

# Exam in Corporate Tax and Tax Law

Parkhomenko Alex\*  
MIF 5812429

Professor Dr. Joseph A. McCahery  
Amsterdam Business School

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\*[alex.parkhomenko@par-ma.com](mailto:alex.parkhomenko@par-ma.com), [www.par-ma.com](http://www.par-ma.com)

## Part I: Identification and Significance

**LLC.** It is essentially a corporation which is taxed like a partnership but without many of the S Corporation restrictions. A LLC has fewer statutory formalities than a corporation, but it does not provide the full range of exit strategies or liquidity options as does a corporation. It is not possible to grant stock option incentives to LLC employees in the same manner as a corporation. Further, an acquisition of an LLC generally may not be done on a tax-free basis and the expenses of formation are higher than for forming a corporation. LLCs are very often used in JVs and M&A deals, because it has pass through taxation status, flexibility in distributing income, etc.

**R&W.** Representations and warranties are provisions made in an agreement by either party that refer to past/present facts or matters that are important to the agreement. From a perspective of a buyer, R&W are seen as a way of allocating and reducing future risks. R&W are not intended to protect the buyer against an overvaluation of the company. They are intended to certify that all of the means of production are indeed under the company's control and that there are no hidden liabilities.

**Liquidation preference** determines how the equity is shared on a liquidity event (liquidation, dissolution or winding up of the company, etc.). Liquidation preference determines money returned to a particular series of the company's stock ahead of other series of stock. In the contract language, a certain multiple of the original investment per share is returned to the investor before the common stock receives any consideration. A "1x" liquidation preference is often standard.

The next thing to consider is whether or not the investor shares are participating. There are three varieties of participation: full participation, capped participation and non-participating. Fully participating stock will share in the liquidation proceeds on a pro rata basis with common after payment of the liquidation preference. Capped participation indicates that the stock will share in the liquidation proceeds on a pro rata basis until a certain multiple return is reached.

The greater the liquidation preference ahead of management and employees, the lower the potential value of the management / employee equity. There's a fine balance here and each case is situation specific, but a rational investor will want a combination of "the best price" while

insuring "maximum motivation" of management and employees.

**Hedge fund** is a private investment fund that charges a performance fee and is open to only qualified investors. Hedge Funds are lightly regulated, have tax exempt status (pass through taxation) and compensate their managers with a share of the fund's profits. Hedge fund's activities are limited only by the contracts governing the particular fund. It can make greater use of complex investment strategies (short selling, entering into futures, swaps and other derivative contracts and leverage).

Hedge Funds are interesting to investors as they provide access to more complex investment strategies and alternative asset classes, have tax exempt status and are slightly regulated (contractual).

**Dilution** is a result of issuance of new shares by a company. Large amount of share (*ceteris paribus*) leads to a lower ownership percentage for existing stockholders. The key issue is the price of new issue: if the price was lower than previous one that implies a severe dilution to existing stockholders because someone buying a company at a lower price and the proceeds from the sale do not compensate for a dilution. If the price was higher than original, there is a dilution, but company gets additional cash.

Anti-dilution clauses are an instrument to prevent adverse dilution. There are two main methods - full-ratchet and weighted average anti-dilution provision. Full-ratchet is used to protect preferred stockholders (the same percentage of ownership) in expense of common stockholders (dilution of common stockholders).

Weighted average anti-dilution provision uses a prescribes a formula, which accounts for both size and price of later financing, so it is very neutral to both preferred and common stockholders.

**GP and LP** - agent and principal in a deal. GP is a manager of fund (partnership) who is responsible for day-to-day operations, investment decisions, etc. LPs are investors, who provide capital, are passive and enjoy limited liability, but have limited ability to influence GP decisions. Due to potential problems of adverse selection and moral hazard between the GPs and the LPs, the compensation structure and covenants set out in contracts are key factors by which investors (LPs) are able to screen and monitor GPs. If these contracts can be appropriately designed to align the GP's incentives with those of the investors, then the LPs can

enjoy high returns on their long-term investments.

## Part II: Discuss the Quote

### Subpart A, Quest. 1

*Decline of the NYSE in a global IPO market*

There are several possible reasons that could explain plummeting market share of the US (NYSE) in Global IPO market.

**First explanation** is associated with the era of hi-tech companies and dot-com bubble: during late 1990s hi-tech industry attributed to the large part of IPOs going on in the USA, a lot of investors were attracted to NYSE or NASDAQ. This is why many foreign companies (especially pure hi-tech) were attracted to the US capital market - because here they could get good valuation (especially in dot-com times), interested investors, bankers and infrastructure.

After dot-com bubble foreign companies started to look for different type of institutional investors around the world, so the share of the US in global IPO declined.

**The second reason** - higher compliance and disclosure costs. Sarbanes-Oxley Act of 2002 made it much more expensive and troublesome to raise capital in the US: companies had to disclose more, spend more time and bear higher liability risk.

Indeed, even the profile of companies going to IPO has changed dramatically - from hi-tech to companies in emerging markets (BRIC) that were experiencing tremendous growth at that time. These companies were quite undervalued in their local markets due to segmentation, so investors could buy them at very attractive valuations, which made questions of corporate governance and pre-IPO disclosure irrelevant. Key factor of success of IPO of these companies - momentum, roadshows, network of institutional investors. London was more active in working with these companies, promoting LSE, than New York.

In addition to that, London was geographically and politically more attractive. India and China has strong cultural ties, Russian oligarch often were seeking political protection in London. In the beginning of the 21st century, London had accommodated large number of high net worth individuals from Russia (Berezovski, Abramovich, etc.), who were often

suspected in money laundering in the U.S.A. These investors could use their funds freely in London to invest in IPOs.

## Subpart A, Quest. 2

### *Governance in Private Equity Firms*

The key element of private equity deals is its contractual basis. The fact that GPs and LPs can agree on terms of their deal with only light regulation behind that, allows investors (LPs) invest in a different risk-return asset class. Moreover, tax exemption status and flexibility in contractual terms is a reason why investors like to invest in PE.

Due to potential problems of adverse selection and moral hazard between the GPs and the LPs, the compensation structure and covenants set out in contracts are key factors by which investors are able to screen and monitor GPs. If these contracts can be appropriately designed to align the GP's incentives with those of the investors, then the LPs can enjoy high returns on their long-term investments.

The limited partnership structure has two key features to align the incentives of the GPs with those of the LPs: 1) Performance Incentives and 2) Direct Means of Control.

The two main types of performance incentives for the GPs are reputation and compensation. Reputation may also allow GPs to raise larger funds, negotiate higher better contractual features, gain access to better deals.

The GPs generally receive management fee (around 2%) of the fund's total committed capital and carried interest, in which the GP shares a certain percentage, usually 20%, of the profits of the fund after the initial capital is returned to the LPs. This performance-based pay reduces gives a GP an incentive to exert appropriate effort levels in managing the fund. The carried interest induces a GP to make responsible investments in order to return capital to their investors because then only will they share in any profits.

There are might be a provision such that GP must meet some minimum hurdle-rate or achieve a "preferred return" before taking their 20% share of the profits. The most common preferred return, or hurdle rate,

is 7%. The 7% represents the annual compounded return that GP must provide for their investors, over and above returning their initial capital, before beginning to share in the upside profits of the fund.

**Control.** The power and extent to which advisory boards are used is fairly limited, it is common for these partnership agreements to include covenants which protect the interests of the investors (LPs) and help to ensure that proper actions are taken by the GPs.

Here, it should be noted that these additional information problems could potentially be mitigated by variations in compensation structures, such as lower fixed pay and higher carried interest. However, we do not observe drastic changes to compensation structures in practice because this would attract unwanted attention from regulators and investors.

Carried interest remains fairly stable across funds, variations in control may primarily come through the addition or subtraction of covenants which are a much less obvious way to adjust for particular informational asymmetries.

Gompers (1999)<sup>1</sup> analyzes a broad sample of 140 partnership agreements and identifies the key covenant provisions that are prevalent in greater than 5% but less than 95% of the total number of covenants. There were 14 different covenant types that fit this criterion, and each was categorized into one of three groups depending on whether the covenant governed 1) the overall management of the fund, 2) the activities of the GP, or 3) the permissible types of investments.

The first category involves covenants that control the overall management of the fund. An example of such a covenant would be to limit the dollar amount invested in any one firm. Since GPs may be inclined to bail out faltering investments through additional follow-on funding, this covenant reduces the potential agency costs between GP and LP.

The second broad class of covenants includes those associated with restricting specific activities of the GPs. LP agreements can include covenants that limit the GP's ability to invest personal funds in portfolio firms. If a GP invests a large sum in one portfolio fund, for example, he would be motivated to put more effort into monitoring that one in-

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<sup>1</sup>Gompers and Lerner. *The Venture Capital Cycle*. MIT Press 1999. Cambridge, Massachusetts.

vestment perhaps at the expense of other portfolio firms. Thus, the LP may require the GP to invest equally across all investments, if allowing them to invest any money at all.

The third general category of covenants restricts the permissible types of investments that can be made by the GPs. These covenants are primarily motivated by the fact that compensation levels for PE professionals are much higher relative to typical money managers and investment manager. While the typical money manager investing in public securities receives an annual fee of a mere 0.5% of asset, the typical GP will receive a management fee of 2% along with carried interest of 20%. Thus, it would not be efficient for LPs to compensate GPs at such high levels if GPs merely invested in public securities. Thus, LPs typically specify the different types of asset classes and the allowable percentage of total capital that can be dedicated to each asset class.

## Subpart B

LLC is essentially a corporation which is taxed like a partnership but without many of the S Corporation restrictions.

The main advantages of LLC are:

- A LLC has fewer statutory formalities than a corporation (no shareholder annual meeting, board does not have a word, less paper, etc.)
- Pass through taxation status, which makes it a great vehicle for JV and M&A deals, aggressive tax planning.
- Limited Liability
- Flexibility in distributing income: membership interests of LLCs can be assigned, and the economic benefits of those interests can be separated and assigned, providing the assignee with the economic benefits of distributions of profits/losses (like a partnership), without transferring the title to the membership interest.
- In Private Equity deals, LLC can be used as a separate entity for a tax reasons.

Disadvantages of LLC are:

- Does not provide the full range of exit strategies or liquidity options as does a corporation.
- It is not possible to grant stock option incentives to LLC employees in the same manner as a corporation.
- An acquisition of an LLC generally may not be done on a tax-free basis and the expenses of formation are higher than for forming a corporation.
- Structuring LLC (in absence of expertise and experience) may be a long and expensive process.

## Part III: Case Studies and Direct Questions

### Term Sheet Negotiations for Trendsetter, Inc.

Dear Ms. Borg and Mr. Kushdog,

The key elements of term sheets here are: liquidation preference, conversion, dividends, voting rights, protective provisions (control).

Our **main conclusion** is that Alpha Ventures is more beneficial for you than Mega.

**Dividends.** Mega has a cumulative dividends with a 10% rate, while Alpha has an 8% rate noncumulative dividends. Mega has more investor friendly dividends provision, because cumulative dividends are mandatory and accumulating regardless of the action of the Board. The Company has to declare it irrespective of its financial situation and cash position. If the Company does not pay this declared but not paid dividends will be used for a price adjustment in conversion and liquidation preference.

**Liquidation Preference.** Alpha has more broad definition of liquidation, which includes any merger, reorganization or other transaction in which control of the Company is transferred. While Mega has serious exclusions (sale less than 50% of Company's assets, particular type of merger (in fact, acquisition by Company)).

Both Alpha Ventures and Mega Fund require participating preferred, which is a very investor friendly security. From one hand, Alpha can gain more negotiation power via it's ability to call on liquidation in case of any merger, reorganization, etc. This essentially implies that managers (i.e. owners) cannot make any independent steps without consulting with Alpha in this field.

From the other hand, Mega has some exceptions for liquidation event, which are not crucial, and has more severe liquidation preference: 1,25\*purchase price (vs 1x) plus all declared but unpaid dividends (which are cumulative). Moreover, Mega has no cap (Alpha has 3x) for distribution of remaining value. This essentially implies that Mega has a very strong protection of their investment in case of downturn: if there is the last dollar on the table Mega will get it.

**Conversion.** No significant difference.

**Anti-dilution.** Furthermore, anti-dilution and conversion provisions protect preferred shareholders from recapitalizations and aim to maintain preferred shareholders' original percentage of ownership of the company. These termsheets contain two types of anti-dilution protection - full-ratchet and weighted average methods.

Full-ratchet is a very severe form of punishment for common stockholders, where their share is severely diluted. On the other hand, weighted average anti-dilution protection is more favorable to common stock holders (entrepreneur).

Mega has protected it self from poor performance with full-ratchet: if Company issues shares at price less than 50% of Series A purchase price, Mega will use full-ratchet, which will dilute common stock holders. Alpha has only weighted average anti-dilution protection, which is not applicable to issuance of up to 3 mln share to employees, consultants, etc. Alpha's protection can even result in some form of dilution with issuance of shares to employees (e.g. CEO).

**Control** Alpha explicitly sets key decisions where an approval of more than 60% of Series A needed: that is - issuance of any senior or pari passu security, any increase in number of authorized Preferred Shares, etc. Mega fund does not list these key issues in the term sheet, referring to the fact they will be written in the closing document.

Preferred shareholders have two options to have a control over company. First, they can designate members of the Board. Secondly, they can use voting rights over some key decisions.

Alpha and Mega has the same rights to elect two directors. Alpha can also elect the 3rd director if company issuance escrow shares, but that's not the major issue.

Voting rights are explicitly written in Alpha's term sheet and gives it an opportunity to have a vote on key decisions. While Mega does not explicitly set these rights, it mentions an intension to specify them in following documents such as Security Purchase Agreement.

Both funds require the right of first refusal if new shares are issued

and/or common shares are sold by their holders. But Mega also has a redemption provision that requires a buy back of Series A. However, there is no mention about liquidity event, time or any other trigger that lead to redemption.

So in the end, I believe that term sheet of Alpha Ventures is more preferable than a term sheet of Mega.

Sincerely yours,

*Parkhomenko Alex*