Morgan Lewis

VENTURE CAPITAL & PRIVATE EQUITY FUNDS
DESKBOOK SERIES

Making In-Kind Distributions

One of the advantages of structuring venture capital and private equity funds as limited partnerships or limited liability companies is the ability to make distributions of appreciated securities in-kind rather than first liquidating them and distributing the cash proceeds. Such in-kind distributions are particularly attractive to both fund managers and investors alike when a portfolio company has made an initial public offering. Rather than liquidating the securities (after expiration of lock-ups) and immediately incurring capital gains from the sale of the securities, funds often have the option to distribute marketable securities in-kind on a pro rata basis to partners in a nontaxable transaction.

Tax Advantages for Investors

A significant benefit of an in-kind distribution of securities is the potential for the recipient to defer capital gains taxes. Of course, such benefits are irrelevant to tax-exempt investors, who generally prefer cash and often negotiate to limit in-kind distributions or to have an option to receive only cash. But for taxable investors, including the fund managers themselves, the benefits are tangible. An in-kind distribution from a limited partnership or limited liability company is not treated as a sale of the security being distributed and therefore the transaction is nontaxable to the distributing entity.[1] Instead, the distributed securities maintain the same taxable basis in the hands of the recipient as they had prior to distribution and the capital gains tax applicable to the distributed securities is deferred until the securities are sold by the recipient, at which time capital gains is calculated using the fund's original cost basis. In addition, the recipient is able to tack the time period the securities were held by the fund on to the time the recipient holds the securities for purposes of satisfying the long-term capital gains holding period (i.e., at least one year and a day). A third tax benefit to the recipient is that the securities will, if applicable, maintain their status as a qualified small business stock (QSBS), which provides the recipient the opportunity to further defer capital gains tax provided the recipient complies with the tax-free rollover rules applicable to QSBS.[2]

Application of Rule 144

Most venture capital funds make investments in portfolio companies through private placements, resulting in the fund holding "restricted securities." It is typical for these types of funds to be

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1. This is in contrast to the treatment of in-kind distributions from S corporations where the securities are treated as sold by the company at the time of distribution and the resulting capital gain is passed through to the investors as a current tax obligation. Investors receive the distributed securities with a stepped-up basis but also a current tax liability passed through from the S corporation, sometimes requiring partial liquidation of the holdings by the investor to fund the tax liability. This is a significant factor as to why S corporations, while tax pass-through entities, are not widely used as investment vehicles.

2. The basic rule for tax-free rollovers of QSBS is that the gain on the sale of QSBS can be deferred if the QSBS was held for at least six months prior to sale and the taxpayer uses the proceeds to purchase new QSBS within 60 days of the sale. For purposes of the six-month holding period, the taxpayer, if necessary, can tack on to the time it holds the QSBS the time that the fund held the QSBS.

contractually limited to only make distributions in-kind of readily marketable securities, which generally is interpreted as securities that are freely tradable once in the hands of the recipient. These restricted securities will, however, still be considered freely tradable because Rule 144 under the Securities Act of 1933 provides a safe harbor from the restriction on the unregistered resale of securities acquired in a private offering. In order to take advantage of the safe harbor, a recipient of an in-kind distribution of restricted securities must satisfy the conditions below.

Basic Restrictions Imposed by Rule 144

To freely transfer restricted securities, any seller (i.e., the investor receiving the distribution), regardless of its status as an affiliate, must meet the following conditions:

1. The seller must have held the securities for at least six months (including any holding period of the fund permitted to be tacked on as described below).
2. There must be adequate current information about the issuer (i.e., the issuer has complied with the periodic reporting requirements of the Securities Exchange Act of 1934 (Exchange Act)), or, if the issuer does not satisfy the current information condition or is not a reporting company, the seller must hold the securities for at least one year before being able to transfer them freely (subject to the affiliate rules discussed below).

If the seller is an affiliate of the issuer (or was within the prior three-month period), three additional conditions must be satisfied:

1. The number of securities the seller is permitted to sell is limited based on trading volume.[3] To comply with the volume limitations, the seller must aggregate its sales of restricted securities with sales of the fund and/or the other investors and former investors. The fund has the ability, however, to mitigate the effect of the volume limitations condition by limiting the number of securities it distributes (in the aggregate) at any given time to no more than the maximum number allowed under the volume limitation.
2. The sales must be handled in all respects as routine trading transactions, and brokers may not receive more than a normal commission.
3. The seller must file a notice with the SEC on Form 144 if the sale involves more than 5,000 securities or the aggregate dollar amount is greater than $50,000 in any three-month period.

Determination of Affiliate Status

"Affiliate" is generally defined as a person who directly or indirectly controls, or is under common control with, such issuer. To make this determination the recipient of restricted securities must analyze the nature of its own relationship with the issuer, considering factors such as the percentage it and its affiliates own of the issuer, as well as whether the seller is or has a representative who is a member of the issuer's board of directors. The status of the fund as an affiliate of the issuer is irrelevant to the investor, as the SEC does not attribute the fund's status as an affiliate to an investor not affiliated with the fund. Additional analysis would need to be done on a case-by-case basis to determine whether the fund managers themselves, by virtue of their shared control through a general partner entity of a fund with significant holdings, would each be deemed an affiliate.

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3. Generally, the number of equity securities a seller who is an affiliate may sell during any three-month period cannot exceed 1% of the outstanding securities of the same class being sold or, if the class is listed on a stock exchange or quoted on NASDAQ, 1% of the average reported weekly trading volume during the four weeks preceding the filing of a notice of sale on Form 144.

Tacking the Holding Period Under Rule 144

In determining whether they have satisfied the applicable holding period under Rule 144, investors can tack their holding period on to that of the funds, provided the funds are deemed "closely held" by their investors. Unfortunately, "closely held" has not been defined or interpreted under the federal securities laws and the SEC has issued only a handful of no-action letters related to distributions of securities and tacking on of holding periods.[4] Concluding that a fund is closely held is significant because most investments made by a venture capital or private equity fund are held for a significant period of time before being distributed. By tacking its holding period on to that of the funds, a recipient of restricted securities may be able to immediately satisfy any holding period imposed by Rule 144.

In practice, the "closely held" issue has not been viewed as an impediment to in-kind distributions by traditional private equity and venture capital funds, which place their own interests in private transactions, have stable membership and distribute to their partners pro rata in accordance with the terms in their fund agreements. However, this could change at any time with a mere SEC pronouncement on the issue.

If an investor cannot tack the fund's holding period on to its own because the fund is not "closely held," it may be in everyone's best interest for the fund to sell the securities and distribute cash. Alternatively, the fund could seek to enforce contractual rights it may have, such as making a demand that its securities be registered or exercising "piggyback" or "tag-along rights," which would allow the recipients of the distributed securities to include them in the portfolio company's plan of distribution.

Other Issues to Consider When Making In-Kind Distributions

Impact on Market Valuations of Portfolio Company Securities

A challenge for a fund holding securities in a portfolio company that has recently gone public, particularly a portfolio company with thinly traded securities, is to dispose of its holdings without adversely affecting the market price of the securities. A block sale by the fund may adversely affect the price but so may the news of a distribution by a major shareholder. Although it is unlikely that all the limited partners receiving the in-kind distribution will immediately sell their securities (e.g., conventional wisdom is that one-third will sell immediately, one-third will hold for three months, and one-third will hold for the long term), the market will often assume large sales volume in any event and the price of the company's securities will decrease accordingly.

Inside Information and Trading Windows

Another consideration a fund must take into account before making an in-kind distribution is the potential for securities law liability. Some commentators have suggested that either the SEC or private litigants (including the limited partners receiving the distribution) might pursue the fund if it distributes securities in-kind to its limited partners when the manager of the fund has access to material nonpublic information, on the theory that this distribution is tantamount to a sale because either (i) it has reason to know that sales by the limited partners will inevitably result or (ii) the general partner has a pecuniary interest in the distribution itself through its rights to carried interest. This risk is minimized if the distribution occurs during the company's "window period" or other permissible trading period applicable to the portfolio company's officers and directors, occurs without any recommendation by the fund to its investors to sell or hold the distributed securities, and can be demonstrated to have been motivated by

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4 SEC no-action letters have permitted tacking on of holding periods in distributions of securities in circumstances involving (i) a distribution to 82 general partners and 35 limited partners of a partnership, (ii) a dividend distribution of restricted shares of common stock of a reporting company to 222 shareholders of a private company, and (iii) a dividend distribution of shares to 400 shareholders of a publicly traded company.

independent considerations. For instance, if a manager of a fund continues to serve on the portfolio company's board after the company goes public, the best practice for the fund would be to apply any trading restrictions imposed on such director/manager to distributions of the portfolio company's securities by the fund.

Section 16 Reporting Requirements

Another potential securities law liability concern arises under Section 16 of the Exchange Act that requires forfeiture of any "short swing profits" by a director, officer, or 10% stockholder of a company. These are generally measured as the positive difference between any sale price and any purchase price for trades occurring within six months of each other. If the fund is a 10% stockholder or a manager of the fund is a director or officer of the portfolio company, then Section 16 reporting and potential liabilities must be addressed in connection with a distribution or sale by the fund. Such liability may in certain circumstances be avoided by proper compliance with the technical requirements of Section 16, the details of which are beyond the scope of this article.

Value for Determination of Carried Interest

In-kind distributions also give rise to valuation issues for purposes of determining the profits of the fund and the amount of the distribution attributable to the fund manager's carried interest. Investors often are concerned that fund managers will time a distribution to occur at a high point or that the distribution itself will depress the market value as the recipients of an in-kind distribution flood the market with sales as described above. For purposes of calculating profits, GAAP ascribes a value to readily marketable securities based on the trading value as of the actual date of distribution; however, for purposes of calculating the profits upon which a carried interest may be charged, limited partners may desire to ascribe a value using an average calculated over a set period that may include up to 10 days prior or 10 days after (or both) the actual distribution in order to mitigate the impact that a distribution may have on market price. Any valuation method taking into consideration market values after the distribution date will mean that the carried interest will not be known until after the date of distribution and therefore require that a portion of the distribution to all partners be withheld until final determinations as to value and carried interest are made.

Hedging by Limited Partners

Limited partners may be tempted to enter hedge transactions in light of the securities held by a venture capital or private equity fund in certain circumstances. Typically, this occurs either in connection with an anticipated in-kind distribution of publicly traded securities or in situations where a limited partner has knowledge that a fund holds significant amounts of publicly traded securities (and thus the limited partner has indirect exposure to such securities). With respect to in-kind distributions, certain limited partners may negotiate terms requiring that they be provided notice in advance of any in-kind distribution, primarily to give them the opportunity to opt out and request cash in lieu of the distribution. Fund managers often accommodate these requests, but limit their application to situations in which the holding of such securities in-kind by a limited partner would give rise to regulatory issues or materially adverse consequences and occasionally limit the limited partner's ability to trade or hedge in advance of the distribution. Even if no in-kind distribution is contemplated, limited partners often will have knowledge of a fund's undistributed public holdings, particularly if they represent a significant part of the fund's portfolio. Whether a transaction involves hedging an impending distribution in-kind or hedging the known holdings of a venture capital or private equity fund, both fund managers and limited partners face risks.

For the fund managers, risks created by the hedging activities of limited partners include allegations of insider trading (or aiding and abetting of insider trading) and, if the securities held by the fund are subject to a lock-up, liabilities for breach of contract. Lock-ups are often drafted very broadly to pick up

any "partner" of the holder of a security and, as such, venture capital and private equity funds that sign lock-ups may be viewed as having agreed that no limited partner will engage in any transaction relating to the publicly traded security held by the fund. For the limited partners, the risks include allegations of insider trading and exposure relating to hedges made without physical possession of the securities being hedged. Furthermore, adverse consequences for the fund should be viewed as indirectly adverse to the limited partners, and thus actions by a limited partner that could be viewed as a breach of a lock-up by the fund may have adverse consequences for all of the limited partners.

Logistical Considerations

When making in-kind distributions, funds generally engage a broker experienced in fund distributions to handle the logistics. In some cases, such as where a fund manager contemplates making numerous distributions in-kind, it may be efficient and practical for investors to open accounts with the fund's broker in order to have securities deposited directly in such accounts. In most other cases, brokerage account information is provided for DTC transfers by wire into the investor's own brokerage account. Coordination with the issuer's transfer agent will also be necessary in order to have restrictive legends removed from the share certificates upon the distribution. Legal counsel may be required to give comfort to the transfer agent and issuer's counsel that registration is not required for distribution of the securities.

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For more information on the issues discussed here, please contact your Morgan Lewis Private Investment Funds Practice attorney.

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