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LETTER

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CROSS-SPECIES MERGERS ARE ALIEN NO LONGER

Until recently, Connecticut law did not permit so called "cross-species" or "cross-entity" mergers between disparate entity types, such as between a corporation and a partnership. However, as a result of legislation effective as of July 1, 2003, direct cross-entity mergers are now permitted in Connecticut. Thus, any limited liability company (LLC), corporation or partnership may now merge not only with other entities of the same type, but with any "other entity" although there are some continuing limitations for entities providing professional services. For purposes of the merger rules, the term "other entity" means any association or legal entity, other than a domestic or foreign limited liability company, organized to conduct business, including, but not limited to, a corporation, general partnership, limited liability partnership, limited partnership, joint venture, joint stock company, business trust, statutory trust and real estate investment trust.

Accomplishing the Cross-Entity Merger

For a merger to become effective under Connecticut law, both parties to the cross entity merger must enter into a written plan of merger. This plan must include: (1) the name of each party to the merger and the name of the surviving entity; (2) the terms and conditions of the merger; (3) the manner and basis of converting the interests in the target LLC or other entity into the interests of the surviving LLC or other entity; (4) required amendments to the organizational documents of the surviving entity; and (5) any other provisions that are necessary or desirable. For mergers involving corporate entities, for example, the plan of merger must set forth the manner or basis of converting shares of each merging corporation and interests of each merger entity into shares or other securities, interests, obligations, rights to acquire shares or other cash or property or any combination thereof.

Unless otherwise required by the Articles of Organization or the Operating Agreement, the plan of merger must be approved by members constituting at least two-thirds in interest of the LLC or partnership. In addition, any merger that involves an entity other than an LLC must meet the statutory requirements of the other entity, including any requirements that may be imposed by a foreign entity's home jurisdiction. And of course, each entity that is a party to the merger must be permitted to undergo such a merger by the state or country under which it is organized.

After approval of the plan of merger, the surviving entity is required to file Articles of Merger with the Secretary of State, signed by each LLC and other entity that is a party. The Articles must set forth: (1) the name and jurisdiction of formation of each LLC and other entity; (2) the effective date of the merger (if later than the date of filing of the Articles); (3) the name of the surviving entity; (4) a statement that the plan of merger was properly approved by each LLC and/or other entity; (5) if the Articles of Organization of the survivor of the merger have been amended, the amendments to such Articles of Organization, or if a new LLC is created as a result of a consolidation, the Articles of Organization of such new LLC; and (6) a statement that the plan of merger is on file at the place of business of the surviving entity, and that the plan of merger will be furnished upon request and at no cost to any person holding an interest in either an LLC or other entity that is a party to the merger.

Filing of the Articles of Merger acts as the filing of Articles of Dissolution for an LLC that is not a survivor in the merger. Further, upon the effective date of the merger, the membership or other interests in the LLC or other entity that are to be converted or exchanged pursuant to the plan of merger are automatically converted into membership or other interests of the surviving entity, and the former holders thereof are entitled only to the rights provided in the plan of merger or consolidation or the rights otherwise provided by law.

Tax Consequences of Cross Entity Mergers

In most cases, the merger of an LLC into a corporation will be a taxable event to the members of the LLC. Specifically, if the members of the LLC receive less than 80% control of the surviving corporation, the transaction will be considered as a "failed Section 351 exchange," and each of the members of the LLC will recognize income equal to the difference between the tax basis in their LLC interests and the value of the stock received in the surviving corporation. If the LLC members receive 80% or more control of the surviving corporation, then the transaction could be tax-free.

A merger of a corporation into an LLC or partnership will generally be a taxable transaction to both the terminating corporation and its shareholders. Because the corporation's assets are withdrawn from the corporate form, the corporation must recognize gain or loss on the deemed sale of those assets. Next, because the corporation is dissolved, and the shareholders will no longer hold shares in the corporate entity, these shareholders must recognize gain or loss on the value of their shares. The LLC and the members of the LLC in a corporation-into-LLC merger, on the other hand, should not be subject to tax unless there is a potential deemed distribution to them resulting from a reallocation of the LLC's liabilities.

Using a Single Member LLC to Facilitate Corporate Reorganizations

One of the benefits of Connecticut's cross-entity merger rules is that they equally apply to both single member LLCs as well as multi-member LLCs. As a result, single-member LLCs (which are disregarded for federal income tax purposes) may be now be employed to facilitate certain corporate reorganizations. In particular, the benefits of using a disregarded entity in the reorganization context include isolating a risky target corporation, avoiding a shareholder vote on a direct merger with the owner corporation, and complying with regulatory restrictions on directly engaging in the target or owner corporate business. Moreover, disregarded entities may be used to minimize third party consents and state transfer taxes that could result from an asset transfer. The following examples illustrate the practical impact of different methods by which a single-member, disregarded LLC may be used in the merger context.

Merging a Disregarded Entity into a Corporation

Assume that a portion of X Corp will be acquired by Y Corp. Prior to the merger, X Corp could drop the assets it wishes to sell to a disregarded single-member LLC (SMLLC) and then, pursuant to the cross-entity merger rules, the SMLLC can merge into Y Corp. X Corp shareholders could receive cash or Y Corp stock. Under federal tax law, this transaction will likely be considered a taxable sale or, at best a "C" type tax-free reorganization (provided that "significantly all" of the assets of the target corporation are transferred to the SMLLC). However, under Connecticut law, this series of steps may facilitate the assignment of the assets to Y Corp, especially where Y Corp wishes to isolate the assets for liability purposes after the transaction has been completed. Connecticut only imposes a tax on the sale or transfer of a controlling interest in an entity (defined as more than fifty percent of the capital, profits or beneficial interest in the entity) possessing an interest in Connecticut real property. Thus, if less than a controlling interest is transferred, there is no tax.

Merging a "Target" Corporation into a Disregarded Entity

Alternatively, assume that X Corp wishes to acquire Y Corp. Prior to the merger, X Corp forms a wholly owned SMLLC subsidiary and Y Corp merges with and into the SMLLC. Y Corp shareholders receive X Corp stock. And X Corp now holds Y Corp as a separately identifiable LLC that is ignored for federal income tax purposes. For federal tax purposes, the IRS has indicated that this transaction will qualify as a tax-free reorganization.

Conclusion

The cross entity merger rules offer Connecticut entities more flexibility and, in some instances, more favorable tax treatment than previously. Would-be merger participants will do well to consult their tax advisors prior to structuring reorganization transactions involving any type of entity. And, in some instances, entities considering purchases or sales of assets of, or interests in, another entity may benefit from structuring the purchase or sale as a transfer of interests or assets from, or into, a disregarded single-member LLC. *For more information, please contact Louis B. Schatz at (860) 251-5838 or lschatz@goodwin.com.*

Shipman & Goodwin LLP
COUNSELORS AT LAW

One Constitution Plaza
Hartford, Connecticut 06103
(860) 251-5000

300 Atlantic Street
Stamford, Connecticut 06901
(203) 324-8100

43 Arch Street
Greenwich, Connecticut 06830
(203) 869-6222

home page: www.shipmangoodwin.com

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Judge Prohibits Evidence of End-Users' Immunity From Damages for Patent Infringement in Claim Against Supplier: In a pre-trial ruling concerning damages in a patent infringement lawsuit, the court agreed with the plaintiffs that the defendant — the alleged infringer of the plaintiffs' patent rights — should be prevented from offering evidence that certain end users of the defendant's products would be immune for claims of direct patent infringement. The plaintiffs' patent rights involved claims relating to thermal cyclers, which the defendant infringer claimed it sold to at least some customers who use the product for non-commercial research activities related to the human genome project. The defendant argued that, because the end users were not engaged in commercial activity, but rather attempting to advance science, those users would be able to avoid claims of direct infringement based on a common law "experimental use" exception to the patent laws, had they been sued directly by the plaintiffs, and that the defendant should, therefore, be entitled to benefit from the same exception. The U.S. District Court for the District of Connecticut, in *Applera Corp. v. MJ Research, Inc.*, however, agreed with the plaintiffs that the proposed jury instruction submitted by the defendant to explain the experimental use exception was too confusing. According to the court, the judge-made "experimental use" exception to liability for direct patent infringement had to be construed narrowly, and that the defendant would be allowed instead to proffer evidence to the court (rather than to the jury) demonstrating how the exception would apply to particular customers of the defendant. The court entered a number of additional pre-trial rulings directed toward the defendant's efforts to limit its liability for contributory infringement. Among them, the court held that evidence of infringing uses by state entities supplied by the defendant would be allowed (even though the state entity itself could not be held liable for money damages in a direct patent infringement lawsuit due to the immunity afforded by the Eleventh Amendment) and that the defendant had not met its burden of demonstrating that certain uses of the patented device by contractors of the federal government were in fact used by the federal government. *Pat Fahey, (860) 251-5824 or pfahey@goodwin.com*

Board Members Hold Over Until Successors are Elected: The Court of Appeals of Ohio recently ruled that corporate directors whose terms had expired remained on the board until their successors were elected. In *Jovenall v. Zerco Systems International, Inc.*, the stockholders of the defendant corporation (Zerco) elected a board of directors on November 29, 2000. Three directors were elected to one-year terms and four directors were elected to three-year terms. In the first year, two of the three-year directors resigned. No stockholder meeting was held in 2001, and the three one-year directors' terms expired on November 29, 2001. On November 30, 2001 the board members whose terms had not expired (i.e., two three-year directors) elected a third director and a president by written consent. Subsequently, a Zerco stockholder filed an action for a judgment declaring the identity and term of the officers and directors of the corporation as well as injunctive relief barring the current board from acting on behalf of the corporation. The trial court denied the stockholder's claims and the appellate court reversed. The relevant provisions of the Ohio Revised Code provide that "any action that may be authorized or taken at a meeting of the directors may be . . . taken without a meeting with the affirmative vote of all of the directors," and that, unless the articles or the regulations of a corporation provide differently, "directors hold over after the expiration of their original terms in the event that their successors have not been elected or have not qualified." Zerco's regulations did not otherwise provide and, in fact, provided that "each director thereafter shall hold office for a term of three years and until his successor shall be elected and shall qualify or until his earlier death, resignation or removal." Consequently, at the time of the November 30, 2001 elections by written consent, the board consisted of the two remaining three-year directors and the three one-year holdover directors. Because the consents of the one-year hold-over directors were not obtained, the actions taken on November 30, 2001, and any subsequent actions of the board, were invalid. Thus, the trial court abused its discretion in denying the stockholder's request for declaratory judgment. The appellate court also held that the stockholder's action for an injunction barring the current board from acting on behalf of the corporation was moot because any action taken by the board after the November 30, 2001 election was invalid and, absent a subsequent ratification, could be voided. *Carol McVerry, (860) 251-5839 or cmcverry@goodwin.com*

Recovery Not Allowed by Michigan Anti-Oppression Statute for Board Removal, Firing of Shareholder in a Closely Held Corporation: In *Franchino v. Franchino*, the Michigan Court of Appeals affirmed a trial court's grant of summary judgment in favor of defendants, the majority shareholder and corporation, in an action for oppressive conduct under MCL 450.1489 brought by the plaintiff minority shareholder. The appeals court held that MCL 450.1489 does not create a cause of action for shareholders to recover for harm suffered in their capacity as employees or board members. In this case, plaintiff, the minority shareholder of the defendant corporation and son of the defendant majority shareholder, alleged that the majority shareholder fired him, removed him from the board and amended the corporation's bylaws so that defendant could be the only director, all in violation of MCL 450.1489. The trial court agreed that the defendant's conduct may be "oppressive" when viewed in the light most favorable to plaintiff; however, such conduct did not affect plaintiff's interests as a shareholder. The trial court noted that while similar anti-oppression statutes in other states have allowed shareholders to sue for damages sustained as a director or officer of the corporation, many such statutes are either silent on the issue or explicitly protect such interests. In contrast, MCL 450.1489(3) specifically states that it applies only to conduct that affects the shareholder "as a shareholder." The court also declined to adopt a reasonable expectations test, whereby "oppressive" conduct would be interpreted as including conduct that defeats the reasonable expectations of a minority shareholder, because the court concluded that there is no basis for such interpretation under current Michigan law and such interpretation would be inconsistent with MCL 450.1489(3). In affirming the trial court's decision, the appeals court concluded that MCL 450.1489 only protects a shareholder's interest "as a shareholder" and defendant's decision to fire plaintiff, remove him from the board and amend the bylaws did not affect plaintiff's interests as a shareholder under the statute as a matter of law. *Tammi Flowers, (860) 251-5782 or tflowers@goodwin.com*

Update: SEC Adopts Final Rules Requir-

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(Continued)

ing Registration of Hedge Fund Advisers: On December 2, 2004, the SEC issued new Rule 203(b)(3)-2 and related rule amendments under the Investment Advisers Act of 1940 (the "Advisers Act") that have the effect of requiring advisers to hedge funds to register with the SEC under the Advisers Act, thereby becoming subject to the regulatory scheme for registered advisers. The new rules are accompanied by a vigorous dissent by two commissioners. Their effective date is February 10, 2005, and the compliance date for registration under the new rules is February 1, 2006. The new rules restrict the use of the so-called "private adviser exemption" from registration under the Advisers Act by now requiring investment advisers, in determining the number of clients of a "private fund" under management, to "look through" the private fund(s) and to count as a "client" the shareholders, limited partners, members or beneficiaries of the private fund(s). If, during the preceding 12 months, an adviser has advised a private fund(s) with more than 14 "clients" or a combination of private fund clients and individual clients that aggregate more than 14 persons, then the private adviser exemption is lost and the adviser must register. As adopted, the new rules clarify that the adviser need not count itself, and it may exclude certain knowledgeable advisory personnel who are "qualified clients" (i.e., insiders) that may be charged a performance fee. These look-through rules will require a fund of funds to look through a top tier private fund and count its investors as clients. Additionally, the look through rules apply only to a "private fund," which is defined as a company that (a) would be subject to regulation under the Investment Company Act of 1940 (the "1940 Act") but for two exceptions (§3(c)(1) and §3(c)(7) of the 1940 Act), (b) permits its investors to redeem interests in the fund within two years of purchase; and (c) offers interests based upon the investment advisory skills, ability or expertise of the investment adviser. This definition is expected to include most hedge funds, but exclude other business organizations, venture capital funds and private equity funds (which typically contain stricter restrictions on redemption). The new rules do not alter the minimum assets under management that investment advisers must have in order to be eligible for registration ($25,000,000). In calculating these assets, the total value of the securities portfolio must be counted without set-off for borrowings to acquire those securities, but the value of the qualified clients' interests may be excluded. The rules contain certain exceptions for offshore funds. The rules have generated substantial controversy, and various trade associations are assessing whether to challenge them. *Clare A. Kretzman, (203) 324-8116 or ckretzman@goodwin.com*

Shipman & Goodwin LLP
COUNSELORS AT LAW
One Constitution Plaza
Hartford, CT 06103-1919