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THE INTERNET INCUBATOR: STRUCTURES AND ISSUES

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I. WHAT ARE INCUBATORS?[1/]

In recent years, market forces in the information technology area and the growth and popularity of the Internet have produced an alternative business structure that provides increased access to the private equity market for a broader group of investors. These "incubators," "accelerators" or holding company businesses are established by their sponsors to provide a forum for matching ideas with resources such as capital, networking, office space and legal, marketing, administrative and accounting services. Equally important to the success of these businesses is the creation of a network of operating businesses that share ideas, business initiatives and enter into commercial relationships, all under the umbrella of the incubator and its management. As discussed in detail below, however, these incubators must function as actual operating companies and not simply investment vehicles.

Given the limited start-up experience of young Internet entrepreneurs, the incubator has its origins in the attempt to put an idea rapidly through a production line moving from cubicle to cubicle on its way to becoming an established company. The incubator provides a means for accelerating to market the resource intensive Internet businesses at a time when success is as much determined by speed to market as it is by innovative products and services.

Incubators are formed by operating professionals, buyout and venture firms, institutional investors and service and consulting companies. The incubator model is used by these sponsors to: (i) create a holding company structure that focuses on a particular vertical space or region; (ii) leverage into a space that is generally at too early a stage for the core businesses of traditional buyout and venture firms; and/or (iii) extend the reach of traditional private equity to public investors.

Notwithstanding their many formulations, all incubators are structured to build incremental value and to preserve the ability to go public. Although there are drawbacks to this model, the formation and use of incubators (whether named as such or not) continues to gain momentum.

II. WHAT STRUCTURES ARE USED FOR INCUBATORS?

Incubators are formed to own and operate a network of businesses (referred to as "partner companies") that are expected to take advantage of operating synergies and business opportunities

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1/ This Memorandum addresses the structures and issues relating to incubators formed in the United States with the ultimate goal of going public in the United States. An incubator organized in an offshore financial center with the goal of going public in an offshore jurisdiction may be able to rely on the exceptions discussed in Section III. B. below if it makes a limited private placement of its securities in the United States.

within the network and provide ongoing revenue and asset growth to the incubators. For regulatory and other reasons discussed below, the premise of functioning as an operating business (rather than an investment vehicle) is fundamental to the structure and terms of the incubator.

A. Organizing as a Private LLC.

The incubator most often starts life as a private limited liability company (or partnership) so as to avoid double tax on profits realized prior to the incubator's anticipated public offering and to permit flexibility to make asset distributions to investors without taxation. The use of a limited liability company provides flexibility in addressing governance issues as well as alternatives for providing equity to management.

The incubator is typically managed by a Board of Directors (or similar body) with the advice and assistance of a Board of Advisors comprised of leading information technology executives. Although some incubators provide for the payment of a management fee to a manager, they rarely provide for a carried interest, override or similarly structured incentive compensation that is otherwise typical of a venture fund.

The equity arrangements for management of the incubator are often structured to maximize the capital gains opportunity for these executives, at least as to awards of interests granted before the incubator goes public. A typical equity arrangement may involve the grant to management of an interest in the future profits (subject to vesting) of the limited liability company. Other arrangements may include restricted LLC interests and/or options.

The agreements relating to the limited liability company typically address: (i) the business scope of the incubator; (ii) the exclusivity arrangements among its sponsors; (iii) pre-emptive, registration, tag-along, drag-along and other similar rights; (iv) the allocation of certain acquisition opportunities; (v) the initial contributions and commitments of its sponsors; and (vi) the mechanics of restructuring the incubator for purposes of going public. In addition, the structure and terms generally address certain tax and ERISA issues arising out of the nature of its sponsors (and their investors), including issues that arise due to the participation of U.S. tax-exempt or non-U.S. entities.

B. Going Public as a C Corp.

The most conventional way for the incubator to go public is for it to go public as a corporation. If the incubator is initially organized as a limited liability company, the conversion to corporate form is often accomplished by the incubator contributing its assets to a newly created corporation ("Newco") in exchange for stock of Newco, which the incubator would then distribute to its members. At the same time or on a later date, public investors would pay cash to Newco in exchange for stock of Newco. Newco will be subject to corporate level tax on gain realized on its portfolio and, for purposes of computing that gain, Newco's tax basis in assets received from the incubator would equal the incubator's tax basis in those assets, increased by any gain that the incubator recognizes on the formation of Newco. The formation of Newco will be a non-taxable event if it meets certain requirements of the tax laws that look to, among other things, the incubator's diversification and the nature of its assets. In situations where the formation of Newco would result in significant tax, other non-taxable structures may be available.

C. Establishing an Investment Funds Business.

It is not uncommon for the incubator to also be in the business of sponsoring and managing private investment funds. The investment funds business is typically structured with the incubator controlling the general partner or manager of a newly formed private investment fund raised from outside sources that makes traditional, "non-controlling" venture capital-type investments. By doing so, the incubator has more flexibility to benefit from investments that it may otherwise not be able to make for regulatory reasons or that do not fall within the primary business purposes of the incubator's network of partner companies.

III. WHAT ARE THE KEY REGULATORY ISSUES FOR INCUBATORS?

Because the business purposes of the incubator include acquiring interests in partner companies, it will need to consider prior to its formation and during its existence the Investment Company Act of 1940 , as amended (the "40 Act"). Unlike other federal securities laws, which are designed to protect investors primarily through disclosure, the 40 Act also imposes substantive requirements on the operations of investment vehicles known as investment companies. Because these requirements are generally inconsistent with the incubator's purpose of actively managing, operating and promoting networking among partner companies, the incubator is unlikely to be able to effectively function as an investment company. If the incubator is required to register as an investment company, it may be forced to comply with many regulatory requirements, including:

(i) limitations on its ability to borrow;
(ii) limitations on its capital structure;
(iii) prohibitions on transactions with affiliates;
(iv) restrictions on specific investments;
(v) limitations on the composition of the board of directors; and
(vi) compliance with reporting, record keeping, voting, proxy disclosure and other rules and regulations.[2/]

Accordingly, the ability of the incubator to take advantage of the various exceptions and exclusions from the 40 Act is of critical concern to it.

[2/] There is market precedence for registering as a "business development company" under the 40 Act. A business development company is regulated by certain portions of the 40 Act and is exempt from other more stringent portions that typically apply to registered investment companies. Generally, a business development company is required to have (i) at least 70% of its investments in certain defined categories of eligible assets before investing in non-eligible assets, and (ii) it must make available significant managerial assistance to its portfolio companies. Among other things, a business development company is forced to comply with limitations on its objectives, the composition of its board of directors and transactions with affiliates. Given these limitations, most sponsors choose not follow the route of registering as a business development company under the 40Act.

A. What is an "investment company?"

The two definitions of "investment company" of potential application to the incubator are briefly described below.[3/]

1. A Typical Investment Company. Section 3(a)(1)(A) of the 40 Act provides that an investment company includes any issuer (*i.e.*, the incubator) that is or holds itself out as being engaged primarily in the business of investing, reinvesting or trading in securities.[4/]

2. An Inadvertent Investment Company. Section 3(a)(1)(C) of the 40 Act provides that an investment company includes any issuer (*i.e.*, the incubator) engaged or proposing to engage in the business of investing, reinvesting, owning, holding, or trading in securities and that owns or proposes to acquire investment securities having a value [5/] in excess of 40% of its total assets (exclusive of government securities and cash items) on an unconsolidated basis (the "40% Test").[6/] Under Section 3(a)(2), "investment securities" include all securities except government securities, securities issued by employees' securities companies, and securities issued by majority-owned subsidiaries of the owner[7/] which (i) are not investment companies, and (ii) are not relying on the exception from the definition of investment company in Section 3(c)(1) or 3(c)(7) of the 40 Act (which exceptions are briefly described below).

B. Are there any exceptions to the definition of an investment company?

Upon its formation, the incubator at a minimum may be able to rely on two possible exceptions to the definition of an investment company under the 40 Act.

3/ In addition to Sections 3(a)(1)(A) and 3(a)(1)(C), the 40 Act contains one other definition of "investment company" under Section 3(a)(1)(B). This provision relates to issuers engaging in the business of issuing face-amount certificates of the installment type and is not relevant for purposes of this Memorandum.

4/ See Section E. below for a discussion of Section 3(b)(2) relief from being an investment company.

5/ Value is generally defined as: "(i) with respect to securities owned at the end of the last preceding fiscal quarter for which market quotations are readily available, the market value at the end of such quarter; (ii) with respect to other securities and assets owned at the end of the last preceding fiscal quarter, fair value as determined in good faith by the board of directors; and (iii) with respect to securities and other assets acquired after the end of the last preceding fiscal quarter, the cost thereof . . . ."

6/ See Section C. below for a discussion of an exclusion from this definition of an investment company.

7/ A "majority-owned subsidiary" of a person is generally defined as "a company 50 percent or more of the outstanding voting securities of which are owned by such person, or by a company which, within the meaning of this paragraph, is a majority-owned subsidiary of such person." For its part, the term "voting security" is defined as any security presently entitling the owner or holder thereof to vote for the election of directors of a company.

First, Section 3(c)(1) of the 40 Act provides an exception for incubators who are not making and do not presently propose to make a public offering of their securities and whose outstanding securities are beneficially *owned by not more than 100 persons*.

Second, Section 3(c)(7) of the 40 Act provides an exception for incubators who are not making and do not presently propose to make a public offering of their securities and whose outstanding securities are beneficially *owned solely by "qualified purchasers."* A "qualified purchaser" generally includes a natural person who owns not less than $5 million in investments, a company acting for its own account or the accounts of other qualified purchasers, which owns and invests on a discretionary basis not less than $25 million in investments, and certain trusts.

Because these exceptions are not available to the incubator when it proposes to make a public offering, it is typically unable to rely on the exceptions provided in Sections 3(c)(1) and 3(c)(7) of the 40 Act shortly after commencing operations.

C. What is the 45% Test?

If the incubator is not able to satisfy the 40% Test, it may rely on the exclusion provided by the "safe harbor" of Rule 3a-1. This rule provides that, notwithstanding the 40% Test, the incubator is not deemed to be an investment company *if no more than 45% of its total assets*[8/] *consist of, and no more than 45% of its net income after taxes (for the last four fiscal quarters combined) is derived from*, securities other than (a) securities issued by majority-owned subsidiaries that are not investment companies and (b) securities issued by companies which are primarily controlled by the incubator, through which the incubator is engaged in a business other than that of investing, reinvesting, owning, holding or trading in securities and which are not investment companies (the "45% Test"). The 45% Test is determined on an unconsolidated basis, except that the incubator is consolidated with any wholly-owned subsidiaries.

In order for a company that is not majority-owned by the incubator to satisfy the 45% Test:

(i) the incubator must control the company;[9/]
(ii) the incubator must have more control than any other person; and
(iii) the incubator must be engaged in operating the business through board representation and active participation in the management of the company.

8/ For the value of total assets, liabilities are not take into account.

9/ "Control" is defined as the power to exercise a controlling influence over the management or policies of a partner company, unless such power is solely the result of an official position with such company. The 40 Act provides a presumption of control by a person that owns more than 25% of the voting securities of a partner company. In cases where the incubator owns less than 25% of the voting securities but nevertheless controls the partner company, it may seek a determination of control from the SEC under Section 2(a)(9) of the 40 Act. Among other things, ownership of voting securities, cross-directorships and relationships with partner companies are indicative of control for this purpose.

D. Is it practically possible to function as an incubator in reliance on the 40% Test and the 45% Test?

The management of the activities of the incubator in compliance with the 40% Test and the 45% Test becomes increasingly difficult as the incubator grows and implements its business strategy. Common problems that make compliance with the numerical tests a difficult balancing act include:

(i) the failure to make a sufficient number of acquisitions of majority-owned partner companies;

(ii) the dilution of interests in a partner company caused by subsequent financing rounds, the partner company going public or insufficient cash and capital resources to maintain primary control;

(iii) the investment by other major investors in a partner company that undercut the primary control of the incubator;

(iv) the changing valuations of public partner companies driven by fluctuating market valuations of Internet-related stocks; and

(v) the capital gains (or income) generated by the sale of a non-controlled partner company.

For these and other similar reasons, many public or soon-to-be public incubators that have attempted to rely on the 40% Test and the 45% Test have ultimately sought exemptive relief from the Securities and Exchange Commission (the "SEC").

E. Is there any relief from the 40 Act?

The 40 Act provides a mechanism for the SEC to determine on a case-by-case basis the status of entities that appear to be inadvertent investment companies under Section 3(a)(1)(C), but are in fact engaged in a non-investment company business. Section 3(b)(2) of the 40 Act[10/] provides that, notwithstanding Section 3(a)(1)(C), the following is not an investment company within the meaning of the 40 Act:

> "Any issuer which the Commission, upon application by such issuer, finds and by order declares to be primarily engaged in a business or businesses other than that of investing, reinvesting, owning, holding, or trading in securities either directly or (A) through majority-owned subsidiaries, or (B) through controlled companies conducting similar types of businesses . . . ."[11/]

10/ Other potential relief includes (i) an SEC determination of "control"under Section 2(a)(9) (see Footnote 9 above) and (ii) an SEC determination under Section 6(c) that relief "is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this Act."

11/ Rule 3a-2 provides a temporary exemption from the 40 Act for companies with "a bone fide intent to be primarily engaged . . . within a year in a business other than that of investing, reinvesting, owning, holding or trading in securities." It should be noted, however, that the incubator will not be able to rely on Rule 3a-2 more than once during any three-year period.

The determination of the incubator's primary engagement under Section 3(b)(2) is a factual issue concerning the nature of its business. The factors used in this determination are:

(i) the incubator's historical development;
(ii) its public representations of policy;
(iii) the activities of its officers and directors;
(iv) the nature of its present assets; and
(v) the sources of its present income.

The SEC appears to have acknowledged an additional factor to be considered that focuses "on plans for future development of its business." All the facts and circumstances will be examined by the SEC in determining the incubator's primary engagement in the context of a Section 3(b)(2) order.[12/] Accordingly, it is of fundamental importance that the incubator (in form and substance) functions *from the start of its existence* as an operating business and not an investment company.[13/] As such, the operating nature of the incubator must be reflected in all documents and actions relating to its business, including:

(i) the original limited liability company agreement and other constituent agreements of the incubator;
(ii) the press releases, websites, interviews of officers and directors and other general communications of the incubator;
(iii) the backgrounds, titles and activities of officers and directors of the incubator;
(iv) the representations to, and level of involvement and relationships with, partner companies of the incubator;
(v) the regular valuation and careful management of the assets of the incubator; and
(vi) the careful management of the sources of revenues of the incubator.

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Incubators undoubtedly operate in the traditional market space of venture capitalists. Their apparent advantages include their ability to provide an unprecedented network of contacts, a ready source of cash and stock to consummate transactions and patient capital that is not driven by IRRs or institutions seeking distributions. Notwithstanding the drawback of necessarily managing by with an eye on the 40 Act rather than purely by market forces, the incubator model has a great deal of promise in the information technology area and possibly in other areas of the marketplace.

12/ A Section 3(b)(2) order granted by the SEC may not be perpetual. Where there is a material change in circumstances and the incubator is uncertain whether it can rely upon the original exemptive order, the incubator may need additional relief. In such a case, the incubator may file an application for an amended exemptive order addressing the new circumstances.

13/ An incubator that commences operations as an investment vehicle in reliance on Section 3(c)(1) or 3(c)(7) of the 40 Act and then attempts to function as an operating business may not be considered favorably by the SEC for purposes of a Section 3(b)(2) order.

This Memorandum is intended solely for general informational purposes and should not be construed as, or used as a substitute for, legal advice with respect to the formation and operation of Internet incubators.

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