MEMO TO THE PARTNER

FORMATION OF A FOR-PROFIT SUBSIDIARY OF A NON-PROFIT CORPORATION TO FACILITATE TECHNOLOGY TRANSFER

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TO: Law Office Partner
FROM: Associate
RE: Non-Profit's Formation of For-Profit Subsidiary

At your request, I have researched two issues on behalf of our client, Research Foundation, Inc. ("RF"):

- Whether the formation and ownership of one or more for-profit subsidiary corporations of RF, organized under the laws of the State of Tennessee for purposes of technology transfer or development (the "Subsidiary"), is prohibited or restricted under applicable Tennessee corporate law or federal tax law; and

- Assuming formation of the Subsidiary, whether stock issued by the Subsidiary must be registered under federal or state securities laws.

Facts

RF is a "public benefit" not-for-profit corporation organized under the laws of the State of Tennessee and qualifies for an exemption from federal income taxes as a public charity under Section 501(c)(3) of the Internal Revenue Code of 1986, as amended (the "Code"). 26 U.S.C.S. § 501(c)(3). RF supports and assists in carrying out the research mission of various non-profit research centers in the State of Tennessee. RF's stated purpose in its organizational documents is to enhance the competitive position of the sponsored research centers for research and development funding, to facilitate expanded research and development activities at

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the sponsored research centers, and to facilitate the commercialization of research outcomes and the transfer of research-generated technology from the sponsored research centers to commercial and industrial enterprises in furtherance of economic development.

RF would like to form the Subsidiary, transfer technology or inventions to the Subsidiary, retain equity ownership in the Subsidiary, and provide for equity ownership in the Subsidiary by related inventors and third parties (including, potentially, venture capitalists). Through the Subsidiary, RF could promote entrepreneurial spirit and stimulate Tennessee's economy by supporting development and dissemination of intellectual property and by helping to create technology-related businesses. Creation of the Subsidiary is desirable because it would allow RF and the inventors more ownership in the technology or invention than under the current organizational structures and because it has the potential of generating more revenue through equity ownership for RF, the inventors, and outside investors. RF would like to have as much as 75 percent, or as little as 25 percent, ownership in the Subsidiary. The Subsidiary would allow for easier extraction of value by RF through the sale of all or part of its equity position and limit RF's liability to third parties for obligations of the Subsidiary.

Formation and Ownership of the Subsidiary

Under TENN. CODE ANN. § 48-53-101, a corporation may engage in any lawful business unless a more limited purpose is set forth in its charter. According to Section 3(a) of RF's charter, RF's purposes are (among other things):

> to enable promoting, supporting and carrying out the research mission of non-profit research centers in and outside the higher education system in the State of Tennessee . . . , to enhance the competitive position of Tennessee non-profit research centers for research and development funding, and to facilitate the commercialization of research outcomes and the transfer of research-generated technology from Tennessee non-profit research centers to commercial and industrial enterprises in furtherance of the economic development of the State of Tennessee . . . .

These express purposes are apparently lawful as written and do not exclude the possibility of state ownership in a for-profit entity that is used to achieve

these corporate purposes. Based on what we know, the Subsidiary would be formed by RF to serve these purposes.

Moreover, under the laws of the State of Tennessee, unless its charter otherwise provides, a not-for-profit corporation:

> [h]as the same powers as an individual to do all things necessary or convenient to carry out its affairs including the power to . . . (4) Purchase, receive, lease, or otherwise acquire, and own, hold, improve, use, and otherwise deal with, real or personal property, or any legal or equitable interest in property; . . . (6) Purchase, receive, subscribe for, or otherwise acquire; own, hold, vote, use, sell, mortgage, lend, pledge, or otherwise dispose of, or grant a security interest in; and deal in and with shares or other interests in, or obligations of, any other entity . . . and (19) Do all things necessary or convenient, not inconsistent with law, to further the activities and affairs of the corporation.

TENN. CODE ANN. § 48-53-102. RF's charter does not limit the powers granted to RF under TENN. CODE ANN. § 48-53-102; if anything, the charter reinforces those statutory powers as they relate to the formation and ownership of stock in a subsidiary corporation. For example, Section 3(a)(1)(i) of RF's charter specifically states that RF may "form, hold and dispose of interests in for-profit and not-for-profit subsidiaries and interests in entities formed or controlled by others to facilitate commercialization of the Intellectual Property of non-profit research centers in Tennessee." Accordingly, both the statute and RF's charter expressly provide RF with the power to form and own stock in the Subsidiary.

It is also important to evaluate the legality of the formation and ownership of the Subsidiary under the Code. Restrictions in this area are different for tax-exempt organizations that are private foundations than for tax-exempt organizations that are not private foundations (known as public charities). Every organization that qualifies for federal income tax exemption as an organization described in Section 501(c)(3) of the Code is a private foundation unless it falls into one of the categories specifically excluded from the definition of that term (referred to in 26 U.S.C.S. § 509(a)(1)-(4) of the Code). 26 U.S.C.S. § 501(c)(3). According to the director of RF, RF is a public charity. Under the Code, there are restrictions relating to certain attributes and activities of public charities, such as purpose, private inurement, and lobbying to name a few. 26 U.S.C.S. § 501(c)(3) and (h). However, I have identified no

restrictions relating to the formation and ownership of a for-profit corporation by a public charity. *See* U.S. Internal Revenue Service Publication No. 557 (May 2003) *available at* http://www.irs.gov/pub/irs-pdf/p557.pdf. In fact, a recent Revenue Ruling references facts that include ownership by a not-for-profit parent corporation of a for-profit subsidiary. *See* PRIVATE RULING 200315024, released Apr. 11, 2003. Therefore, the Code apparently does not prohibit or limit the power of RF to form and own the Subsidiary.

Federal Registration of Securities

Federal securities law requires that offers and sales of securities be registered, unless the securities or the transaction are exempt. 15 U.S.C.S. § 77e(a)-(c). A security, as defined by the Securities Act of 1933, as amended (the "1933 Act"), includes stock, unless the context requires otherwise. 15 U.S.C.S. § 77b(a)(1). Under applicable decisional law, stock issued by the Subsidiary would be considered a security (*see Landreth Timber Co. v. Landreth*, 471 U.S. 681 (1985) (analyzing when "stock" is a security); *United Hous. Found., Inc. v. Forman*, 421 U.S. 837 (1975) (same)), and the 1933 Act therefore requires that an issuer file a registration statement with the United States Securities and Exchange Commission ("SEC") and obtain an order from the SEC declaring the registration statement effective, unless an exemption is applicable. 15 U.S.C.S. § 77e(a)-(c). Registration is a costly and time-consuming process. Failure to register a security may carry criminal penalties, administrative sanctions, and private civil liability. *See* 15 U.S.C.S. § 77l.

Fortunately, the 1933 Act exempts certain kinds of securities and transactions from these federal registration requirements. An exempt security is not required to be registered when it is issued or traded. In order to qualify as an exempt security under the 1933 Act, the Subsidiary's stock would have to be one of a number of expressly listed securities, including, among others:

1) a government security, under 15 U.S.C.S. § 77c(a)(2);

2) commercial paper, under 15 U.S.C.S. § 77c(a)(3);

3) a security subject to non-SEC regulation, such as a security issued by a bank, under 15 U.S.C.S. § 77c(a)(2); or

4) a security of a not-for-profit issuer, under 15 U.S.C.S. § 77c(a)(4).

The Subsidiary's stock does not fit and likely will not fit into any of the categories of securities expressly listed in Section 3 of the 1933 Act. Accordingly, we must turn to the second type of exemption for relief from the federal securities law registration requirements.

The second type of exemption from registration is a transactional exemption. Securities offered or sold under a transactional exemption are not themselves exempt, and each time they are offered or sold, the offeror or seller must find an applicable transactional exemption to avoid registration. RF, therefore, must evaluate whether each transaction in which the Subsidiary offers, issues, or sells stock (whether to RF, an inventor, or a third party) meets the requirements of an exemption from registration.

Set forth below are brief descriptions of certain transactional exemptions that apply to primary offerings by an issuer. These exemptions do not cover subsequent trading by investors or secondary offerings by affiliates (including control persons) of the issuer. An offering sought to be exempted under a transactional exemption must meet all the exemption's requirements and conditions. I believe that the initial offers and sales of stock by the Subsidiary are likely to fit into one or more of these transactional exemptions.

Intrastate Offerings: Section 3(a)(11) of the 1933 Act exempts purely local offerings from registration. 15 U.S.C.S. § 77c(a)(11). For these purposes, a purely local offering is an offering by in-state issuers to in-state residents. Under this exemption, the issuer must be a person residing and doing business within the state of the offering. However, merely doing some business in the state is not enough. *See* Securities Act Release No. 4434 (Dec. 6, 1961) ("If the proceeds of the offering are to be used primarily for the purpose of a new business conducted outside the state of incorporation and unrelated to some incidental business locally conducted, the exemption should not be relied upon."). The requirements or "terms" of this exemption do not limit the amount of money that can be raised, how often the exemption can be used, or the number or sophistication of offerees and purchasers. If the Subsidiary is incorporated and doing business within the State of Tennessee, then the Subsidiary will be deemed to "reside" in the State of Tennessee. 15 U.S.C.S. § 77c(a)(11). The statutory exemption specifies that stock can only be offered and sold to persons resident within that same state. This means that all offerees and purchasers of the Subsidiary's stock must have actual resident and domiciliary intent in the Subsidiary's state of domicile. The statutory exemption is lost if any offer or

sale is made to an out-of-state resident. The exemption also may be rendered unavailable if any purchaser offers or resells to an out-of-state investor.

The SEC has interpreted Section 3(a)(11) narrowly. To offset these narrow rulings, the SEC promulgated Rule 147, a safe harbor rule with standards that define (among other things) the scope of a covered offering, when issuers and offerees are deemed to be in-state, and when out-of-state resales are permissible. *See* 17 C.F.R. 230.147.

Private Placements: Section 4(2) of the 1933 Act exempts from registration any offering by an issuer not involving a public offering. 15 U.S.C.S. § 77d(2). Courts have interpreted this provision to mean that registration of a securities offering is unnecessary only when investors have adequate sophistication and information to protect themselves. *See SEC v. Ralston Purina Co.*, 346 U.S. 119, 1453 (1953); *SEC v. Kenton Capitol, Ltd.*, 69 F. Supp. 2d 1, 24 (D.D.C. 1998). The requirements or "terms" of this exemption also do not limit the dollar size of a private offering or the number of investors; however, limiting the number of investors is often helpful to the overall analysis. *See* Securities Act Release No. 285 (Jan. 24, 1935); JAMES D. COX, ET AL., SECURITIES REGULATION: CASES AND MATERIALS 388-89 (3d Ed. 2002). The person claiming the exemption bears the burden of establishing it. The legal analysis of investor sophistication requires an assessment of the investor's ability to evaluate the investment and his or her access to information about the investment. Thus, a sophisticated investor requires less disclosure, and vice versa. The person claiming the exemption must show that each offeree and each purchaser meets this sliding scale test. If the person claiming the exemption cannot make an adequate showing as to any individual offeree or investor, then the exemption is lost for the entire offering. Investors who purchase securities in a private placement cannot offer or resell the securities without registration, absent an available exemption applicable to the offer or resale. Moreover, resales of private placement securities may transform the whole offering into a public distribution and ruin the original exemption for the private placement issuance to the investor and others.

Regulation D: Regulation D consists of three separate avenues of exemption from the registration requirements of the 1933 Act. A summary paragraph regarding each is set forth below.

Rule 504: Rule 504 generally provides an exemption from registration for offerings that are limited to an aggregate offering price of $1,000,000 in any twelve-

month period. An issuer that desires to rely on this exemption cannot be subject to the reporting requirements of Section 13 of the Securities Exchange Act of 1934, as amended (the "1934 Act"). 15 U.S.C.S. § 78m. Under Rule 504, there are no limits placed on the number or kind of investors, no affirmative disclosure obligation (other than disclosures deemed prudent to comply with Rule 10b-5 under the 1934 Act, and other applicable antifraud rules), no solicitation or advertising limitations, and no restrictions on resales.

Rule 505: Rule 505 may provide an exemption from registration for offerings, other than those made by an investment company, that are limited to $5,000,000 in any twelve-month period. The offering cannot be made by any form of general solicitation or advertising, and once the securities are purchased, they cannot be resold without registration or an exemption from registration. The offering can be sold to an unlimited number of "accredited" investors; however, Rule 505 limits the number of "nonaccredited" investors to 35. According to Rule 501(a), an accredited investor is a bank, an insurance company, a small business development company licensed by the Small Business Administration, or certain individuals or entities with specified financial sophistication, net worth, knowledge, and experience in financial matters. 17 C.F.R. 230.501(a). All non-accredited investors must receive exclusive written disclosure and have an opportunity to ask questions of the issuer.

Rule 506: In general, under Rule 506, an issuer can sell an unlimited amount of securities under the same basic conditions as Rule 505, with one added condition. If any sale is made to nonaccredited investors, each non-accredited investor must have (or be represented in the transaction by someone who has) sufficient knowledge and experience in business and financial matters so she can evaluate the merits and risks of the investment.

The terms of each offer and sale of Subsidiary securities should be evaluated, with the advice and assistance of counsel, to ensure that each is an exempt transaction.

State Registration of Securities

State securities (or "Blue Sky") laws also require the registration of offers and sales of securities, unless these laws are preempted by federal regulation or an exemption is available. Federal law does not apparently preempt state securities regulation of the initial offers or sales of Subsidiary stock. Depending on the federal

exemption to which the offering is subject, however, an applicable state law exemption also may apply. State law exemptions often largely parallel those exemptions provided in and under the 1933 Act. Exemptions vary from state to state, however, and may be more restrictive than the federal exemptions. For example, Tennessee law provides exemptions for (among other things): securities issued or guaranteed by the federal government; securities issued by a 501(c)(3) organization; and certain offers or sales of securities to accredited investors. *See* TENN. CODE ANN. § 48-2-103(a)(1), (2), and (14). Again, the terms of each offer and sale of Subsidiary securities should be evaluated, with the advice and assistance of counsel, to ensure that each is an exempt transaction.

Conclusion

Based solely on and subject to the foregoing, RF is permitted, under both applicable Tennessee corporate law and federal tax law, to form and own shares of stock in the Subsidiary. Furthermore, although the facts of each securities offering must be analyzed on an individual basis, it is likely that primary offers and sales of stock made by the Subsidiary will fall into an applicable exemption under federal and, perhaps, Tennessee securities laws.