

Introduction

In a structure commonly referred to as an “up-C,” an existing limited liability company or other partnership form (referred to here for convenience as “LLC”) undertakes a public offering through a newly formed corporation, which is structured as a holding company that owns an interest in the LLC. Private companies owned principally by individuals or by private equity sponsors are frequently organized as LLCs or other entities that are considered partnerships for tax purposes. These entities are not taxed at the entity level, subjecting the owners to only one layer of income tax. Traditionally, if the owners wanted to undertake a public offering of the entity’s securities, the owners would re-organize the LLC or partnership as a corporation and offer and sell that company’s common stock to the public in the offering. Increasingly, owners are employing the up-C structure as an alternative. Use of the up-C approach allows the LLC or other entity to undertake a public offering, albeit through a holding company, while maintaining the partnership status for the LLC, where the principal assets and operations of the business remain. This structure is particularly attractive to private equity-backed companies because it maintains many of the tax benefits of a partnership, offers an ongoing exit strategy, and enables the sponsors to preserve some control over the business.

Overview of the Structure

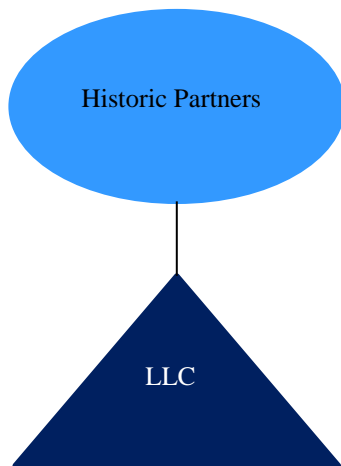
The up-C structure derives its name from the upREIT structure, which has been commonly used by real estate investment trusts since the 1990s. In the up-C structure, the owners of an operating business, organized as a partnership for tax purposes, form a corporation, with shares of Class A and Class B common stock, which becomes the managing member of the existing operating company. The newly formed corporation offers shares of Class A common stock to the public in an IPO. The shares of Class B common stock are issued to the historic owners and entitle the Class B holders to voting rights, but not economic rights (such as dividends or liquidation rights) in the new public company.

Following the IPO, the company will effectively be a holding company and will have as its subsidiary the LLC (as well as any of the LLC’s subsidiaries). The principal assets and operating business will continue to be at (or below) the LLC level.

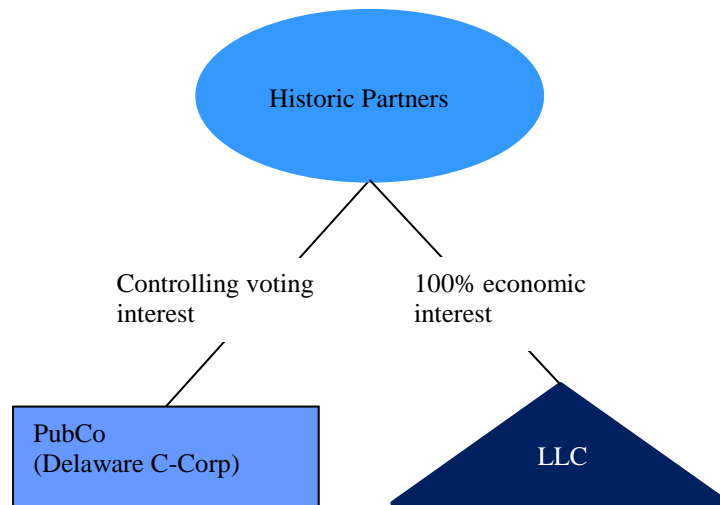
The company will receive the IPO proceeds from the sale of Class A shares, which it will then use to purchase LLC units from the LLC in connection with becoming the managing member of the LLC. These can be either newly-issued LLC units or, if the historic owners have determined to make a partial exit from their investment in the company, LLC units held by existing owners.

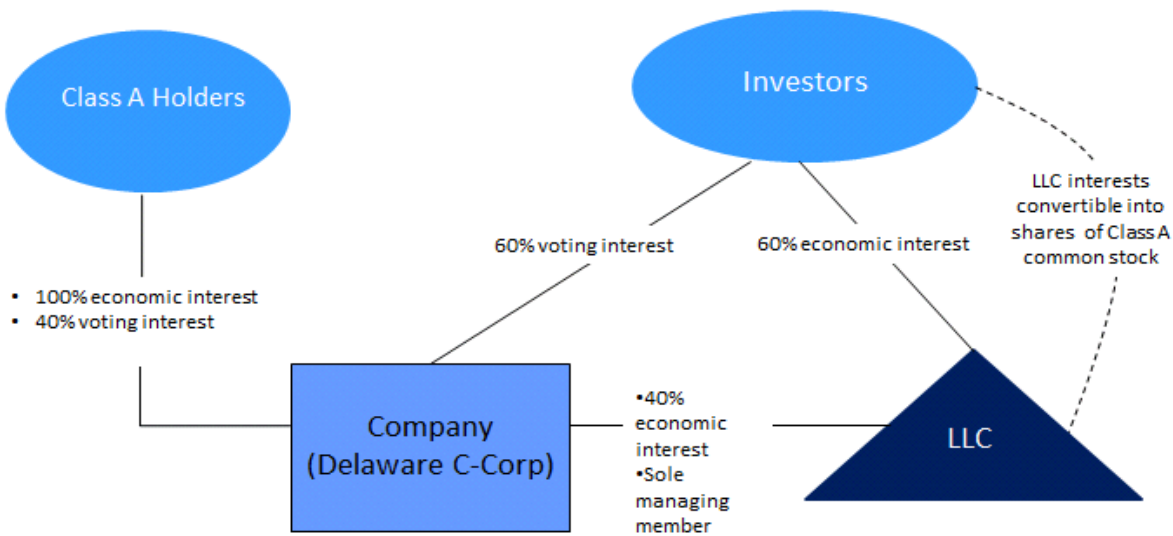
The following diagrams illustrate (1) a typical pre-IPO partnership structure, (2) a typical up-C structure immediately after formation of a C-Corp, and (3) a typical structure following the IPO of the company:

Pre-IPO



Following Formation of C-Corp



Post-IPO*

*The particular percentages can vary and have been included here only for illustrative purposes.

Overview of the BenefitsTax Benefits

The most significant benefits of the up-C structure for historic owners are contained in the terms of a tax receivable agreement (a “TRA”), which is an agreement entered into in connection with the IPO. Each time a historic partner exchanges units of the existing operating company for shares in the now public company, the company will receive a “step-up” in the tax basis of its assets. This tax basis step-up is allocated to the company’s share of the historic business’s assets, and in many cases the step-up is primarily allocable to intangible assets that are amortizable on a straight-line basis over 15 years (also referred to as “Section 197 intangibles”).

The up-C structure allows the company to pay the LLC members for the value of this step-up in basis, creating a market dynamic that permits value to be extracted from the company after the IPO, without decreasing the value of the company in the offering. The company pays a negotiated percentage, 85% or 90%, of the value of the actual state and federal income tax savings to the historic owners, pursuant to the TRA. For tax purposes, these payments are treated as contingent installment sale proceeds, generating both additional step-up and deemed interest deductions for the company. These additional step-up and deemed interest deductions increase the amount of any TRA payments over time.

Because public stockholders tend not to assign full value to the tax attributes of a corporation, they do not discount the value of a corporation to account fully for future payments to be made under a TRA. This has permitted historic owners of a business going public to capture additional value. The public stockholders also benefit from the pass through tax treatment at the LLC level because the up-C structure results in increased cash flow and higher earnings per share for the company.

Liquidity

There are significant additional benefits for the historic owners of a business that is contemplating an up-C structure. First, an existing equity owner is able to maintain its current ownership of a private LLC interest, with its tax structure, and remain subject to only one layer of tax. At the same time, the existing equity owners can also achieve liquidity, from time to time, with respect to their LLC interests, by exchanging the LLC interests for shares of Class A common stock of the company which may then be publicly-traded. However, when exchanged for Class A common stock, the securities are “restricted securities” as defined in Rule 144 under the Securities Act of 1933, as amended, unless registered pursuant to an exchange registration statement or a resale registration statement. The company will also have flexibility in using its equity to make strategic acquisitions or compensate its employees. It will be able to issue shares of Class A common stock (or for employees, options to purchase Class A common stock), but it could also issue LLC units to a strategic partner for whom the tax and other attributes of LLC ownership are attractive. Further, in any proposed acquisition or sale of the company, the purchase price could be increased significantly due to the value of the basis step-up.

Voting control

In connection with the IPO, the company will amend its certificate of incorporation and bylaws to provide that each LLC member will receive one or more shares of a newly-created Class B common stock. These shares of Class B common stock will vote along with the shares of Class A common stock, and will allow the holder to participate in any stockholder vote on an as-converted basis (i.e., each historic member of the LLC is able to vote as if it had already converted all of its holdings of LLC units for shares of Class A common stock, maintaining control over the business for the historic owners in line with their continued economic interests). Through this mechanism, the historic owners will continue to exercise control of the newly public company commensurate with their economic interest in the operating business.

Documentation Requirements

To effectuate the up-C structure, the newly-formed company will enter into various arrangements with the LLC and its historic owners. These include a TRA, an exchange agreement, and a registration rights agreement.

Under the TRA, the company agrees to make payments to the historic owners based on a percentage of the amount of savings realized by the company due to the increase in tax basis resulting from the exchange of LLC units. The customary distribution in tax savings is 85% to the historic investors and 15% to the company. Additionally, the TRA may provide for a lump sum payment to the historic investors in the event of a merger, asset sale, or other form of business combination or change in control. Notably, receipt of payment under the TRA is often not contingent on continued ownership in the company.¹

The exchange agreement will provide for the exchange of LLC units for shares of Class A common stock of the company. The agreement will be subject to certain transfer restrictions and other protections meant to minimize the burden on the company. For instance, the exchange agreement may restrict holders of LLC units from exchanging for shares of Class A common stock for a period of a year after the IPO and may require such exchanges to be made in increments of at least 1,000 LLC units at a time.

The company may also enter into a registration rights agreement with certain holders of Class A common stock (or other securities convertible into or exchangeable or exercisable for shares of Class A common stock, including the LLC units), which gives such holders the right to request that the company use its reasonable efforts to file with the Securities and Exchange Commission either an exchange registration statement or a resale registration statement covering the Class A common stock. Restrictions may be placed on resale registration rights, such as requiring a minimum amount of expected net proceeds before proceeding. Additionally, the registration rights agreement may also provide for “piggyback” registration rights, whereby other holders of LLC units have the right to include their shares of Class A common stock in any proposed resale registration statement.

SEC-Required Disclosures

The details of the up-C structure must be disclosed in the registration statement at the time of the IPO. The disclosure should focus on the following sections of the registration statement:

- Under the heading “Organizational Structure,” there should be a description of the formation/reorganization transactions (e.g., the formation of the corporation as a holding company to the LLC and the amendment of the LLC agreement), the transactions to be undertaken in connection with the IPO, and the post-IPO structure;
- Under the heading “Description of Capital Stock,” there should be a description of the two class structure, which explains, for example, voting rights, liquidation rights, rights to receive dividends, preemptive rights, or any other rights associated with the ownership of shares of Class A or Class B common stock; and
- Under the heading “Certain Relationships and Related Party Transactions,” there should be a description of, where applicable, the amended LLC agreement, the TRA, the exchange agreement, the registration rights agreement and any arrangement or transaction which qualifies as a “related party transaction.”

Use of the up-C Structure

Though some additional organizational complexity is introduced with the up-C structure, it provides a number of advantages to entities organized as partnerships pursuing an IPO. Historically, the up-C structure has not been widely utilized; however, issuers with larger market capitalizations, and with private equity owners are increasingly considering it as an alternative. As shown in the attached [Annex A](#), many high profile companies, like Shack Shake Inc., employed the up-C structure to access the public market.

¹ Companies considering using an up-C structure in an IPO should be prepared for additional accounting, modeling and compliance work associated with implementing and continuing to support a TRA. Going forward, the company will have to make TRA payments and accurately disclose potential liabilities under the TRA.

ANNEX A

List of Up-C IPOs (as of May 24, 2016)

Adeptus Health Inc.*	First Wind Holdings, Inc.	Pennymac Financial Services, Inc.*
AMC Entertainment Holdings, Inc.	Fortress Investment Group LLC*	Philadelphia Energy Solutions Inc.
American Renal Associates Holdings, Inc.*	FXCM, Inc.*	Planet Fitness, Inc.*
Amplify Snack Brands, Inc.*	GoDaddy Inc.*	Premier Inc.
Apollo Global Management LLC*	Graham Packaging Co., Inc.	Pzena Investment Management, Inc.*
Apparel Holding Corp.*	Habit Restaurants, Inc.*	Realogy Holdings Corp.
ARES Management LP*	Hanson Building Products Ltd	Red Rock Resorts, Inc.*
Artisan Partners Asset Management, Inc.	Health Insurance Innovations, Inc.	Re/Max Holdings, Inc.*
Artio Global Investors, Inc.*	Imperial Capital Group, Inc.	RHI Entertainment, Inc.*
Aurora Diagnostics, Inc.	Interactive Brokers Group, Inc.*	RMR Group Inc.
Aveon Group LP*	KKR & Co. LP*	Sabre Corp*
Berry Plastics Group, Inc.	Ladder Capital Corp*	Shake Shack Inc.*
BGC Partners, Inc.*	Lazard Ltd.*	Silvercrest Asset Management Group, Inc.
Blackstone Group LP*	LoanDepot, Inc.	Spark Energy, Inc.*
Cantor Entertainment Technology, Inc.	Malibu Boats*	Spirit Airlines, Inc.*
Carlyle Group LP*	Manning & Napier, Inc.*	Summit Materials, Inc.*
Chesapeake Oilfield Services, Inc.*	Medley Management Inc.*	Surgery Partners, Inc.*
Cloud Peak Energy, Inc.*	Mercury Payment Systems, Inc.*	Truett-Hurst, Inc.*
ConvergEx, Inc.	Moelis & Co.*	Turner Investments, Inc.
Duff & Phelps Corp.*	National Beef, Inc.	Vantiv, Inc.*
Dynavox, Inc.*	National CineMedia, Inc.*	Virgin Mobile USA, Inc.
Edgen Group, Inc.*	Neff Corp*	Virtu Financial, Inc.*
El Pollo Loco Holdings, Inc.*	Northern Tier Energy, Inc.	VTV Therapeutics, Inc.*
Emdeon, Inc.*	Oaktree Capital Group LLC*	Wayne Farms, Inc.
Enovation Controls, Inc.*	Och Ziff Capital Management Group LLC*	Woodside Homes, Inc.*
Evercore Partners, Inc.*	OTG EXP, Inc.	Wright Express Corp.*
Evolent Health, Inc.*	Parsley Energy, Inc.*	
Fifth Street Asset Management Inc.*	PBF Energy, Inc.	

*Public companies currently listed on stock exchange.

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