

IPO Boot Camp

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IPO READINESS: STRUCTURE AND TAX

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Domicile

- Review suitability of corporate and tax domicile – they need not be the same
- Corporate domicile considerations
 - Corporate financing flexibility
 - Shareholder approval requirements for the issuance of equity securities
 - Pre-emptive rights
 - Ability to waive pre-emptive rights
 - Requirements?
 - For how much?
 - For how long?
 - Availability of blank check preferred stock

Domicile (continued)

- Anti-takeover protection
 - Takeover code
 - Staggered board
 - No-action by written consent
 - Ability to limit special meetings
 - Removal of directors
 - Blank check preferred stock
- Residency requirements for directors
- Stock transfer tax
- Availability of tax treaty
- Say on pay
- Tax domicile considerations
 - Tax rates
 - Sourcing

Corporate Structure

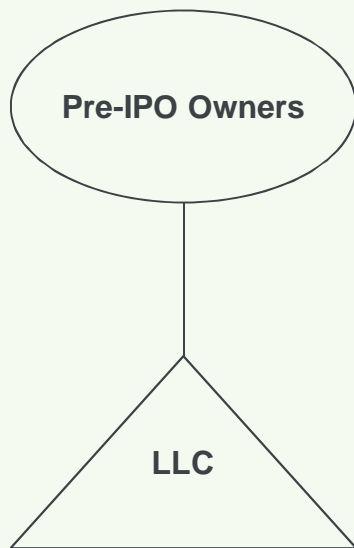
- “C” corp
 - Single versus dual class stock
- “Up-C”
 - Tax receivable agreement
 - Single versus dual class stock
- MLPs, REITs and Yieldcos
- ADRs versus Shares
 - No longer necessary in many jurisdictions
 - Generally only used
 - To limit stock transfer tax in applicable jurisdictions
 - To facilitate settlement if issuer is dually listed

Dual Class Stock

- Dual classes of stock are not uncommon – in our 2014 IPO survey of the 100 largest IPOs
 - 28% of non-controlled companies had two or more classes of stock
 - 30% of controlled companies had two or more classes of stock
- Multiple classes of common stock
 - Permit founders, parents, etc. to maintain control even if they are diluted below 50% economic ownership
 - May permit a tax free spin-off even if the parent is diluted below 80% economic ownership
 - 2013 IRS pronouncement that they would no longer issue private letter rulings for distributions involving dual class stock has had a chilling effect
- Key terms
 - High vote/low vote ratio
 - Sunset provisions
 - Conversion on transfer

Tax Considerations

Typical Pre-IPO Structure: Partnership Tax Status



Historic Tax Treatment

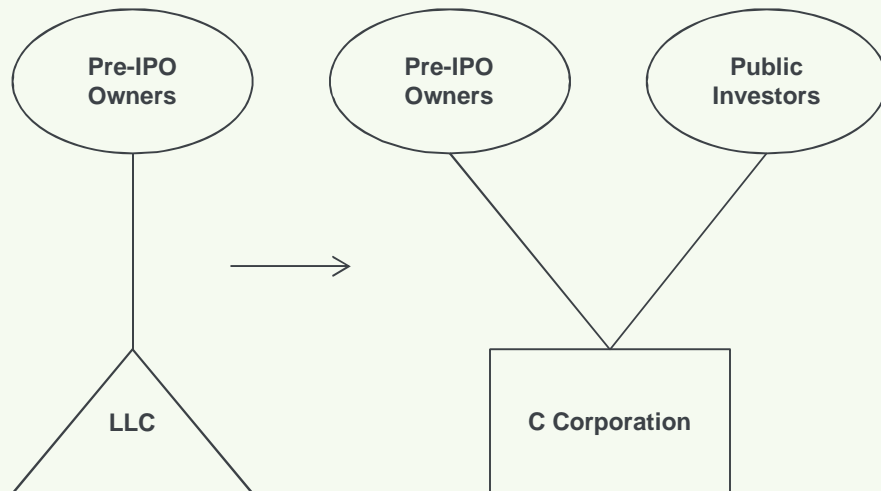
- LLC is treated as a partnership for U.S. federal income tax purposes. It is not subject to tax at the entity level and its income is passed through directly to Pre-IPO Owners

Tax Treatment After IPO

- Unless the LLC can satisfy the qualifying income test under Section 7704 of the Code, using the LLC as the IPO vehicle will result in the LLC being treated as a publicly traded partnership, which is taxed as a corporation

Tax Considerations

Traditional IPO Structure: Conversion to C-Corp

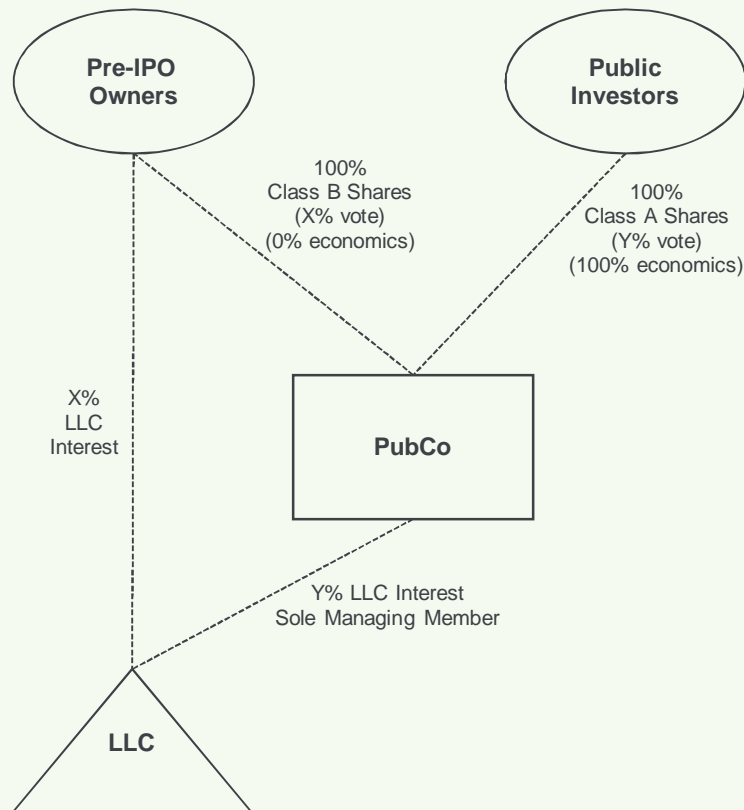


Disadvantages:

- Double taxation
 - All income earned by the corporation is subject to entity-level tax
 - Dividends distributed are taxed again at the shareholder level
- Typically no tax basis step-up for the corporation's assets
- Pre-IPO Owners lose flow-through tax treatment (including with respect to operating losses)

Tax Considerations

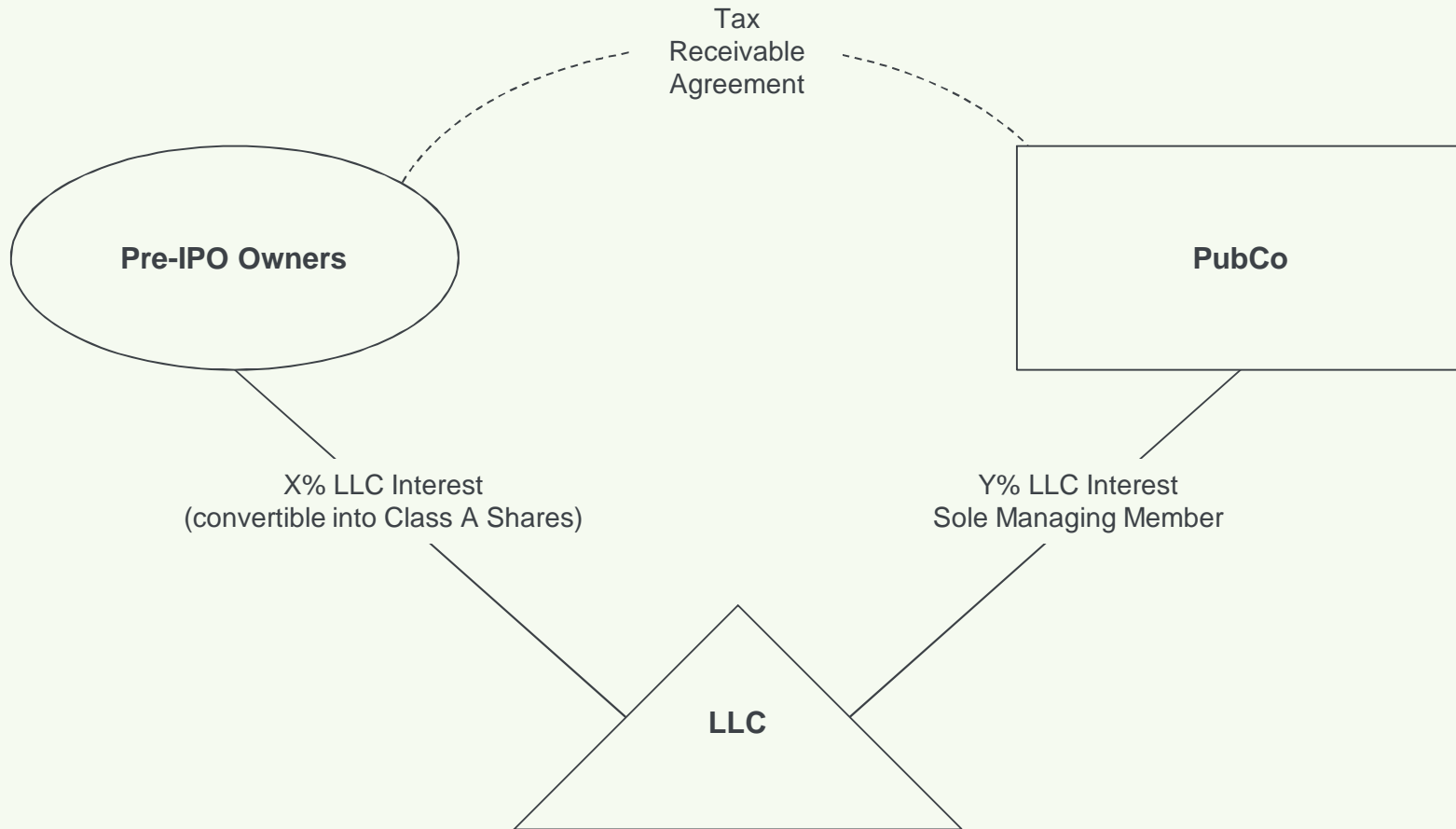
Up-C IPO Structure



- Up-C structure allows Pre-IPO Owners to (i) raise capital for the operating business, (ii) achieve liquidity, (iii) maintain voting control over PubCo and (iv) maintain pass-through taxation with respect to the operating business while (v) providing PubCo with a tax basis step-up on exit of Pre-IPO Owners, which typically provides PubCo with incremental depreciation and amortization deductions that reduce its future tax liabilities
- PubCo typically shares the tax benefits of the tax basis step-up with the Pre-IPO Owners through a Tax Receivable Agreement (TRA)

Tax Considerations

Tax Receivable Agreements



Tax Considerations

Features of the TRA

- LLC makes (or has made) an election under Section 754 of the Code. This tax election provides PubCo with a fair market value basis in the assets of the LLC to the extent of the proportionate share of the LLC Interest purchased by PubCo from the Pre-IPO Owners
 - By contrast, in a traditional IPO, the LLC would typically be converted into a corporation, or drop its assets to PubCo in a tax-free Section 351 exchange, with PubCo receive a carry-over basis in the LLC's assets
- A significant portion of this tax basis step-up is often allocated to depreciable and amortizable assets (such as certain intangibles, including goodwill, which are amortizable on a straight-line basis over 15 years), and the benefit comes in the form of additional depreciation and amortization deductions allocated to PubCo
- Through the TRA, PubCo pays the Pre-IPO Owners a negotiated percentage (typically 85%) of the federal and state tax benefits actually realized by PubCo each year attributable to the tax basis step-up
- Payments made pursuant to the TRA are treated as contingent installment sales proceeds for tax purposes, generating additional step-up and deemed interest deductions to PubCo. The TRA typically requires PubCo to make iterative payments to Pre-IPO Owners for the additional tax benefit
- TRAs may also cover (i) pre-existing basis in LLC assets attributable to transactions occurring before the IPO, and (ii) if PubCo acquires blocker corporations from the Pre-IPO Owners, any net operating losses or other tax assets in the blocker corporations

Tax Considerations

Example of TRA Benefits

Sample TRA Payments	
PubCo Tax Basis Step-Up	\$150 million
Amortization Period	15 years
Annual Amortization Allocated to PubCo	\$10 million
PubCo Tax Rate	40%
PubCo Annual Tax Savings	\$4 million
PubCo Retained Tax Benefit (15%)	\$0.6 million
Annual TRA Payment to Pre-IPO Owners (85%)	\$3.4 million
Total Payments to Pre-IPO Owners in 15 years <small>**Actual amounts of TRA payments are often greater to account for the additional basis step-up and interest deductions attributable to the TRA payments</small>	\$51 million (\$3.4 million x 15)

Tax Considerations

Issues Related to TRAs

- Bankers generally advise that TRAs do not impact the valuation of a corporation in an IPO
 - Public shareholders tend not to assign full value to the tax attributes of a corporation (valuations of public companies are generally based on metrics that ignore the cash tax benefits of tax attributes)
- Up-C structures with TRAs are now generally accepted in the market
 - There have been over 45 Up-C IPOs since 2009, including 17 in 2014
- PubCo typically must disclose current, as well as future potential, maximum liability under the TRA
- Continuing administration of the TRA involves some effort/expense
 - Accounting firms are typically hired to assist in modeling and administering the TRA
- TRAs typically contain termination and change of control provisions which may require PubCo to make TRA payments before a corresponding benefit is realized

Anti-Takeover Provisions

Defense	Description	Provision Location
Classified or "Staggered" Board	<ul style="list-style-type: none"> Directors are divided into separate classes Usually three classes, with directors in each class serving three-year terms and only one class elected annually Makes it more difficult for raiders or dissidents to use proxy contest to take control of target immediately Under Delaware law, if you have a classified board, your directors can be removed only for cause 	Charter
Shareholder Rights Plans/ Poison Pills	<ul style="list-style-type: none"> Gives shareholders (other than "triggering stockholder") right to purchase common or preferred stock at substantial discount, if triggering stockholder buys enough stock to cross pill's "trigger" (usually 10-20%) Threatens substantial economic and voting dilution to potential acquirer unless target's Board takes affirmative action to "disable" the rights Adopted solely by Board (approval of rights agreement); implemented/amended solely by Board 	Rights Agreement
Board Vacancies and Size	<ul style="list-style-type: none"> Provisions giving Board the sole authority to fix its size and fill vacancies Provide Board control over its size and constitution Typically Board size is subject to minimum and maximum numbers; Board has ability to select size within these constraints Having Board determine its size prevents raiders/dissidents from "packing" Board by increasing its size and filling newly created vacancies 	Charter and/or Bylaws
Limits on Shareholders' Ability to Act by Written Consent or to Call a Special Meeting	<ul style="list-style-type: none"> Charter or bylaw provisions that restrict shareholders from (i) taking action by written consent and/or (ii) calling a special meeting: <ul style="list-style-type: none"> Critical defensive provisions that give Board control of voting mechanism Restrict "window of vulnerability" to proxy contest conducted in connection with annual meeting 	Charter
Removal of Directors	<ul style="list-style-type: none"> Provisions that permit removal of directors only for cause prevent raiders/dissidents from causing removal of director for any reason other than fraud, criminal acts, etc. These provisions are necessary complement to classified board provision In Delaware, a classified board provision in Company's charter automatically provides for removal only for cause, even if charter is silent on removal issue. 	Charter

Anti-Takeover Provisions (continued)

Defense	Description	Provision Location
Blank Check Preferred Stock	<ul style="list-style-type: none"> ▪ “Blank check preferred stock” describes provisions that gives Board broad discretion to establish voting, dividend, conversion and other rights for preferred stock: <ul style="list-style-type: none"> ➢ Provides Board with flexibility to meet changing financial conditions in setting preferred stock terms ➢ Also grants Board authority to issue preferred stock necessary to implement certain defenses, including a poison pill/stockholder rights plan 	Charter
Limited Ability to Amend Charter or Bylaws	<ul style="list-style-type: none"> ▪ Limitations on rights of shareholders to amend corporation’s governing documents typically take form of provisions requiring a “supermajority vote” of shareholders to amend charter and/or bylaws: <ul style="list-style-type: none"> ➢ In Delaware, stockholder vote is required to amend charter and shareholders cannot be denied absolutely the right to amend bylaws ➢ Proxy contests seeking to amend bylaws can be restricted more effectively by using supermajority stockholder vote requirements for such action 	Charter
Supermajority Stockholder Vote to Approve Merger	<ul style="list-style-type: none"> ▪ Supermajority provisions establish stockholder vote requirements that are higher than minimum levels set by state law to approve merger/other business combination: <ul style="list-style-type: none"> ➢ These provisions typically require approval of holders of two-thirds or more of outstanding shares for actions that would otherwise require majority approval (e.g., Delaware statute requires only a majority vote) ➢ Supermajority vote requirements may be found in tandem with fair price provisions ➢ Because the Board must approve any merger before it is submitted to shareholders, this provision is “defensive” only if there has been a loss of Board control ➢ In fact, supermajority approval could make a “friendly” deal more difficult — the higher the vote threshold require, the greater the likelihood that a block of stock may have veto rights over corporate action (especially since approval criteria is based on outstanding shares) 	Charter
Cumulative Voting	<ul style="list-style-type: none"> ▪ Cumulative voting permits shareholders to apportion the total number of votes they can cast in an election of directors in any fashion they desire, including casting all of the votes for one director ▪ With cumulative voting, the total number of votes to be cast would equal the number of directors to be elected at meeting multiplied by the number of shares eligible to vote ▪ Cumulative voting enables holders of a minority stake to elect one or more directors if they can muster sufficient support: <ul style="list-style-type: none"> ➢ For example, owners of 11% of voting shares of a corporation with 10 open board seats are assured of electing one director if they vote all their shares cumulatively for a single nominee 	Charter and/or Bylaws

Anti-Takeover Provisions (continued)

Defense	Description	Provision Location
Advance Notice Provisions	<ul style="list-style-type: none">▪ All public companies should have Charter or Bylaw provision requiring shareholders to provide advance notice of business that they intend to present at a shareholders' meeting:<ul style="list-style-type: none">➢ Requirements may apply to Board nominations, resolutions to be offered from the floor, or both▪ Advance notice provisions prevent "last minute" matters from being proposed at meetings of shareholders, generally dissuading disruptive practices	Usually Bylaws
Expanded Constituency Provision	<ul style="list-style-type: none">• Express authorization for Board to consider interests of non-shareholder constituencies (e.g., creditors, employees, community, etc.).	Charter

Anti-Takeover Provisions

Market practice

- While anti-takeover defenses at public companies continue to be under pressure from ISS and activist shareholders, still typical to include in IPOs
- 2014 DPW IPO Corporate Governance survey:

	Non-Controlled	Controlled
Blank check preferred stock	98%	100%
Classified board	70%	83%*
Removal of a director only for cause permitted	72%	74%
Shareholders prohibited from calling a special meeting	83%	93%*
Shareholder action by written consent permitted	22%	78%*
Supermajority shareholder vote required to amend bylaws	70%	85%*
Shareholder rights plan at time of IPO	0%	0%
Advance notice for shareholder action	98%	98%

** Includes many that “spring” once no longer controlled company*

Exclusive Forum Provisions

- Exclusive forum provisions are an increasingly popular construct that limits shareholders ability to bring breach of fiduciary duty and similar claims except in the specified jurisdiction
 - Delaware has affirmed the enforceability of provisions that specify Delaware courts for companies domiciled in Delaware
 - 69% of the companies in our 2014 IPO survey had an exclusive forum provision

Relationship with Pre-IPO Stockholders

Overview

- Reconstitution of the board
- Management services agreement
 - Maintain vs terminate with or without termination fee
 - Valuation impact
- Amending/granting of registration rights
- Termination/amendment/execution of shareholders agreement

Relationship with Pre-IPO Stockholders

Maintaining control post IPO

Shareholders agreement

- Board/committee member designation rights and/or board observer rights, if any
- Transfer restrictions, if any including ROFO or ROFR
- Special voting requirements, if any
- Preemptive rights, if any
- Contractual veto rights
- Other covenants – e.g., delivery of financial information and other reports

What are the sunset provisions for such rights?

Relationship with Pre-IPO Stockholders

Maintaining control post IPO

Board/committee rights may include:

- Right to certain number of board seats (to be reduced upon sell down of ownership stake in company)
- Right to nominate a certain number of directors for election by the annual meeting (to be reduced upon sell down of ownership stake in company)
- Right to board observer seats
- Right to board committee seats, subject to independence requirements

Relationship with Pre-IPO Stockholders

Maintaining control post IPO

Contractual veto rights may include:

- Merger, consolidation, reorganization, etc.
- Liquidation, bankruptcy, etc.
- Authorization or issuance of any shares of [senior] capital stock or any options, warrants or other rights to acquire [senior] capital stock or any security convertible into or exchangeable for any [senior] capital stock (subject to specified exceptions, such as limited issuances to employees and M&A transactions).
- Declaration or payment of dividends on [junior classes of] capital stock.
- Redemption, repurchase or other acquisition of capital stock.
- Approval or modification of the annual operating budget, or any expenditure that would exceed [\$___] [___%] of [line item] [total budget].
- Acquisitions and dispositions of any assets or business (whether by purchase or sale of assets, purchase or sale of stock, merger or otherwise) with a value of more than \$___.
- Debt or capital expenditures exceeding the budget or specified thresholds.
- Investments or guarantees exceeding the budget or specified thresholds.
- Transactions with shareholders, officers, directors or other affiliates

(Cnt'd..)

Relationship with Pre-IPO Stockholders

Maintaining control post IPO

Contractual veto rights may include (cont'd):

- Change strategic direction or scope of company's business.
- Employee stock options and other management equity compensation arrangements.
- Hiring or termination of key employees; employment agreements with annual compensation over \$__.
- Amendment of certificate of incorporation or bylaws (including by merger, consolidation, combination reclassification or otherwise).
- Change size of board.
- Adopt a "poison pill"
- Permit sale of shares by management.
- Public offering of [equity] securities.
- Appointment of public accountants.

This is not an exclusive list of all possible voting provisions. The facts of each situation should be considered carefully.

Obtaining Consents

- Approval of shareholders for structural changes
- Class votes such as “Qualifying IPO” triggers in preferred
- Termination/amendment of shareholders agreement
- Approval of lenders
- Change of control provisions in leases and contracts
- Confidentiality restrictions in material agreements that need to be filed and disclosed