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Joseph W. Bartlett

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PREFACE

The following materials represent a collation and restatement in an expanded second edition of the two earlier volumes—*Venture Capital: Law, Business Strategies, and Investment Planning* together with *Corporate Restructurings, Reorganizations, and Buyouts.* The combination is driven, first, by the desire to update the materials by incorporating significant developments occurring since 1988 when *Venture Capital* was first published and 1990, when *Corporate Restructurings* was published. Secondly, the combination reflects the realities of the marketplace. The commonly held view of the activity labeled "venture capital" focuses on early stage finance . . . equity financings of nonpublic issuers in their developmental stage, principally issuers exploiting so-called high-tech opportunities. In today's financial universe, however, venture capital is a good deal more than early stage finance; some commentators indeed isolate early stage, high-tech activity as "traditional venture capital" so as to distinguish other investment modes in which venture capital investors, intermediaries and issuers are involved. The latter activities, far greater in dollar volume in the United States, include buyouts (up until recently known as "leveraged buyouts"), restructurings and turnarounds. Unfortunately, there is no single descriptive term or phrase. What is involved is a process of investment, generally in privately held firms, by so-called financial (i.e., interested solely in financial returns) and strategic investors, the latter being companies who seek both a financial return and a strategic add-on effect from their investment. On occasion this sector of the financial universe is referred to as alternative investments, being alternatives to investment in publicly traded securities and rated fixed-income securities, whether publicly or privately traded. In short, venture capital, writ large, entails a variety of investment processes which are distinguished by certain central features.

Thus, the investors are seeking to place money at risk in a high-risk/high-(potential) reward sector . . . not public equities or rated debt (hence "alternative" investments). These specific risks are, to be sure, different: a pre-seed investment in a high-tech issuer involves the risk the product will not work or, if it works, will not sell; that untried management will fumble the ball; and that some other competitor will be able to reverse-engineer the technology and take over the market through sheer muscle. A turnaround, buying a company out of bankruptcy or near-bankruptcy proceedings, entails a special risk generated by the fact that the business has failed at least once. A buyout, even in today's universe, usually entails significant leverage and, therefore, added risk; moreover, in separating a division or subsidiary from its parent, the risk arises that some or all of the links to the parent were umbilical, providing nourishment which the enterprise cannot afford to lose. There are, on the other hand, significant similarities amongst the activities we label venture capital. The issuers involved are usually, if not always, privately held. The issuance of public securities is viewed as the exit stage, when the venture investors cash in on their investments; the maturation process takes place while the company is out of the public eye, not required to respond to the vagaries of the public markets or to regulatory eccentricities. Capital for venture investing comes from a variety of sources—often, if not principally, mediated by private investment partnerships, themselves sometimes labeled PIVs (pooled investment vehicles). Since the investments are, by definition, illiquid, one of the principal exit strategies is an initial public offering or IPO. Since the venturesome investors ordinarily take board seats (or designate one or more members of the board), the investors qualify as "value added" investors; they directly influence company policy and keep management on its toes.

There are, on the other hand, distinct differences between the various investment modalities within the umbrella heading of "venture capital" as we have defined it. It is unusual, for example, for a restructuring or buyout to involve a strategic partner, meaning a public corporation whose line of business matches up with that of the enterprise in question. In traditional venture capital, on the other hand, a good deal of the funding originates with strategic partners, who plan ultimately to buy the company and take advantage of the technology as part of the strategic partner's commitment to innovation (as in "innovate or die"). Traditional venture capital rarely entails genuine debt financing, "genuine" in this context meaning indebtedness the holder expects to see repaid on some sort of orderly basis; early stage issuers are scheduled to lose money and repayment of debt is, therefore, viewed as unfeasible or counterproductive. The deal sizes are usually smaller in traditional venture capital investing. The ultimate feeders of the private investment vehicles are the same institutions by and large—generally employee benefit plans which have split their portfolios into segments by reserving a relatively minor (although absolutely major in real dollar terms) percentage for alternative investments.

There are, of course, other forms of high-risk/high-reward investments not covered in the following materials. Thus, real estate is an area where risk appetites are similar to those of the venture capitalist, as is drilling for oil and gas and engaging in exotic trading and investment strategies, some of which are pursued by pooled investment vehicles called hedge funds. To the large pool of capital (the pension and mutual funds), investment portfolios in the aforementioned areas are also often labeled "alternative investments," asset classes other than publicly traded equities and rated fixed-income securities. We have separated out, from the universe of alternative investments, restructurings, buyouts, turnarounds and traditional ventures because of the many similarities from a legal, tax and financial standpoint. To repeat, we are talking about value-added investors, generally employing capital from professionally managed partnerships; the securities purchased are illiquid and equity flavored (although sometimes hybrid); the exit strategies are long term (relatively speaking) with the investors anticipating capital gains when the company becomes public or is sold.

Within the above boundaries, these materials are designed to be comprehensive, in hopes that a single source of both textual material and annotated forms may be helpful in nudging the state of the law towards a high level of standardization. The transaction costs of buyouts, restructurings and (certainly) early stage financings are relatively high, since each point in the pertinent agreements is often negotiated *ab initio,* various sets of counsel bringing their own idiosyncratic ideas to the table. If the relevant considerations, both pro and con, on a given point are set out in a single text and annotated in the margin of standardized forms, it may be possible for many of the issues to lose some of their contentiousness. That is not to say that any provision in a legal agreement is boilerplate; there is no such category of language in the law and it is dangerous to assume otherwise. However, in various areas, the hope is that custom and usage will enhance standardization of the process; if common points have been sufficiently argued that they may now be discussed by shorthand reference to a common text or form, additional predictability and efficiency should ensue. As indicated, an important component of the ambitious foundation of these materials is to introduce a compendium of commonly used forms, each of which is annotated to the relevant sections in the analytical discussion. To repeat, the goal is efficiency and minimization of cost; if and to the extent the forms become accepted, then efficiency will be promoted. Moreover, by annotating the forms to the text, our hope is that low-cost providers in a given law office may become adept in the use of a form, without the necessity of involving senior lawyers at least in the initial stages of drafting.

The short of the matter is that the objective of the second edition is highly ambitious; the hope is to bring together, in one legal text, the relevant materials to explain an investment activity involving billions of dollars annually in this country (which, however, lacks a shorthand name). Moreover, the objective is to create efficiencies, to facilitate dialogue on the basis of shared knowledge of the facts and law on a given issue, and to streamline the drafting process without sacrificing, indeed while enhancing, the thought content of the final product.

Chapter One, the overall introduction, sets out a preview of the subsequent discussions in each of the following five parts. **Section 1.1** previews Part I of the text, dealing with traditional venture capital investing; that section explores various definitions of traditional venture capital, identifies some of the specialized terminology venture capitalists use, outlines certain business areas which lie outside the scope of the material, provides some notations on the topics to be discussed subsequently and concludes with brief remarks on the significance of venture capital in today's economy.

Section 1.4 discusses the material covered in Part II, having to do with strategic alliances, a high-class term for joint ventures; that section highlights the protean nature of this structure and deals with alliances between for-profit and not-for-profit firms.

Section 1.5 introduces the subject matter of Part III—buyouts—including preliminary remarks on structure; the rights of existing creditors affected by the buyout and their remedies, if aggrieved (including principally fraudulent conveyance and equitable subordination); buyouts which do not, strictly speaking, entail entire changes in ownership (herein restructurings); and some remarks on business terms.

Part IV, introduced by **§ 1.8,** deals with restructurings, the investment opportunities professionals find in acquiring securities of distressed issues.

Part V covers the vehicles organized by financial partners to invest in alternative investments. Generally, and therefore the subject of this subpart, the entities of choice are private limited partnerships, sometimes referred to as pooled investment vehicles (PIVs) or private investment partnerships (PIPs). The expectation is that a new entity, incorporated partnerships in the form of limited liability companies (LLCs), will become increasingly popular and a full-scale discussion of that form of organization is also rehearsed in Part V.

New York, New York JOSEPH W. BARTLETT
February 1995

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A former Undersecretary of Commerce, law clerk to Chief Justice Earl Warren and President of the Boston Bar Association, Mr. Bartlett graduated from Stanford Law School where he was president of the Law Review. He has been an acting professor of law at Stanford and an instructor in law at Boston University Law School.

Mr. Bartlett has acted as counsel to, a director of, and a shareholder in a number of development stage companies during his 30-year career in the venture capital business. He was a founding stockholder and a director of GMIS, Inc.; chairman of a publicly traded REIT; a former director of Advanced Telecommunications Corp. (recently sold to LDDS, Inc.); and is a director of Cyrk Inc., which recently concluded a successful initial public offering. Mr. Bartlett has been a director of Shawmut Bank N.A., the Shawmut Corporation, the Harbor National Bank and the Northeast Federal Savings and Loan Association. He has served as a trustee of a series of public mutual funds and as counsel to asset managers throughout his career, including the managers of public and privately invested assets. He has been a limited partner in a number of pooled investment vehicles, including Bain Capital and Needham Emerging Growth Partners. He has been profiled in trade publications as one of the leading practitioners in venture capital nationwide.

SHORT REFERENCE LIST

Short Reference	*Full Reference*
AMTI	alternative minimum taxable income
CERT	corporate equity reduction transaction
CRCO	consolidated return change of ownership
EBIT	net earnings before deducting interest and taxes
EBITDA	net earnings before deducting depreciation and amortization
Enforcement Act	Securities Enforcement Remedies and Penny Stock Reform Act of 1990
ESOP	employee stock ownership plan
FASB	Financial Accounting Standards Board
gaap	generally accepted accounting principles
General Utilities	*General Utilities and Operating Co. v. Helvering*, 296 U.S. 200 (1935)
Halloran	Halloran, Benton, Gunderson, Kearney & de Calvo, Venture Capital and Public Offering Negotiation (2d ed.)
HSR	Hart-Scott-Rodino Antitrust Improvements Act of 1976, 15 U.S.C. § 18a, implemented by the Federal Trade Commission's Rules in 16 C.F.R. §§ 801–803.
Investment Company Act of 1940	15 U.S.C. §§ 80a-1 to -64
ISO	incentive stock option
MBO	management buyout
NASAA	North American Securities Administrators Association
NASD	National Association of Securities Dealers

NASSA	National Association of State Securities Administrators
NSO	nonqualified stock option
PIK	payment in kind securities
PIP	private investment partnership
Pratt's Guide	S. Pratt, Pratt's Guide to Venture Capital Sources (16th ed. 1992)
READ	retained earnings available for distribution
Revised Model Act	Model Revised Business Corporation Act Annotated (1984), revised 1993 Supp. by ABA Committee on Corporate Law (Section of Corporation, Banking and Business Law)
SAR	stock appreciation rights
SPAC	special purpose acquisition company (aka shell company)
SRLY	separate return limitation year
'33 Act	Securities Act of 1933
'34 Act	Securities Act of 1934
TRA '86	Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2781
UBTI	unrelated business taxable income

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