Thompson Hine

Business Law Update

Spring 2020

Business Perspectives

Frank D. Chaiken, Practice Group Leader, Corporate Transactions & Securities

When we started Thompson Hine's *Business Law Update* some years ago, we considered the alternative title *Business as Usual*. Our firm is focused on innovation, finding new ways to deliver and charge for our services that are client-focused, efficient, and solution-oriented. "Business as usual" isn't really the message we want to send, so we decided against it.

Nowadays, perhaps we all would be happy to go back to business as usual, in this era of working from home, social distancing, and the concerted worldwide effort to slow the spread of a dangerous pandemic. We at Thompson Hine are doing our part in that effort by working, remotely, to help our clients with mission critical legal issues. This has included an all-out effort to address the many questions arising from the current crisis, particularly in the critical areas of human resources and access to funding. Much of this information is collected on our COVID-19 Task Force page and at ThompsonHine.com.

We started the crisis period responding to many of our clients asking a simple question: Are we essential? Now, we all would like to know the answer to that from a philosophical point of view. But from a practical point of view, these companies needed to know whether they were allowed to continue operating under the stay-at-home orders adopted in the various states, as part of the national efforts to flatten the pandemic curve.

Latin scholars among us will point out that the linguistic root of the English word "essential" is *esse:* to be, to exist. The states' orders first focus on goods and services required to maintain existence: food, shelter, clothing, medical treatment. But they go further. Because when you start to think about what is needed to fill the basic needs, to put

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Recent News & Related Articles

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- FTC and DOJ Announce Changes to Civil Merger Review Process During COVID-19 Pandemic, Including Changes to HSR Early Termination Procedure
- Communicating With Your Lenders Early and Often Is More Important Than Ever

For more details on any of the topics covered in this *Business Law Update*, please contact the authors via the links at the end of each article or David R. Valz, editor-in-chief. For information on our Corporate Transactions & Securities practice, please contact Frank D. Chaiken, practice group leader.

food and medicine on store shelves, you quickly realize that most of the goods and services in our economy really are "essential" – even lawyers (in most states).

For the most part, the "are we essential/can we stay open" questions have been answered. Thornier questions remain for those businesses who continue to operate but face a severe downturn in demand for their goods and services, such as how to deal with employee furloughs and layoffs, contract defaults, payment delays, and supply chain disruption.

In our Corporate work, we have seen that some things are more essential than others. Public companies and investment funds still must comply with reporting and governance requirements. Supply and service contracts, financing arrangements, many nuts-and-bolts business issues still have to be addressed. On the other hand, many M&A deals have been put on hold. Buyers are conserving liquid funds. Both buyers and sellers are pausing to evaluate the impact of the shutdown on medium-term, and even long-term, earnings and valuations. Not all deals are dead, particularly those well along in the process. We are expecting, and already seeing, an increase in restructuring and other distressed company-related transactions. The longer-term impact on investment strategies remains to be seen.

So, it is not all "business as usual." But we can keep calm and stay the course by, among other things, continuing our quarterly *Business Law Update*—as usual. I especially want to thank our contributors and our firm's outstanding staff for helping us get this edition out the door. I add our profound gratitude for the health care professionals, first responders, and others continuing to provide basic community services and infrastructure. They define the word "essential" in these difficult times.

As always, please feel free to reach out to any of us with any questions you may have, or just to keep in touch.

Be well.

Frank Chaiken leads the firm's highly regarded Corporate Transactions & Securities practice, which comprises more than 100 professionals who represent clients of all sizes across virtually every industry. If you have questions or would like to share your thoughts, please contact Frank at 312.998.4249 or Frank.Chaiken@ThompsonHine.com.

Securities Quarterly – Spring 2020

Please visit our website for the latest edition of *Securities Quarterly*, our publication that provides updates and guidance on securities regulatory and compliance issues. In this edition, we look at developments during the first quarter of 2020, periodic reporting requirements that public companies should consider as they prepare their Form 10-Q filings for the first quarter of 2020, as well as other general updates in securities laws and regulations.

COVID-19

My Supplier Declared Force Majeure: Does It Really Not Have to Perform?

By John D. Cottingham, Rob D. Powell and Justin D. Tillson

The widespread imposition of policies mandating social distancing in response to the COVID-19 outbreak have been wreaking havoc on supply chains for several weeks, resulting in suppliers' frequent use of force majeure declarations to excuse their performance. But does a supplier's declaration of force majeure mean it doesn't need to perform its obligations under an agreement?

When a declaration of force majeure is made, whether the supplier's performance is really excused will depend on the contractual force majeure terms, the facts and circumstances behind the declaration, the obligations affected and how the contract and facts are interpreted.

What Law Governs the Declaration?

The first inquiry following receipt of a force majeure declaration is to determine what law governs. Force majeure provisions are designed to excuse all or a part of a party's performance when certain circumstances beyond that party's control arise. The language in the contract establishes the parties' intent and can be critical to how it will be interpreted.

Interpretations of force majeure provisions can vary greatly across states, and even more so across international borders. As a result, a declaration necessarily implicates the choice of law provision in the agreement. This provision will typically establish what jurisdiction's law governs. Each state in the United States has enacted some version of the Uniform Commercial Code (UCC), though they are not all identical. In addition, not all state and federal courts interpret the UCC provisions in the same manner. In the case of international commerce, the United Nations Convention on Contracts for the International Sale of Goods (CISG) applies unless it is specifically disclaimed in the contract.

Force majeure provisions can also impose protocols for notice, timetables for non-excuse or termination, and other terms relevant to evaluating a declaration and the way it was made. If applicable, the supplier's compliance with these protocols can impact whether the declaration is valid and if performance can be excused.

Does the Event Really Excuse the Supplier's Performance?

Consider the Event Alleged to Constitute a Force Majeure

Force majeure clauses typically include a non-exclusive description of the types of circumstances covered by the clause, and since all potential events cannot be anticipated, they often also include "catchall" language such as "and any other events beyond the parties' control."

Courts tend to interpret force majeure clauses narrowly, so the supplier will be more likely to succeed with enforcing the clause if the event impacting performance is specifically articulated. Where the reason for non-performance is COVID-19, for example, it will be more difficult to challenge a declaration if the articulated events include "pandemics," "declarations of a state of emergency," or "government orders." Where the specific event is not articulated, state courts may look to the principles of impracticability under the UCC and impossibility under state common law.

States vary on how closely the actual event must relate to the articulated event, and whether the supplier can succeed if relying solely on a catchall phrase. For example, New York courts generally limit excuses to those events specifically listed, but where a catchall phrase is included the courts may excuse performance for events like those listed. In Ohio, however, some courts have given effect to broadly written catchall provisions without requiring the clause to list specific events.

Some catchall provisions qualify the right to declare a force majeure, such as a reference to "unforeseen events" or that the event must be beyond the declaring party's "reasonable" control. In fact, courts will often interpret a catchall provision to exclude foreseeable events unless it specifically states otherwise. In the context of the COVID-19 pandemic, for example, a court could find that the previous occurrence of outbreaks in other parts of the world make this pandemic foreseeable. A catchall provision can also inadvertently narrow the scope of applicable events, such as by referencing "other similar events" or "other such events" instead of just "other events" beyond a party's control.

Analyze the Impact of the Event on the Supplier's Ability to Perform

Absent an agreement to the contrary, a supplier must not only demonstrate the occurrence of a force majeure event – it also must show that the event was the reason the supplier could not perform its obligations. The supplier must generally make reasonable efforts to perform, and if the event restricts only some part of performance, the supplier may only be excused in part. While a supplier subject to a stay-in-place or similar government order due to COVID-19 may more likely demonstrate how the event prevented its performance, other factors should be considered, such as if the supplier is an "essential business" or how certain exceptions in the order could permit the supplier to continue performance.

Determine Allocation Rights and Mitigation Obligations

A state's UCC may require that a supplier allocate its available product in a particular manner – typically the requirement is that the supplier make an allocation among its customers that is "fair and reasonable." In addition, language in the contract may specifically obligate the supplier to allocate some or all its available product to the customer if the supplier declares a force majeure event. In the absence of any particular contractual provision, communication with the supplier early about its available capacity is critical.

As mentioned above, a supplier is also required to perform to the extent possible and mitigate any losses that could result from the force majeure event. This may require that a supplier source its own products from another, perhaps more expensive, supplier. Generally, if a supplier can perform, it must do so, even if it is more difficult than the supplier originally anticipated.

Conclusion

The emergence and rapid spread of COVID-19 has created uncertainty in global supply chains. A supplier may be tempted to send a force majeure declaration to a customer in an effort to avoid difficult or inconvenient performance of its contractual obligations. The customer should examine the declaration and the circumstances surrounding the purported force majeure event to verify whether the supplier is relieved of its obligation to perform, and, if so, to what extent.

For more information, please contact John Cottingham, Rob Powell or Justin Tillson.

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Mergers & Acquisitions

New Vertical Merger Guidelines Face Bipartisan Calls for Stronger Antitrust Enforcement

By Mark R. Butscha, Jr. and Daniel Ferrel McInnis

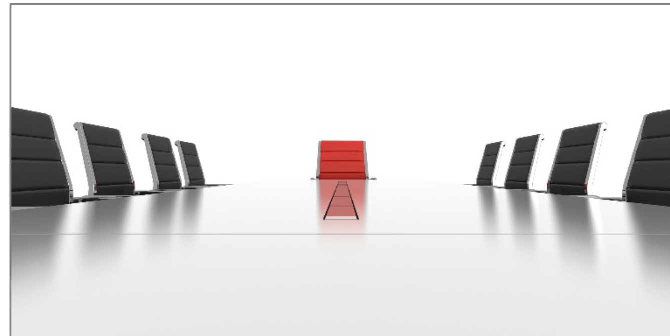
Companies contemplating mergers and acquisitions need to understand antitrust risk. In horizontal deals between competitors, counsel rely upon the detailed Horizontal Merger Guidelines issued by the U.S. Department of Justice Antitrust Division (DOJ) and the Federal Trade Commission (FTC), as well as considerable enforcement precedent. But vertical deals are much more difficult to assess because enforcement is much rarer and the vertical merger guidelines, issued in the 1980s, are outdated and largely ignored.

In January 2020, DOJ and FTC took what they view as a step toward greater enforcement transparency by jointly releasing new Draft Vertical Merger Guidelines (Guidelines) for public comment. These proposed new Guidelines follow closely on the heels of DOJ's loss in its challenge to the combination of AT&T and Time Warner, DOJ's first litigated vertical merger case in more than 30 years, and they would replace the now moribund 1984 Non-Horizontal Merger Guidelines. The purpose of the Guidelines is to "outline the principal analytical techniques, practices and enforcement policy" of the DOJ and FTC with respect to vertical mergers. While the draft reflects existing practice, it is light on detail and only partially achieves the goal of presenting a new analytical framework.

The public comment period has closed, and it is possible that the Guidelines may be significantly revised before they are finalized. In addition to 70 public comments and statements by two FTC commissioners, a bipartisan group of 43 members of Congress has called for stronger Guidelines and enforcement. Whether the views of the commenters affect the final Guidelines remains to be seen, but the desire for increased scrutiny of vertical mergers is clear.

The Draft Guidelines

The Guidelines address "distinct considerations" raised by vertical mergers, which "combine firms or assets that operate at different stages of the same supply chain." Nonetheless, the Guidelines note that many of the "principles and analytical frameworks used to assess



horizontal mergers apply to vertical mergers" and incorporate portions of the Horizontal Merger Guidelines concerning market definition, market share, market concentration, anticompetitive effects and coordinated effects.

Perhaps the most significant and controversial portion of the draft Guidelines proposes a "safe harbor" for vertical mergers where the parties' combined market share is less than 20 percent in both the "relevant" market and the "related" market. But this line is not absolute; the Guidelines merely say the government is "unlikely" to challenge such a merger. Dueling commenters criticize the proposal as too lax or too restrictive given that vertical mergers almost always have obvious efficiencies. One FTC commissioner even said this was the "biggest concern with the Guidelines." Whether or how this "safe harbor" is treated in the final Guidelines remains to be seen.

The Guidelines also discuss theories of harm (e.g., foreclosure and raising rivals' costs), albeit with little expansion upon these commonly understood theories and no discussion of several others (e.g., barriers to entry and regulatory evasion). Moreover, they only suggest that these theories may be proven through empirical analysis, an issue that doomed DOJ's case in the AT&T-Time Warner litigation.

The Guidelines also address efficiencies, recognizing that because "vertical mergers combine complementary economic functions and eliminate contracting frictions, they have the potential to create cognizable efficiencies that benefit competition and consumers." Therefore, DOJ and

FTC will "not challenge a merger if cognizable efficiencies are of a character and magnitude such that the merger is unlikely to be anticompetitive in any relevant market." Of note, the Guidelines discuss elimination of double marginalization (EDM), which means the elimination of two separate firms needing to earn separate profits. This is a concept that many economists argue should be assumed in all vertical mergers but which is controversial to vertical merger opponents. The Guidelines split the difference somewhat by suggesting that the merging parties would bear the burden of proving EDM.

In sum, the draft Guidelines do not drastically alter the current analytical framework for evaluating vertical mergers and leave many issues unaddressed or undeveloped. Nonetheless, the draft is a starting point that may benefit the business community and the bar by increasing transparency and predictability.

Reactions to the Draft Guidelines

Two FTC commissioners abstained from voting to publish the Guidelines and released separate statements criticizing the draft. Seventy comments from antitrust practitioners, economists, academics, and trade associations were submitted before the comment period expired at the end of February. The comments ran the gamut. The head of the DOJ Antitrust Division noted, "[s]ome comments criticize the proposed guidelines for suggesting gross overenforcement against vertical mergers … Other comments criticize the proposed guidelines for suggesting gross underenforcement against vertical mergers."

In addition, a bipartisan group of 43 members of the U.S. House of Representatives sent a letter to DOJ and FTC expressing concern that "the rise of vertical mergers" was "reducing competition, particularly in the health care market" and having "a detrimental impact on the free market and consumers." The letter urged FTC and DOJ to "strengthen their approach to vertical merger enforcement, in order to better promote market competition and protect consumers."

These comments and statements demonstrate that the Guidelines are of a piece with renewed focus on vertical mergers, which for decades had usually been permitted without structural remedies (e.g., divestitures). Antitrust practitioners and the business community will closely monitor the effect of these viewpoints on the Guidelines and on enforcement policy and practice in the coming years.

Conclusion

The Guidelines in their current form do not meaningfully change the methodology for analyzing vertical mergers. Once finalized, however, they may provide some measure of increased transparency and predictability. Scrutiny of vertical mergers has increased in recent years, and some public comments—including comments from members of Congress—reflect support for stricter Guidelines and stronger enforcement. Parties contemplating vertical mergers should bear this context in mind and seek advice from experienced antitrust counsel to navigate these issues.

For more information, please contact Mark Butscha or Dan McInnis.

Real Estate

PFAS: Due Diligence and Risk Assessment in Real Estate Transactions

By Heather Richardson

Based on the recent regulatory focus, public scrutiny and litigation relating to PFAS, parties to a real property transaction need to ensure that PFAS are included in the risk assessment of any deal. "PFAS" is a category of over 6,000 per- and polyfluoroalkyl compounds that include perfluorooctane sulfonate (PFOS) and perfluorooctanic acid (PFOA). PFAS, sometimes referred to as "forever chemicals" because of their strong chemical makeup and persistence in the environment, will remain front and center with the U.S. Environmental Protection Agency, the Department of Defense, citizens groups and nearly every state, and therefore need to be considered in any real property transaction.

PFAS compounds impact many transactions because they are ubiquitous in the environment and found in many products, including stain- and water-repellent fabric; non-stick products (e.g., non-stick cookware); certain cosmetics, shampoo, conditioners, hand creams, sunscreen, toothpaste and dental floss; polishes, waxes and paints; cleaning products; firefighting foams; aerospace/aviation products; photographic anti-reflective coatings; mist-suppressant foams for electroplating; car wax; popcorn bags; waterproof/breathable clothing; architectural composite resins; and paper and cardboard coatings. PFOS and PFOA compounds have been phased out of production in the United States, but they are still imported in consumer products.

Ensure PFAS Is Included in Environmental Diligence

In order to avoid potentially costly and long-term cleanups or litigation, buyers need to assess PFAS risks in any transaction. In most real property purchases, a buyer attempts to meet all appropriate inquiry and exercise due care in order to attempt to obtain prospective purchaser defenses. It is important that a buyer retain a qualified consultant and counsel to assess the potential PFAS risk relating to any business or property being acquired.

PFAS are not currently listed as hazardous substances under the Comprehensive Environmental Response Compensation and Liability Act, and the applicable standards for conducting a Phase I environmental site assessment (ESA), ASTM 1527, do not currently include PFAS in the definition of hazardous substances, so PFAS currently are considered out of scope for an ASTM 1527 Phase I ESA. In April 2019, the ASTM standards included a footnote regarding non-scope considerations to acknowledge growing regulator attention to emerging contaminants, especially PFAS. At this time, chemicals will not be expressly named in the standards, but language will be added to alert Phase I ESA providers that releases of chemicals that are not classified as "hazardous substances" for compliance with federal regulation may be considered "in scope" for compliance with state regulations and contractual obligations. In most cases, PFAS should be added as non-scope items to a Phase I ESA.

Potential Red Flag PFAS Issues

A purchaser should consider whether any potential red flag PFAS activities occurred on or near the property or relate to the characteristics or business activities of the target, including the following:

- The manufacture of PFAS chemicals or firefighting foam;
- The supply of products containing PFAS to a third-party manufacturer;
- The manufacture or treatment of products to make them water or oil resistant (or the use of fabric protection products or similar materials in large volumes);

- The disposal of large volumes of consumer or industrial products containing PFAS;
- Firefighter training activities;
- The occurrence of an industrial fire or major accident;
- The existence of a landfill, airport or military base on or near the property;
- Known PFAS contamination on-site in a location near municipal or private drinking water sources or surface water;
- A history of PFAS-related claims by workers; and
- The use of fume suppressants in electroplating.

In the event that a PFAS risk is identified in a transaction, the parties will need to determine how to allocate the potential risk. Purchasers should be aware that sites that obtained regulatory closure in the past may be reopened due to PFAS concerns. Though a buyer may insist on Phase II sampling to confirm whether PFAS are present, Phase II sampling can be challenging because of cross-contamination risks and the lack of standard methods for sampling. Additionally, it is important to assess what regulatory standards would even apply based on the location of the facility and the changing regulatory obligations.

Tips for Addressing PFAS Issues in Transactions

First, make sure PFAS are covered in the scope of diligence and in the deal documents (e.g., definition of “hazardous substances” and representations and warranties). Older purchase agreement forms may not cover PFAS. Next, assess whether there are state regulations that govern PFAS remediation and reporting obligations. The laws regarding emerging contaminants are changing every day and need to be assessed. Finally, work with qualified environmental counsel and consultants to understand and develop creative solutions to allocate PFAS risk. Options to address PFAS concerns include indemnities, releases, environmental insurance and deed restrictions.

If you have any questions about PFAS issues in real estate transactions, please contact Heather Richardson or any other member of Thompson Hine’s Environmental practice group.

Emerging Companies

SEC Proposes Rule Changes to Crowdfunding Regulations

By Lindsay Karas Stencel

Just as the COVID-19 pandemic was beginning to sweep the United States, the Securities and Exchange Commission (SEC) proposed meaningful changes to multiple securities exemptions, including Regulation Crowdfunding (Reg CF), which could prove to be immensely helpful for startups looking to raise capital in ways that do not include the traditional in-person interactions.

Reg CF was born out of Title III of the JOBS Act upon the addition of a new Section 4(a)(6) to the Securities Act of 1933, as amended (Securities Act) to permit companies to engage in crowdfunded offerings of private securities to generally solicit investors online without having to go through the traditional, and very expensive, public offering registration process.[1] In the spirit of investor protection, Title III also added a new Section 4A to the Securities Act containing numerous hoops that emerging companies, funding portals (where all crowdfunded investments are made) and investors had to jump through to launch a successful crowdfunded offering. As of 2017, an emerging company could raise up to $1.07 million during a 12-month period through crowdfunded offerings, and all purchases of securities had to occur through an SEC-registered intermediary, though they could be marketed publicly anywhere that led the potential investors back to the crowdfunding portal. Investors, whether or not accredited, were also limited in the amount which they could invest in crowdfunded offerings over a 12-month period.

Despite this access to a new source of investment capital, many emerging companies on the traditional high-growth startup pathway steered clear of the Reg CF offering because of the negative perception venture capitalists had towards crowdfunding, generally, and the relatively small amount of investment capital that could be raised in any 12-month period.[2] This forced most emerging companies to remain on the known course of seeking investment via in-person meetings with friends and family and angel investors to get much needed startup capital to launch their businesses, which has since become quite challenging during the COVID-19 health crisis.

Then, on March 4, 2020, SEC Chairman Jay Clayton publicly recognized that emerging companies “that are on a pathway to become a public reporting company … use the exempt offering rules to access critical capital needed to create jobs and scale their businesses.”[3] Clayton went on to express that the complexity of the current regulatory framework is confusing, especially for smaller companies with limited resources, and those companies should be utilizing their resources to maximize the expansion and growth of their businesses.[4] With his announcement, he also released the proposed rule changes, which for Reg CF would increase the amount that could be raised in a 12-month period through a crowdfunded offering to $5 million. The changes also seek to relax the complex rules for investors, which would eliminate the limitations previously placed on accredited investors who desired to partake in crowdfunded offerings and would allow non-accredited investors to rely on the greater of (as opposed to the lesser of) their annual income or net worth in calculating how much they would be permitted to invest.[5] These rule changes stemmed from proposals and public commentary on the topic previously received by the SEC in

[1] Ennico, Cliff, *The Crowdfunding Handbook*, 2016, page xix.
[2] Miller, Ron, “Can Crowdfunding and Venture Capital Coexist?” March 2, 2016.
[3] Aloid, JD, “SEC Proposes Raising Reg CF to $5 Million, Reg A+ to $75 Million, Adds Other Improvements to Security Exemptions,” March 4, 2020.
[4] Id.
[5] Ibid.

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2019. The proposed rule changes will remain open for public comment for 60 days following publication in the *Federal Register*.

With the proposed rule changes, the SEC aims to improve the viability of the Reg CF exemption while simultaneously providing a more manageable legal framework for startups to operate within and greater access to investors and capital. And in a time when founders cannot go out and meet with their potential investors, there is no better time than the present to increase the amounts that emerging companies can seek to raise online and to broaden the pool from whom it may be raised. In an age where Zoom meetings and webinars are the primary manner in which individuals can access the outside world, being able to generally solicit even more of the public for up to $5 million dollars of crowdfunding capital in any 12-month period may prove to be the manner in which countless startups seek to validate their business ideas and get much needed investment capital in the door without having to step out of theirs.

Please contact Lindsay Karas Stencel with any questions.

Return-to-Work Considerations for Employers

Thursday, May 7 – Webinar

1:00 - 2:00 p.m. ET

Please join partners Deborah S. Brenneman, John Wymer and M. Scott Young for a webinar focusing on the array of issues that employers should consider as they prepare to reopen their workplaces.

State governments and federal agencies such as the EEOC and OSHA, among others, are all issuing new guidance and orders, which may overlap or conflict with each other and existing statutory regulations. In addition, employers are confronting novel questions where the answer or best practice may differ based on their location, the demographics of their workforce, and the industry in which they operate.

The questions and topics that we will address include:

- What if an employee prefers to remain furloughed and collect enhanced unemployment compensation benefits?
- How do we deal with employees who refuse, or are reluctant, to return to work for fear of catching the virus?
- What specifically can/should we do to protect returning employees, customers, vendors and other third parties?
- What issues should we consider when deciding what safety measures to implement in our workplace in response to the virus?
- How do we address these issues in a unionized workforce?
- Should we designate someone (with appropriate background and expertise) with overall responsibility for return-to-work protocols and enforcement?
- If an employee reports that they have the virus, do we have reporting or other obligations? What is our potential liability exposure?

Please register online to receive the webinar login information.

Funding a Startup? Consider the Section 1202 Capital Gain Exclusion

By Alexis J. Kim and James C. Koenig

Quietly lurking in the shadows of the tax code is a provision that allows holders of certain stock to permanently exclude up to 100% of their gain on a stock sale under Section 1202 of the Internal Revenue Code of 1986, as amended (Code). Investors in startup ventures may exclude 100% of capital gain on a stock sale, up to a maximum of the greater of $10 million or 10 times the holder's basis in the stock.

Stock that meets all of the requirements of Section 1202 is referred to as "qualified small business stock" (QSBS). For example, if an investor were to invest $1 million in QSBS, the investor could exclude up to $10 million of gain on a subsequent sale of the QSBS. So, a sale of the QSBS for $11 million would result in a $10 million gain, but $0 U.S. income tax liability because the entire $10 million capital gain would be excluded by Section 1202.

While a detailed explanation of the requirements that must be met in order to take advantage of the Section 1202 exclusion is beyond the scope of this article, some of the basic requirements are listed below.

1. The stock is held in a U.S. C corporation and was acquired at original issuance from the corporation in exchange for money or other property, or as compensation for services.
2. The shareholder has held the stock for more than five years at the time of the sale.
3. The corporation must meet an aggregate gross assets test immediately after issuance, generally $50 million including cash held by the corporation and the adjusted bases of other property.
4. The corporation meets an active business test, and the business is not in any of the following areas:
   - Banking, insurance, financing, leasing, investing or similar;
   - Farming;
   - Oil or gas mining;
   - Operating a hotel, motel, restaurant or similar;
   - Any business involving performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or a business where the principal asset is the reputation or skill of one or more employees.
5. There are additional restrictions, reductions and limitations governing transfers and redemptions of stock and complex requirements apply if the stock is held through a pass-through entity.

Planning is required at the time of initial formation of a business entity for a tax benefit that is not immediately available, and the benefit depends as much on the success of the business venture as on the requirements imposed by the tax code. If investors are considering whether to structure a startup business venture to take advantage of Section 1202, they should consider whether Section 1202 is a good fit with the planned business operations and exit strategy. The list below provides general guidelines that should be considered in determining if a business venture could or should structure itself so as to allow owners to take advantage of the Section 1202 exclusion on exit.

- Is the business venture likely to throw off losses in early years? If so, will the owners be satisfied with losses being available to offset corporate level income only and not passed through?
- Is the business venture in an industry that requires or commonly employs a corporate structure rather than a limited liability company taxed as a partnership?

- Do the owners anticipate being able to structure the exit as a stock sale and not as an asset sale? The Section 1202 exclusion applies only in the case of a stock sale.
- Are the owners prepared and willing to hold the stock for at least five years from original issuance?
- Is the business venture expected to pay regular dividends to the owners during its first five years? If so, are the owners willing to pay tax on dividend distributions?

In limited situations, it may also be possible for an existing LLC treated as a partnership for tax purposes to engage in a conversion to a corporation and qualify for the Section 1202 exclusion. The conversion must be structured properly so that it is treated as a contribution of assets to a new corporation for tax purposes. This allows the shareholders who previously held the LLC units to use the value of the assets held by the LLC at the time of conversion to calculate their basis in the C corporation stock. Then, so long as the other requirements are met, if the shareholders hold the stock for at least five years before selling, they would be eligible for the Section 1202 exclusion.

The basic premise of Section 1202 – capital gain exclusion – is straightforward and formulaic, however, the rules that apply to Section 1202 are very detailed and slight changes in facts could make a difference as to whether or not stock qualifies for the gain exclusion. Many factors should be considered before deciding that a new business venture would be best structured to qualify the newly issued stock as Section 1202 stock. Analysis of eligibility for the Section 1202 exclusion should be done with assistance from experienced tax counsel during the startup phase, periodically throughout operations to ensure compliance, and again at the time of exit.

With any questions, please contact Alexis Kim or Jim Koenig.

Preparing Your Business for the COVID-19 World

Force Majeure and More: Planning for Climate Change, Pandemics and Disruptions After COVID-19

Tuesday, May 12 – Webinar

1:00 - 2:00 p.m. ET

Please join us for the third in a series of informative webinars that will examine issues to consider as we emerge from stay-at-home and shelter-in-place orders as well as issues facing businesses operating in the reality of a COVID-19 world. Key topics include:

- Applicability of force majeure clauses, Uniform Commercial Code and common law defenses to business disruptions
- Contract provisions that should be considered as part of disaster risk management
- Excusable delays in construction contracts – remedies and how to plan for them
- Material adverse change clauses and applicability to pandemics and disasters
- Protection of supply chains and product distribution networks

Our presenters will be Jeffrey R. Appelbaum, Jennifer N. Elleman, Tom Feher, Matthew David Ridings and Jennifer S. Roach.

Please register online to receive the webinar login information. CLE credit has been requested for this program.

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