splits, stock dividends, reclassification and the like) of Series B Preferred Stock are outstanding, one (1) director (the "Series B Director") shall be elected by the holders of a majority of all of the outstanding shares of Series B Preferred Stock voting as a separate series.

(B) For so long as a minimum of 26,949,440 shares (as adjusted for stock splits, stock dividends, reclassification and the like) of Series A Preferred Stock are outstanding, one (1) director (the "Series A Director") shall be elected by the holders of a majority of all of the outstanding shares of Series A Preferred Stock voting as a separate series.

(C) Three (3) directors (each a "Common Director" and collectively the "Common Directors") shall be elected by the holders of a majority of the voting power of the outstanding shares of Class A Common Stock and Class B Common Stock, voting as a single class.

(D) Any remaining directors (each, an "At-Large Director" and collectively, the "At-Large Directors") shall be elected by the holders of a majority of the voting power of the outstanding shares of Class A Common Stock, Class B Common Stock and Preferred Stock (on an as-converted to Class B Common Stock basis), voting as a single class.

(ii) Removal of Directors, Reduction of Number of Directors.

(A) If at any time there are fewer than 45,280,000 shares (as adjusted for stock splits, stock dividends, reclassification and the like) of Series B Preferred Stock outstanding (i) the right of the holders of the shares of Series B Preferred Stock to elect the Series B Director will terminate, (ii) a voting shift shall be effected, the Series B Director shall cease to be qualified and the term of office of the Series B Director will automatically terminate, and (iii) the authorized number of directors shall be reduced by one. In addition, the Series B Director may be removed by vote or written consent of a majority of the shares of Series B Preferred Stock then outstanding, voting as a separate series.

(B) If at any time there are fewer than 26,949,440 shares (as adjusted for stock splits, stock dividends, reclassification and the like) of Series A Preferred Stock outstanding (i) the right of the holders of the shares of Series A Preferred Stock to elect the Series A Director will terminate, (ii) a voting shift shall be effected, the Series A Director shall cease to be qualified and the term of office of the Series A Director will automatically terminate, and (iii) the authorized number of directors shall be reduced by one. In addition, the Series A Director may be removed by vote or written consent of a majority of the shares of Series A Preferred Stock then outstanding, voting as a separate series.

(C) The Common Directors may be removed by vote or written consent of the holders of a majority of the voting power of the shares of Class A Common Stock and Class B Common Stock then outstanding, voting as a single class.

(D) The At-Large Directors may be removed by vote or written consent of the holders of a majority of the voting power of the shares of Class A Common Stock, Class B Common Stock and Preferred Stock (on an as-converted to Class B Common Stock basis) then outstanding, voting as a single class.

The foregoing provisions set forth in this Section 5(b)(ii) are subject to any limitations imposed by statute or applicable law.

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6. Protective Provisions. So long as at least 92,500,000 shares of Preferred Stock are outstanding (as adjusted for stock splits, stock dividends, reclassification and the like), the Corporation shall not (by amendment, merger, consolidation or otherwise) without first obtaining the approval (by vote or written consent, as provided by law) of the holders of at least a majority of the then outstanding shares of Preferred Stock, voting together as a class on an as-converted basis:

(a) effect a Liquidation Transaction;

(b) alter or change the rights, preferences or privileges of the shares of a series of Preferred Stock so as to materially and adversely affect the shares of such series in a manner that does not similarly affect all series of Preferred Stock;

(c) increase or decrease (other than by conversion) the total number of authorized shares of the Preferred Stock;

(d) authorize or issue, any other equity security, including any security (other than Series A, Series B, Series C, Series D or Series E Preferred Stock) convertible into or exercisable for any equity security, having a preference over, or being on a parity with, any series of Preferred Stock with respect to voting (other than the pari passu voting rights of Class A Common Stock or Class B Common Stock), dividends, redemption, conversion or upon liquidation;

(e) amend, waive, or repeal any provision of, or add any provision to, the Corporation's Certificate of Incorporation, as amended, or Bylaws; or

(f) redeem, purchase or otherwise acquire (or pay into or set aside for a sinking fund for such purpose) any share or shares of Preferred Stock, Class A Common Stock or Class B Common Stock; provided, however, that this restriction shall not apply to the repurchase of shares of Class A Common Stock or Class B Common Stock from employees, officers, directors, consultants or other persons performing services for the Corporation or any subsidiary pursuant to agreements under which the Corporation has the option to repurchase such shares at no greater than cost upon the occurrence of certain events, such as the termination of employment, or through the exercise of any right of first refusal.

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(C) Rights, Powers and Restrictions of Class A Common Stock.

The rights, powers and restrictions granted to and imposed on the Class A Common Stock are as set forth below in this Article IV.

1. Dividend Rights. Subject to the prior rights of holders of all classes of stock at the time outstanding having prior rights as to dividends, the holders of the Class A Common Stock shall be entitled to receive, when and as declared by the Board of Directors, such dividends as may be declared from time to time by the Board of Directors with respect to the Class B Common Stock out of any assets of the Corporation legally available therefor, and no dividend shall be declared or paid on shares of the Class B Common Stock unless the same dividend with the same record date and payment date shall be declared or paid on the shares of Class A Common Stock; provided, however, that dividends payable in shares of Class B Common Stock or rights to acquire Class B Common Stock may be declared and paid to the holders of the Class B Common Stock without the same dividend being declared and paid to the holders of the Class A Common Stock if and only if a dividend payable in shares of Class A Common Stock or rights to acquire Class A Common Stock (as the case may be) at the same rate and with the same record date and payment date as the dividend declared and paid to the holders of the Class B Common Stock shall be declared and paid to the holders of Class A Common Stock.

2. Liquidation Rights. Upon the liquidation, dissolution or winding up of the Corporation or the occurrence of a Liquidation Transaction, the assets of the Corporation shall be distributed as provided in Section 2 of Article IV(B).

3. Redemption. The Class A Common Stock is not redeemable.

4. Voting Rights. Each holder of Class A Common Stock shall have the right to one (1) vote per share of Class A Common Stock, and shall be entitled to notice of any stockholders' meeting in accordance with the Bylaws of the Corporation, and shall be entitled to vote upon such matters and in such manner as may be provided by law. Except as expressly provided by this Restated Certificate or as provided by law, the holders of shares of Class A Common Stock shall at all times vote together with the holders of Class B Common Stock as a single class on all matters (including the election of directors) submitted to vote or for the consent of the stockholders of the Corporation. The number of authorized shares of Class A Common Stock may be

increased or decreased (but not below the number of shares thereof then outstanding) by the affirmative vote of the holders of shares of stock of the Corporation representing a majority of the votes represented by all outstanding shares of stock of the Corporation entitled to vote, irrespective of the provisions of Section 242(b)(2) of the Delaware General Corporation Law.

5. Subdivisions or Combinations. If the Corporation in any manner subdivides or combines the outstanding shares of Class B Common Stock, then the outstanding shares of Class A Common Stock will be subdivided or combined in the same proportion and manner.

6. Equal Status. Except as expressly set forth in this Article IV, Class A Common Stock shall have the same rights and powers of, rank equally to, share ratably with and be identical in all respects and as to all matters to Class B Common Stock.

(D) Rights, Powers and Restrictions of Class B Common Stock. The rights, powers and restrictions granted to and imposed on the Class B Common Stock are as set forth below in this Article IV.

1. Dividend Rights. Subject to the prior rights of holders of all classes of stock at the time outstanding having prior rights as to dividends, the holders of the Class B Common Stock shall be entitled to receive, when and as declared by the Board of Directors, such dividends as may be declared from time to time by the Board of Directors with respect to the Class A Common Stock out of assets or funds of the Corporation legally available therefor, and no dividend shall be declared or paid on shares of the Class A Common Stock unless the same dividend with the same record date and payment date shall be declared or paid on the shares of Class B Common Stock; provided, however, that dividends payable in shares of Class A Common Stock or rights to acquire Class A Common Stock may be declared and paid to the holders of the Class A Common Stock without the same dividend being declared and paid to the holders of the Class B Common Stock if and only if a dividend payable in shares of Class B Common Stock or rights to acquire Class B Common Stock (as the case may be) at the same rate and with the same record date and payment date as the dividend declared and paid to the holders of the Class A Common Stock shall be declared and paid to the holders of Class B Common Stock.

2. Liquidation Rights. Upon the liquidation, dissolution or winding up of the Corporation or the occurrence of a Liquidation Transaction, the assets of the Corporation shall be distributed as provided in Section 2 of Article IV(B).

3. Redemption. The Class B Common Stock is not redeemable.

4. Voting Rights. Each holder of Class B Common Stock shall be entitled to ten (10) votes per share of Class B Common Stock, and shall be entitled to notice of any stockholders' meeting in accordance with the Bylaws of the Corporation, and shall be entitled to vote upon such matters and in such manner as may be provided by law. Except as expressly provided by this Restated Certificate or as provided by law, the holders of shares of Class B Common Stock shall at all times vote together with the holders of Class A Common Stock as a single class on all matters (including the election of directors) submitted to vote or for the consent of the stockholders of the Corporation. The number of authorized shares of Class B Common Stock may be increased or decreased (but not below the number of shares thereof then outstanding) by the affirmative vote of the holders or shares of stock of the Corporation representing a majority of the votes represented by all outstanding shares of stock of the Corporation entitled to vote, irrespective of the provisions of Section 242(b)(2) of the Delaware General Corporation Law of the State of Delaware.

5. Conversion.

(a) Each share of Class B Common Stock shall be convertible into one (1) fully paid and nonassessable share of Class A Common Stock at the option of the holder thereof at any time upon written notice to the Corporation. Before any holder of Class B Common Stock shall be entitled to convert any shares of such Class B Common Stock, such holder shall surrender the certificate or certificates therefor, duly endorsed, at the principal corporate office of the Corporation or of any transfer agent for the Class B Common Stock, and shall give written notice to the Corporation at its principal corporate office, of the election to convert the same and shall state therein the name or names in which the certificate or certificates for shares of Class A Common Stock are to be issued. The Corporation shall, as soon as practicable thereafter, issue and deliver at such office to such holder of Class B Common Stock, or to the nominee or nominees or such holder, a certificate or certificates for the number of shares of Class A Common Stock to which such holder shall be entitled as aforesaid. Such conversion shall be deemed to have been made immediately prior the close of business on the date of such surrender of the shares of Class B Common Stock to be converted, and the person or persons entitled to receive the shares of Class A Common Stock issuable upon such conversion shall be treated for all purposes as the record holder or holders of such shares of Class A Common Stock as of such date. Each share of Class B Common Stock that is converted pursuant to this Section 5(a) shall be retired by the Corporation and shall not be available for reissuance.

(b) This Section (B)(5)(b) of Article IV shall become effective immediately prior to the closing of a firm commitment underwritten public offering pursuant to a registration statement under the Securities Act in which all outstanding shares of Preferred Stock convert (or will convert within 180 days thereafter) into Class B Common Stock, provided that the Class B Common Stock is then a "covered security" pursuant to Section 18 of the Securities Act (the "Covered Security Date"). On or after the Covered Security Date, each share of Class B Common Stock shall be automatically, without further action by the holder thereof, converted into one (1) fully paid and nonassessable share of Class A Common Stock, upon the occurrence of a Transfer (as defined in Section (E)(4) of this Article IV), other than a Permitted Transfer (as defined in Section (E)(5) of this Article IV), of such share of Class B Common Stock. Each outstanding stock certificate that, immediately prior to such Transfer, represented one or more shares of Class B Common Stock subject to such Transfer shall, upon and after such Transfer, be deemed to represent an equal number of shares of Class A Common Stock, without the need for surrender or exchange thereof. The Corporation shall, upon the request of each such holder and upon receipt of such holder's outstanding certificate, issue and deliver to such holder new certificates representing such holder's shares of Class A Common Stock. Each share of Class B Common Stock that is converted pursuant to this Section (B)(5)(b) of Article IV shall be retired by the Corporation and shall not be available for reissuance.

(c) The Corporation may, from time to time, establish such policies and procedures, not in violation of applicable law or the other provisions of this Restated Certificate, relating to the conversion of the Class B Common Stock into Class A Common Stock and the dual class common stock structure contemplated this Restated Certificate, including without limitation the issuance of stock certificates in connection with any such conversion, as it may deem necessary or advisable. If the Corporation has reason to believe that a Transfer giving rise to a conversion of shares of Class B Common Stock into Class A Common Stock has occurred but has not theretofore been reflected on the books of the Corporation, the Corporation may request that the holder of such shares furnish affidavits or other evidence to the Corporation as it reasonably deems necessary to determine whether a conversion of shares of Class B Common Stock to Class A Common Stock has occurred, and if such holder does not within ten (10) days after the date of such request furnish sufficient evidence to the Corporation (in the manner provided in the request) to enable the Corporation to determine that no such conversion has occurred, any such shares of Class B Common Stock, to the extent not previously converted, shall be automatically converted into shares of Class A Common Stock and the same shall thereupon be registered on the books and records of the Corporation. In connection with any action of stockholders taken at a meeting or by written consent, the stock ledger of the Corporation shall be presumptive evidence as to who are the stockholders entitled to vote in person or by proxy at any meeting of stockholders or in connection with any written consent and the classes of shares held by each such stockholder and the number of shares of each class held by such stockholder.

6. Subdivisions or Combinations. If the Corporation in any manner subdivides or combines the outstanding shares of Class A Common Stock, then the outstanding shares of Class B Common Stock will be subdivided or combined in the same proportion and manner.

7. Equal Status. Except as expressly set forth in this Article IV, Class B Common Stock shall have the same rights and powers of, rank equally to, share ratably with and be identical in all respects and as to all matters to Class A Common Stock.

8. Reservation of Stock. The Corporation shall at all times reserve and keep available out of its authorized but unissued shares of Class A Common Stock, solely for the purpose of effecting the conversion of the shares of Class B Common Stock, such number of shares of Class A Common Stock as shall from time to time be sufficient to effect the conversion of all outstanding shares of Class B Common Stock into shares of Class A Common Stock

9. Protective Provision. The Corporation shall not, by amendment, merger, consolidation or otherwise, without first obtaining the approval (by vote at a stockholders meeting or written consent, as provided by law) of the holders of at least a majority of the then outstanding shares of Class B Common Stock, voting as a

separate class, amend, alter, repeal or waive Sections (B)(2)(b), (B)(2)(d), (C), (D) or (E) of this Article IV.

10. Liquidation Event. On or after the Covered Security Date, the Corporation shall not consummate a Change in Control Transaction (as defined below) without first obtaining the approval (by vote at a stockholders meeting or written consent, as provided by law), of the holders of at least a majority of the then outstanding shares of Class B Common Stock, voting as a separate class. For the purposes of this section, a "Change in Control Transaction" means the occurrence of any of the following events:

(a) the sale, encumbrance or disposition (other than licenses that do not constitute an effective disposition of all or substantially all of the assets of the Corporation and its subsidiaries taken as a whole, and the grant of security interests in the ordinary course of business) by the Corporation of all or substantially all of the Corporation's assets; or

(b) the merger or consolidation of the Corporation with or into any other corporation or entity, other than a merger or consolidation that would result in the Class B Common Stock of the Corporation outstanding immediately prior thereto continuing to represent (either by remaining outstanding or by being converted into voting securities of the surviving entity or its parent) more than fifty percent (50%) of the total voting power represented by the voting securities of the Corporation or such surviving entity or its sole parent entity outstanding immediately after such merger or consolidation.

(E) Definitions. For purposes of this Article IV:

1. "Family Member" shall mean with respect to any natural person who is a Qualified Stockholder, the spouse, parents, grandparents, lineal descendents, siblings and lineal descendants of siblings of such Qualified Stockholder.

2. "Qualified Stockholder" shall mean (a) the registered holder of a share of Class B Common Stock immediately following the Covered Security Date; (b) the initial registered holder of any shares of Class B Common Stock that are originally issued by the Corporation after the Covered Security Date pursuant to the exercise or conversion of options or warrants or settlement of restricted stock units (RSUs) that, in each case, are outstanding as of the Covered Security Date; (c) each natural person who Transferred shares of or equity awards for Class B Common Stock (including any option or warrant exercisable or convertible into or any RSU that can be settled in shares of Class B Common Stock) to a Permitted Entity that is or becomes a Qualified Stockholder pursuant to subclauses (a) or (b) of this Section (E)(2); and (d) a Permitted Transferee.

3. "Permitted Entity" shall mean with respect to a Qualified Stockholder (a) a Permitted Trust (as defined below) solely for the benefit of (i) such Qualified Stockholder, (ii) one or more Family Members of such Qualified Stockholder and/or (iii) any other Permitted Entity of such Qualified Stockholder, or (b) any general partnership, limited partnership, limited liability company, corporation or other entity exclusively owned by (i) such Qualified Stockholder, (ii) one or more Family Members of such Qualified Stockholder and/or (iii) any other Permitted Entity of such Qualified Stockholder.

4. "Transfer" of a share of Class B Common Stock shall mean any sale, assignment, transfer, conveyance, hypothecation or other transfer or disposition of such share or any legal or beneficial interest in such share, whether or not for value and whether voluntary or involuntary or by operation of law, including, without limitation, a transfer of a share of Class B Common Stock to a broker or other nominee (regardless of whether there is a corresponding change in beneficial ownership), or the transfer of, or entering into a binding agreement with respect to, Voting Control (as defined below) over such share by proxy or otherwise; provided, however, that the following shall not be considered a "Transfer" within the meaning of this Article IV:

(a) the granting of a revocable proxy to officers or directors of the Corporation at the request of the Board of Directors in connection with actions to be taken at an annual or special meeting of stockholders;

(b) entering into a voting trust, agreement or arrangement (with or without granting a proxy) solely with stockholders who are holders of Class B Common Stock that (i) is disclosed either in a Schedule 13D filed with the Securities and Exchange Commission or in writing to the Secretary of the Corporation, (ii) either has a term not exceeding one (1) year or is terminable by the holder of the shares subject thereto at any time and (iii) does not involve any payment of cash, securities, property or other consideration to the holder of the shares subject thereto other than the mutual promise to vote shares in a designated manner; or

(c) the pledge of shares of Class B Common Stock by a stockholder that creates a mere security interest in such shares pursuant to a bona fide loan or indebtedness transaction for so long as such stockholder continues to exercise Voting Control over such pledged shares; provided, however, that a foreclosure on such shares or other similar action by the pledgee shall constitute a "Transfer" unless such foreclosure or similar action qualifies as a "Permitted Transfer".

A "Transfer" shall also be deemed to have occurred with respect to a share of Class B Common Stock beneficially held by (i) an entity that is a Permitted Entity, if there occurs any act or circumstance that causes such entity to no longer be a Permitted Entity or (ii) an entity that is a Qualified Stockholder, if there occurs a Transfer on a cumulative basis, from and after the Covered Security Date, of a majority of the voting power of the voting securities of such entity or any direct or indirect Parent of such entity, other than a Transfer to parties that are, as of the Covered Security Date, holders of voting securities of any such entity or Parent of such entity. "Parent" of an entity shall mean any entity that directly or indirectly owns or controls a majority of the voting power of the voting securities of such entity.

5. "Permitted Transfer" shall mean, and be restricted to, any Transfer of a share of Class B Common Stock:

(a) by a Qualified Stockholder to (i) one or more Family Members of such Qualified Stockholder, or (ii) any Permitted Entity of such Qualified Stockholder; or

(b) by a Permitted Entity of a Qualified Stockholder to (i) such Qualified Stockholder or one or more Family Members of such Qualified Stockholder, or (ii) any other Permitted Entity of such Qualified Stockholder.

6. "Permitted Transferee" shall mean a transferee of shares of Class B Common Stock received in a Transfer that constitutes a Permitted Transfer.

7. "Permitted Trust" shall mean a bona fide trust where each trustee is (a) a Qualified Stockholder, (b) Family Member or (c) a professional in the business of providing trustee services, including private professional fiduciaries, trust companies and bank trust departments.

8. "Voting Control" shall mean, with respect to a share of Class B Common Stock, the power (whether exclusive or shared) to vote or direct the voting of such share by proxy, voting agreement or otherwise.

1. Financing of Corporations

d. Debt financing from outsiders and investors

iv. Recharacterization of Debt as Equity (pages 230-238)

An excellent summary of the distinction between equitable subordination and debt recharacterization can be found in *Cohen v. KB Mezzanine Fund II, LP (In re SubMicron Sys. Corp.)*, 432 F.3d 448, 454-455 (3d Cir. Del. 2006)

> At the outset, it is important to distinguish recharacterization from equitable subordination. Both remedies are grounded in bankruptcy courts' equitable authority to ensure "that substance will not give way to form, that technical considerations will not prevent substantial justice from being done." *Pepper v. Litton*, 308 U.S. 295, 305, 60 S. Ct. 238, 84 L. Ed. 281 (1939). Yet recharacterization and equitable subordination address distinct concerns. Equitable subordination is apt when equity demands that the payment priority of claims of an otherwise legitimate creditor be changed to fall behind those of other claimants. See, e.g., *Citicorp Venture Capital, Ltd. v. Comm. of Creditors Holding Unsecured Claims*, 160 F.3d 982, 986-87 (3d Cir. 1998); *Bayer Corp. v. MascoTech, Inc. (In re Autostyle Plastics, Inc.),* 269 F.3d 726, 749 (6th Cir. 2001). In contrast, the focus of the recharacterization inquiry is whether "a debt actually exists," *In re Autostyle Plastics*, 269 F.3d at 748 (internal quotation marks omitted) or, put another way, we ask what is the proper characterization in the first instance of an investment. For these reasons, we agree with those courts that have determined that "the issues of recharacterization of debt as equity capital and equitable subordination should be treated separately." *Blasbalg v. Tarro* (*In re Hyperion Enters., Inc*.), 158 B.R.

> 555, 560 (D.R.I. 1993); see, e.g., *In re Autostyle Plastics*, 269 F.3d at 749 (explaining that "because both recharacterization and equitable subordination are supported by the Bankruptcy Code and serve different purposes, we join those courts that have concluded that a bankruptcy court has the power to recharacterize a claim from debt to equity" and collecting cases); *Aquino v. Black* (*In re Atlantic Rancher, Inc*.), 279 B.R. 411, 433 (Bankr. D. Mass. 2002) (stating that "while once considered solely in conjunction with the doctrine of equitable subordination, bankruptcy courts now consider recharacterization a separate cause of action").

Interestingly, there is some minor conflict among the federal circuits regarding the ability of bankruptcy courts to recharacterize. Most circuits agree that recharacterization is a viable cause of action in bankruptcy actions, a highly-criticized Ninth Circuit BAP decision holds that it is not.[2] For an up to date discussion see, Margolis, *Debt Recharacterization in the Ninth Circuit,* 30-9 ABIJ 50 (2011).

In another article, the authors predict that we will see a rise in debt recharacterizations as a result of the complex financial transactions leading up to the economic recession:

> It will be interesting to see if bankruptcy courts view the slew of unorthodox and insider-originated financings that are being entered into now (and are sure to be challenged in future bankruptcy cases) as a collective symptom of the worst credit crunch in a generation. It will be even more interesting to see if, . . . these courts will contextualize these non-arm's-length transactions, and what that analysis will mean for the future of recharacterization in the bankruptcy context. Unconventional financing is a sign of these dark economic times. How the courts will respond to these arrangements is to be determined.

Once More unto the Breach: A Recharacterization Refresher for an Uncertain Economy, Medford and Bartolomei, 28-2 ABIJ 42 (2009)

[2] *In re Pacific Express, Inc*., 69 B.R. 112 (B.A.P. 9th Cir. Cal. 1986)

Chapter 6 – Profits and Distributions

C. Corporate Dividends and Distributions

2. Accounting for and Regulating Dividends

In 2011, California substantially modified its statute on distributions to shareholders, requiring many changes to this subsection.

On p. 285, replace the existing language of Cal. Corp. Code § 500 with the following:

§ 500. Distributions; retained earnings or assets remaining after completion …

(a) Neither a corporation nor any of its subsidiaries shall make any distribution to the corporation's shareholders unless the board of directors has determined in good faith either of the following:

(1) The amount of retained earnings of the corporation immediately prior to the distribution equals or exceeds the sum of (A) the amount of the proposed distribution plus (B) the preferential dividends arrears amount.

(2) Immediately after the distribution, the value of the corporation's assets would equal or exceed the sum of its total liabilities plus the preferential rights amount.

Sections 501 and 114 remain as they appear in the book. The summary in the first bullet-point on p. 287 should be replaced with the following:

- Under Cal. Corp. Code §500, the test is stated in the alternative, either by reference to the corporation's "retained earnings," leaving amounts represented by the common stock (par value) and contributed capital in excess of par, **or** by reference to the value of the liabilities plus preferential distributions, as in the MBCA §6.40 (see below).

The table on p. 287 should be recaptioned in the second line as follows (bold indicating new language):

Accounting	State law	Available for distribution in:		
		California (first alternative)	Delaware	**MBCA and California (second alternative**

Important correction: on page 286, Model Business Corporation Act §6.40(c)(2) should read "the corporation's **total assets**" rather than "the corporation's total net assets."

On p. 295, add the following before Cal. Corp. Code §316:

§ 500. Distributions; retained earnings or assets remaining after completion …

(c) The board of directors may base a determination that a distribution is not prohibited under subdivision (a) or under Section 501 on any of the following:

(1) Financial statements prepared on the basis of accounting practices and principles that are reasonable under the circumstances.

(2) A fair valuation.

(3) Any other method that is reasonable under the circumstances.

Note this largely conforms California law on this point to MBCA §6.40(d) on p. 297.

4. Distributions Made Over Time

On p. 304, substitute the following for Cal. Corp. Code § 166 :

§ 500. Distributions; retained earnings or assets remaining after completion …

(d) The effect of a distribution under paragraph (1) or (2) of subdivision (a) is measured as of the date the distribution is authorized if the payment occurs within 120 days after the date of authorization.

(e)(1) If terms of indebtedness provide that payment of principal and interest is to be made only if, and to the extent that, payment of a distribution to shareholders could then be made under this section, indebtedness of a corporation, including indebtedness issued as a distribution, is not a liability for purposes of determinations made under paragraph (2) of subdivision (a).

(2) If indebtedness is issued as a distribution, each payment of principal or interest on the indebtedness shall be treated as a distribution, the effect of which is measured on the date the payment of the indebtedness is actually made.

Chapter 7 –Management and Control

D. In a Limited Liability company

3. The Changing LLC Landscape

Add at the end of the second paragraph: Re-ULLCA has now been adopted in eight states and the District of Columbia.[1]

E. Fiduciary Duties and the Business Planner

Add the following after the first full paragraph on p. 375:

As mentioned at the end of the previous section,[2] Re-ULLCA in § 110 allows most of the provisions of the statute to be modified in the operating agreement, including many of the provisions governing fiduciary duties. Although such "primacy of contract" has been criticized as unduly lax,[3] it is likely that the Delaware Limited Liability Company Act goes even further in allowing opt-out from fiduciary principles, leaving only a general implied duty of good faith and fair dealing, characterized as the duty to refrain from "arbitrary or unreasonable conduct which has the effect of preventing the other party to the contract from receiving the fruits of the bargain."[4]

[1] www.uniformlaws.org/Act.aspx?title=Limited Liability Company (Revised)

[2] See Section D.3 of this Chapter.

[3] See Rutheford B. Campbell, Jr., *"New" Fiduciary Standards under the Revised Uniform Limited Liability Company Act: More Bottom Bumping from NCCUSL*, 61 Me.L.Rev. 27 (2009) (more critical of the statement of the manager's duty of care than the opt-out procedures in § 110).

[4] Fisk Ventures, LLC v. Segal, 2008 WL 1961156 (Del. Ch. May 7, 2008) at *10 (citations omitted). For a thoughtful discussion of the development of Delaware's corporation and LLC laws in this area, see Mark J. Lowenstein, *The Diverging Meaning of Good Faith*, 34 Del. J. Corp. L. 433 (2009).

Chapter 8 – Departure of an Owner and Buy-sell Agreements

F. Financing the Purchase

1. Introduction to Cross-Purchase vs. Entity Purchase Agreements (pages 413-431)

In the main text, the cases of *Lubin Meyer, P.C. v. Lubin* and *Stephenson v. Drever* set forth the idea that buy-sell agreements are, first and foremost, contracts that govern the terms and timing of the transfer of equity interests by departing owners to remaining owners, or the entity. Unless the buy-sell agreement specifically provides that a triggering event *automatically* causes the equity interests to be transferred, the departing owner (or successor) retains all of the usual rights associated with the ownership interest until the transfer is completed. In the case of corporate stockholders, this includes, among other rights, the rights to vote for directors, participate in dividend distributions, access information and the right to protection from fraud or manipulation at the hands of majority stockholders. Well-drafted buy-sell agreements will make sure that if the equity interests are not automatically transferred, then the rights of the departing owner are limited or disabled as a result of the triggering event.

Many drafters of buy-sell agreements seem to miss the simple concept that departing owners retain their rights as equity holders until either (i) the transfer of the equity interest to the entity or remaining equity holders is *completed*; or, (ii) the contract disables the rights associated with equity ownership at the time of departure. *See, Riesett v. W.B. Doner & Co.*, 293 F.3d 164, 169-170 (4th Cir. 2002)*:*

> The Shareholder agreement does not state that title to an employee's stock immediately passes to Doner upon that employee's termination; rather, it merely obligates the employee to sell and the company to buy all of the shares the employee owns at some point in time after termination of employment. The text of the Shareholder agreement bears repeating:
>
> > upon the termination of a Shareholder's employment with the Company for any reason . . . Company will buy, and such shareholder . . . will sell, all of such Shareholder's Shares for the price established under Section 4.1 or .2 below, as applicable, with settlement to be made in accor dance with Section 5 below.
>
> Section 5 provides when the "closing" or such a sale or purchase of stock would take place:
>
> > The Closing Date will be . . . (b) if the purchase is made other than under clause (a) above, the later of (1) 90 days after the date of the event giving rise to the purchase of Shares from the Shareholder and (2) 30 days after the financial statements needed to determine the Book Value of such Shareholder's Shares have been completed.
>
> A reasonable jury could certainly conclude that, under the Shareholder Agreement, a terminated employee retains his rights as a shareholder until "closing," and that Riesett

therefore retained his rights as a shareholder after termination. Indeed, it is even possible, although we need not reach the issue, that the shareholder agreement unambiguously means that an employee does not automatically lose his shareholder status upon termination of employment. The agreement did not require Riesett to sell his stock immediately (and he did not), nor did it automatically strip Riesett of his status or rights as a shareholder upon termination. The agreement easily could have been drafted with provisions that would have eliminated any ambiguities and clearly stated that employees immediately lose their rights as shareholders upon termination of employment. It was not so drafted, and the district court erred in granting summary judgment on this ground.

G. Entity-specific Considerations

1. Statutory Limitations on Corporate Buyouts (pages 442-444)

Changes To California Dividend Statutes

Effective January 1, 2013 there are some changes to the California Dividend Statutes. The changes make California's restrictions on corporate distributions more consistent with analogous restrictions applicable to California limited liability companies. The "cash flow" test of Section 501 remains unchanged. However, the balance sheet test of Section 500 is altered to allow boards of directors to consider the fair market value of a corporation's assets, instead of historical carrying cost. The new provisions also grant directors specific authority to rely on whatever financial information a board deems reasonable under the circumstances, when determining whether the corporation has sufficient assets relative to its liabilities to distribute cash or property to its shareholders.

§ 500. Distributions; Conditions; Exemptions

(a) Neither a corporation nor any of its subsidiaries shall make any distribution to the corporation's shareholders (Section 166) unless the board of directors has determined in good faith either of the following:

(1) The amount of retained earnings of the corporation immediately prior to the distribution equals or exceeds the sum of (A) the amount of the proposed distribution plus (B) the preferential dividends arrears amount.

(2) Immediately after the distribution, the value of the corporation's assets would equal or exceed the sum of its total liabilities plus the preferential rights amount.

(b) For the purpose of applying paragraph (1) of subdivision (a) to a distribution by a corporation , "preferential dividends arrears amount" means the amount, if any, of cumulative dividends in arrears on all shares having a preference with respect to payment of dividends over the class or series to which the applicable distribution is being made, provided that if the articles of incorporation provide that a distribution can be made without regard to preferential dividends arrears amount, then the preferential dividends arrears amount shall be zero. For the purpose of applying paragraph (2) of subdivision (a) to a distribution by a corporation, "preferential rights amount" means the amount that would be needed if the corporation were to be dissolved at the time of the distribution to satisfy the preferential rights, including accrued but unpaid dividends, of other shareholders upon dissolution that are superior to the rights of the shareholders receiving the distribution, provided that if the articles of incorporation provide that a distribution can be made without regard to any preferential rights, then the preferential rights amount shall be zero. In the case of a distribution of cash or property in payment by the corporation in connection with the purchase of its shares, (1) there shall be added to retained earnings all amounts that had been previously deducted therefrom with respect to obligations incurred in connection with the corporation's repurchase of its shares and reflected on the corporation's balance sheet, but not in excess of the principal of the obligations that remain unpaid immediately prior to the distribution and (2) there shall be deducted from liabilities all amounts that had been previously added thereto with respect to the obligations incurred in connection with the corporation's repurchase of its shares and reflected on the corporation's balance sheet, but not in excess of the principal of the obligations that will remain unpaid after the distribution, provided that no addition to retained earnings or deduction from liabilities under this subdivision shall occur on account of any obligation that is a distribution to the corporation's shareholders (Section 166) at the time the obligation is incurred.

(c) The board of directors may base a determination that a distribution is not prohibited under subdivision (a) or under Section 501 on any of the following:

(1) Financial statements prepared on the basis of accounting practices and principles that are reasonable under the circumstances.

(2) A fair valuation.

(3) Any other method that is reasonable under the circumstances.

(d) The effect of a distribution under paragraphs (1) or (2) of subdivision (a) is measured as of the date the distribution is authorized if the payment occurs within 120 days after the date of authorization.

(e) (1) If terms of indebtedness provide that payment of principal and interest is to be made only if, and to the extent that, payment of a distribution to shareholders could then be made under this section, indebtedness of a corporation, including indebtedness issued as a distribution, is not a liability for purposes of determinations made under paragraph (2) of subdivision (a).

(2) If indebtedness is issued as a distribution, each payment of principal or interest on the indebtedness shall be treated as a distribution, the effect of which is measured on the date the payment of the indebtedness is actually made.

* * *

§ 501. Prohibited distribution; Inabilityto meet maturing debts and liabilities

Neither a corporation nor any of its subsidiaries shall make any distribution to the corporation's shareholders (Section 166) if the corporation or the subsidiary making the distribution is, or as a result thereof would be, likely to be unable to meet its liabilities (except those whose payment is otherwise adequately provided for) as they mature.

4. Statutory Considerations for LLC's (page 451)

As discussed earlier in this Supplement, California has now adopted the 2006 RULLCA.[1] In the text it states that:

> California has adopted a provision similar to the 2006 ULLCA. The California Limited Liability Company Act states: ". . . unless the articles of organization or written operating agreement provide otherwise, the withdrawn member shall not be entitled to payment for the member's interest in the limited liability company." On the other hand, Delaware has adopted provisions more in line with the 1996 version of the ULLCA: " . . . if not otherwise provided in a limited liability company agreement, such member is entitled to receive, within a reasonable time after resignation, the fair value of such member's limited liability company interest as of the date of resignation based upon such member's right to share in distributions from the limited liability company

The new California RULLCA eliminates the text referred to in this paragraph in former section 17252 of the former California ULLCA. It's unknown what impact this will have on the default rule that will operate when a member withdraws or dissociates from an LLC. RULLCA §17706.03(a)(1) and (3) provides that the dissociated member has no right to participate as a member in the management and conduct of the LLC's activities and holds any transferable interest owned by the dissociated member prior to dissociation solely as a transferee. RULLCA does not state that the dissociated member is not entitled to any payment for the LLC interest.

Because RULLCA does not a clear default rule on this issue, it should be expressly provided in the operating agreement whether departing owners are, or are not, entitled to payment for the members interest.

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1. California Revised Uniform Limited Liability Company Act. *Stats 2012 ch 419 § 20 (SB 323), effective January 1, 2013, operative January 1, 2014.*