National Venture Capital Association (NVCA)

As the voice of the U.S. venture capital community, the National Venture Capital Association (NVCA) empowers its members and the entrepreneurs they fund by advocating for policies that encourage innovation and reward long-term investment. As the venture community’s preeminent trade association, NVCA serves as the definitive resource for venture capital data and unites its 400 plus members through a full range of professional services. Learn more at www.nvca.org.

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Venture financings are almost exclusively structured as investments in C corporations. Is it finally time for venture professionals to modify this time-honored deal structure and to begin investing in limited liability companies? In my mind, it is.

Going back, I have tried to figure out how we got to where we are now and why we are stuck here. The first venture financing deal that I worked on was in 1982. As company counsel, I remember being impressed by the investment documents prepared by counsel for the investing venture funds. The investment agreement, charter, shareholder agreement, voting and co-sale agreement and registration rights agreement were tightly drafted, carefully integrated and appeared to cover seemingly every contingency with precision and clarity. There were some memorable provisions as well. In that deal, the preferred stock antidilution terms had a full ratchet. That took some time to understand, and once understood, I never fully accepted the concept. I still do not.

If one looks at the NVCA Model documents, the core elements of the documents presented to our client in that deal in 1982 have remained largely intact. Over the years, the forms have been refined, enhanced and fine-tuned. Other forms, such as indemnification agreements for directors, have been added. In short, the forms

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1 A full ratchet is the abbreviated term for ratchet antidilution whereby the conversion ratio of a convertible preferred stock is adjusted to the price that any shares issued at a lower price subsequent to the original issuance of the shares of convertible preferred are issued. The effect can dramatically increase the number of shares of common stock into which the preferred stock is convertible for the benefit of the holder of such preferred stock to the detriment of holders of other stock.

2 See www.nvca.org.
continue to be tightly drafted, carefully integrated and cover every known contingency. The forms and related commentary are very useful tools for practitioners and benchmarks for what is accepted practice in many cases.

As with everything in business, however, changes take place, and maybe it is time to rethink how venture deals are structured and documented.

Specifically, I would submit that there are now significant, multiple reasons for venture firms and their professionals to break from tradition and start using a modified limited liability company structure as the investment structure. I appreciate that many venture professionals are cringing and have now stopped reading. Those who have not stopped reading, please keep an open mind about what follows.

The Proposed Structure
The proposed structure is a passive Delaware-organized LLC holding company whose sole activity is to hold one or more wholly owned operating C corp subsidiaries. Employee equity is awarded at the holding company level (often in a more tax-advantaged manner than option grants as described below); UBTI/ECI\(^3\) is avoided since no operating income flows to the LLC during the term of the investment as the income is trapped at the C corp level; converting the LLC to a C corp on the eve of an IPO is easily doable.\(^4\) In addition, during the term of the investment, all of the complicated tax allocations that no one wants to understand or explain to multiple equity holders are largely irrelevant since no income flows to the LLC during operations and no tax distributions need be made. The only time these allocations come into play is when there is a dividend recap (a phenomenon present in the buyout world) or an exit event, and the allocations are generally straightforward at that time.

Before getting to the case for the LLC structure, it is worth observing that other investment professionals whose deal structure and documentation are similar to those of the venture investors, and who once exclusively used the C corp structure, have modified their practices over time.

In the parallel universe of the buyout world, LLC structures are being utilized frequently for portfolio company investments. As we all know, buyout professionals award employee equity, take companies public, deal with multiple investor groups with differing securities and different priorities, and sell companies in tax-free and taxable transactions. LLC-based documents for these deals are being refined and enhanced (much the same way corporate documents have been refined over time) and continue to be refined. Parties have gotten familiar and comfortable with and many believe (myself included) that all of the matters in the NVCA forms can be covered (and some of these matters can be covered in a better way) in the LLC

\(^3\) Many of the typical investors in a venture capital fund are tax-exempt investors, such as pension funds and college endowments, and foreign persons. The investment gains from portfolio investments for such investors are generally not subject to tax in the United States. There are exceptions to this treatment. For tax-exempt investors, the major exception is UBTI, which is “unrelated business taxable income.” UBTI is generally income from a trade or business. See Sections 511, 512 and 513 of the Internal Revenue Code. Therefore, income from a trade or business conducted by a pass-through entity, such as a limited liability company, would be taxable in the hands of the tax-exempt investors in the venture fund. Similarly, foreign investors are subject to tax on such trade or business income, which is known as ECI, or “effectively connected income,” i.e., income effectively connected with a U.S. trade or business. See Sections 864, 871, 881 and 882 of the Internal Revenue Code. Many venture capital funds place limits or outright prohibitions upon investments by the fund that will generate UBTI or ECI.

\(^4\) Some buyout firms that do not have tax-exempt or foreign investors use full pass-through entities, i.e., a single LLC and no corporate operating subsidiary, or a LLC at every level. This can be particularly useful at exit in allowing buyers to avail themselves of tax basis step-ups for asset purchases or for purchase of LLC interests (and appropriate elections) while maintaining one level of tax for the sellers. Occasionally, one will see an LLC structure for state law purposes electing to be taxed as a C corporation for federal income tax purposes. This permits the entity to avail itself of many of the more flexible attributes of the Delaware Limited Liability Company Act, but not the benefits from granting profit interests. Finally, some firms have developed complicated LLC-based structures that avoid UBTI and ECI altogether.
structure. In short, many buyout professionals now prefer the LLC structure.

Before getting into the positives of an LLC structure, one point needs to be dealt with. The principal rationales that I hear for the continued use of the C corp structure are familiarity, efficiency and standardization. These rationales may be rationales of default and habit. True, we are all familiar with corporate-based forms and the detailed statutory pattern that supplies many of the default rules; we all understand that parties to a venture financing want as little deviation as possible from the forms in most deals; and we all appreciate that keeping expense down and moving quickly through the deal process from term-sheet signing to final closing are highly desirable. All that said, with the exception of a truly straightforward Series A round with one or two investors who have worked together in the past and know each other’s preferences, there is complexity in these deals.

For example, if we add into the deal picture a warrant from a venture lender (with antidilution provisions), a license/equity agreement with a research university (also with antidilution protection but different language and preemptive rights), multiple rounds of preferred, pay-to-play provisions and so on, we have a fair level of complexity and nuance. That complexity needs to be worked through, and working through the complexity takes time and expense to be done correctly.

Why an LLC Structure?

Employee equity. On the subject of employee equity, I confess, up-front and fully, that I am not a believer in traditional stock options, given the alternatives.

My biggest problem with options occurs at the time of a liquidity event. Assume a sale of a venture-funded company for cash is in the works. In connection with the sale, unexercised options will be cashed out for the spread between the transaction price and the option exercise price. This spread is ordinary income to the option holder. There is no avoiding this result. Upon learning this, option holders often scramble, without success, to explore ways to convert ordinary income into long-term capital gains. It cannot be done. It is just not possible because the underlying stock cannot be acquired by option exercise and held for more than 12 months within the transaction time frame. To complete the picture, the selling corporation does get a corresponding ordinary deduction in the same amount as the income allocated to the option holders by reason of the option cash-out. Admittedly, this deduction can have value, and sometimes buyers will pay for this value. In other cases, neither buyer nor seller can utilize this deduction, and sometimes buyers are simply not willing to pay for this deduction.

The point is that the management team holding options is bearing an unnecessarily large tax burden that can be easily and painlessly avoided with an LLC structure. The burden can be substantial dollars (millions of dollars in some cases) in additional tax payable by the option holders. Consider the LLC approach to employee equity. In this structure, employees are awarded outright profits interests (meaning a direct ownership LLC interest in profits, losses and distributions of the LLC and not an option) that, as of the date of grant, can have a fair market value of zero (or if not zero, can be structured by setting a distribution threshold described more fully later in this section). The value for this purpose is determined under a special liquidation analysis sanctioned by the IRS. To determine this value, it is assumed that the LLC’s business is sold for fair market value and then liquidated, paying all LLC members in accordance with the LLC agreement’s distribution waterfall. For example, a profits interest granted at the time of a venture firm’s investment should have a zero value because, if the business held by the LLC were sold immediately after the investment, all the sale proceeds would be paid to the venture investors in respect of their preferred securities, and the LLC units held by management would not receive any distribution. The management units can participate in the growth in value of the business subsequent to the grant of the interest. For this reason, profits interests also have a real

5 If recipients of profits interests are employed at the operating subsidiary, the employee-owner problem is avoided. The IRS takes the position (see Revenue Ruling 69-184) that a partner in a partnership (or member in an LLC) cannot also be an employee of the partnership or LLC. Thus, the former employee holding a profits interest will have to report income on a partnership Form K-1 rather than the more familiar Form W-2 for wage withholding. Other consequences follow, such as estimated tax payments, self-employment taxes, potential changes in fringe benefits and potential tax return filings in every state (and foreign country) in which the LLC conducts business. These burdens are eliminated by the employee continuing to provide services to the operating subsidiary corporation while holding the profits interest in the LLC holding company.
advantage over restricted stock issued by a C corporation. 6

At the time of sale, the parent LLC sells the stock of its operating corporate subsidiary. There is one level of tax based upon the gain at the LLC level, which gain is passed through to the LLC members. If the stock being sold has been held for more than one year, which is inevitably the case, the proceeds, distributed to the equity holders (including management) are taxed at long-term capital gains rate at the current federal rate of 15%.

Another feature of the profits interests is that these interests can be granted after the original investment has appreciated in value (or at the time of the original investment, if the value of the interest is greater than zero) without any cost or tax to the management recipient at grant. At each grant date subsequent to the initial investment, it will be necessary to perform the same liquidation analysis described above. Once the business appreciates, it will be necessary to set a distribution threshold for the profits interests granted so that these interests will have a zero value at the date of grant. For example, if on the date of grant, each LLC unit would receive $1.00 of cash on a liquidation of the business, then the profits interest unit can only share in future liquidating distributions after all previously issued units have received $1.00 per unit.

To summarize, the receipt of a profits interest is not a taxable event to the employee, no matter when in the life cycle of the business it is granted, and distributions of sales proceeds can qualify for capital gains treatment. In addition, the interests can be granted with customary performance and time vesting provisions, and the interests are not subject to the burdensome tax rules of IRC Section 409A. 7 The ordinary income problem of options being cashed out described above is eliminated.

The subject of profit interests is, however, under review by Congress. 8

I have other problems with options but, admittedly, these problems are more annoyances and less significant.

When options are granted, unless the aggregate exercise price is nominal, the mindset of the issuing company and the option holder is that the options will likely never be exercised prior to the issuing company going public. Option holders do not like to write big checks for emerging company equity as there is a fair amount of risk. Put another way, option holders like upside potential but not downside risk. Option holders do, however, leave the employ of the issuing company before an exit event occurs. Options may be fully or partially vested at that time, and a limited time period will likely exist post termination of employment for the optionee to exercise the vested options or to have the options lapse. Option holders must decide whether to exercise or not.

So the question is — what disclosures should be made to the employee seeking to exercise, and how does the company cost-effectively protect against the scenario when the option holder exercises but the business ultimately does not do well, and the exercise payment made by an option holder is lost. Federal

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6 A particular advantage of profits interests as compared to restricted stock is the ability to issue profits interests at any time in the life cycle of a portfolio company without tax to the recipient. In the case of restricted stock, the value of the shares will increase as the company matures and that means the price to be paid for the shares by the service provider must increase or the service provider incurs a substantial tax on the compensation income once the restriction lapse, or is treated as lapsed pursuant to a special election made under Section 83(b) of the Internal Revenue Code. In the case of profits interests, the IRS has issued special safe harbor valuation rules permitting the recipient to treat the value of the interest as zero so long as the interest is subordinate to the market value of all other equity outstanding on the day of grant. The value of the outstanding equity is determined by assuming that the business is sold and then liquidated in accordance with the provisions of the governing documents. See Revenue Procedures 93-27 and 2001-43 and IRS Notice 2005-43 and Prop. Reg. Section 1.83-3(j).

7 Section 409A of the Internal Revenue Code can impose severe adverse tax consequences on certain deferred compensation arrangements of employees and other service providers. Stock options are subject to these rules. For example, if the exercise price of a stock option on the date of grant is not fair market value, then the spread, i.e., the difference between exercise price and fair market value, will be taxable when the option is vested and a penalty tax of 20% in addition to the regular tax on the compensation income may be imposed.

To ensure that the exercise price is equal to fair market value, the portfolio company may need to obtain an outside appraisal to substantiate the value. On the other hand, pursuant to current IRS guidance, a profits interest is not subject to the provisions of Section 409A. See IRS Notice 2005-1.

8 In recent years, several bills have been introduced in Congress proposing to enact a new section 710 of the Internal Revenue Code that would treat the net income attributable to an “investment services partnership interest” (commonly referred to as a “carried interest”) as compensation income except to the extent such income is attributable to a partner’s invested capital. These same rules would apply to members of a limited liability company, “investment services partnership income” is intended to include allocations of income to partners/members who perform investment management services on behalf of passive investors in a partnership/LLC. However, the language of the legislation is broad enough to include any carried interest in an LLC that owns a portfolio company where the employee of that company receives a carried interest in the LLC holding company as equity compensation for performing services for the portfolio company. It is hoped that if this legislation is enacted, Congress will clarify that these types of carried interests are not “investment services partnership interests” for purposes of Section 710.
and state securities laws (specifically the antifraud rules) apply to the option exercise. Not providing any information or providing incomplete information to the exercising option holder carries risk of an antifraud violation. Private companies are simply not geared up to provide complete, accurate and ongoing information to option holders who may wish to exercise. All of this is avoided with the outright grant of profit interests since no exercise (and no parting with funds) is ever required. Again, this point is not by itself enough to change practices, but it is another consideration in the analysis.

**The Trados challenge.** Oversimplified, the Trados case stands for the proposition that:

- Holders of preferred stock in a Delaware corporation
- Holding a majority of the outstanding voting stock
- With the right to designate a majority of the members of the corporation’s board of directors
- With no party holding any veto rights over a sale of the corporation
- Cannot easily or freely sell the corporation at a time at which the preferred holders receive all of the sale proceeds and the common holders receive no sale proceeds;

Naturally, there is more to the case than this summary, so some additional background is in order and needed to appreciate fully the Trados problem.

Trados was a software company funded principally by four venture firms. These firms held in various proportions several series of preferred stock in Trados constituting a majority of the preferred. Much of the preferred was a participating preferred so that after the preferred holders received their preference, they would also share along with the common.

The four venture firms held the right to appoint four of the seven board members and appointed active principals from their funds to the board. Two board members were Trados executives (CEO and CTO). The remaining director was an outsider.

Trados’ directors made a decision to sell the company in 2004. They engaged an investment banker, JMP Securities, and conducted, by all accounts, a real and substantive sales process. At some point during the process, it became clear that the sale proceeds would be less than the aggregate liquidation preference payable to the preferred holders. The board therefore adopted a carve-out plan for management. Under the plan, management would receive a graduated portion of the sales proceeds.

To set the stage, the common was out of the money, and I would assume that management options were likewise out of the money as well. So again, this is a pretty common scenario for a venture-funded company.

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going sideways. Ultimately, an agreement was reached with a buyer for a sales price of $60 million (less than the aggregate liquidation preference payable to the preferred holders) for Trados to be divided up amongst the preferred and management.

The company was sold. The common holders brought suit. The key claim asserted by the common holders was that by selling Trados at a price at which the preferred holders received all sales proceeds (other than carve-out proceeds) and the common holders received zero proceeds, the board violated its fiduciary duty of loyalty to the common stockholders. The Trados board sought to dismiss the case. The Delaware Chancery Court, however, declined to dismiss the case for the following reasons.

First, the court determined that the duties of the Trados directors ran to the common stockholders, not the preferred stockholders, if the interests of the common stockholders and the preferred stockholders were not aligned. Here, they were not aligned or, more accurately, they were partially aligned but only in the case, not present here, in which the common was “in the money” and both common and preferred were to share in sales proceeds after the preferred’s preference was paid.

Second, the directors were not independent (four directors were principals of firms that held preferred stock and received sale proceeds, and two directors were executives who were receiving carve-out plan proceeds), and the directors arguably violated their duty of loyalty. Further, since the directors were interested, they were not protected by the business judgment rule and the case proceeds to trial.10

This gets us to the truly troubling point about the decision, and this involves the duties owed by the board to the common stockholders about a company sale decision at a time where the common holders are receiving nothing. There is language in the case to the effect that, since the common holders were not receiving sales proceeds in the sale that occurred, the common holders would always be potentially better off not having the company sold until they were “in the money.” That is self-evident.

So the tough question is: what does a board controlled by venture-firm designees have to prove at trial that validates a board’s decision to sell at the time when the common is “out of the money.”

That question is left largely unanswered, and in my mind puts the corporate board in a very tough position when confronted with a situation like that in Trados. I would bet that most, if not all, venture investors have experienced a Trados scenario or will experience a Trados scenario at some time in their careers.

How can an LLC structure solve this challenge? The Delaware LLC statute permits parties to an LLC agreement to modify and even eliminate fiduciary duties. If fiduciary duties are eliminated, the only duty that the LLC members and managers owe to each other is the covenant of good faith and fair dealing, but not the duty of loyalty which caused the problem in Trados.

10 To reiterate, the Delaware Chancery Court has not found that the directors of Trados did in fact violate their duty of loyalty. The court simply refused to dismiss the case on this point. Dismissal is always highly desirable. All discovery is avoided; expenses are minimized, and disruption to the business is likewise minimized. The board’s argument to dismiss was as follows. A robust sales process was run by a professional banking firm. The company was sold to an unaffiliated third-party buyer. Nothing unusual or untoward. The technical path to dismissal for the board was to bring itself under the business judgment rule, which provides that, absent conflicts or self-dealing, board judgments if carefully reached are not to be second-guessed. The case therefore should be dismissed at the outset. End of discussion. The court in Trados refused to dismiss for the reasons discussed above.

11 Delaware Limited Liability Company Act Section 18-1101(e).
The duty of good faith and fair dealing has been described by the Delaware Supreme Court as follows:

“Delaware’s implied duty of good faith and fair dealing is not an equitable remedy for rebalancing economic interests after events that could have been anticipated, but were not, that later adversely affected one party to a contract. Rather the covenant is a limited and extraordinary legal remedy. As the Chancellor noted in his opinion, the doctrine ‘requires a party in a contractual relationship to refrain from arbitrary or unreasonable conduct which has the effect of preventing the other party to the contract from receiving the fruits of the bargain’.”

Accordingly, proving a breach of this duty places an exceptionally high burden upon a complaining shareholder to meet. In my opinion (and going out on a limb because there is no case on this point), a properly drafted LLC Agreement which eliminates fiduciary duties would deal with the Trados problem fully and cause the problem to disappear.

Structure of an Exit. Assume that it is time to sell a venture-funded company, and assume that the Trados problem is not present. The company has been in existence for eight years. It was originally funded by angel investors and has gone through several rounds of institutional funding. It now has 75 shareholders, 50 option holders, and 2 venture lender warrant holders.

In the corporate structure, it is impracticable to structure the sale as a sale of stock and have all 75 holders read, accept and sign the acquisition agreement. So the transaction is structured as a merger. If care has been taken at every step, the principal stockholders can likely “drag” along and require all stockholders to approve the merger and join in post-closing indemnity obligations on a pro rata basis. Options can be cancelled and cashed out.

It is not unusual, however, for the following to be at work. Some stockholders may not have executed each amendment to the Shareholders Agreement or the Agreement itself; there may not be a drag-along or waiver of dissenters’ rights in the relevant agreements; there is no certainty that a waiver of dissenters’ rights executed many years before the liquidity event is enforceable; some stockholders may object to the representations or post-closing indemnity obligations set forth in the Merger Agreement; some stockholders may be sufficiently upset with the proposed deal and their investment, and upon learning about the transaction, may even seek to enjoin the transaction after signing and prior to the closing. Buyers generally do not want to hear about any of this. Most buyers want a clean and uncomplicated acquisition of all of the stock of the target company and want to spend no time or money on dissenters’ rights, option holders’ rights or like matters pre-closing or post-closing.

Compare these challenges to how a sale transaction can be effected by a parent LLC of a corporate subsidiary. The managing board (controlled by venture investors) of the parent LLC votes to sell the corporate subsidiary; no stockholder meeting (or its equivalent) is required; no drag-along needs to be invoked; no dissenters’ rights are in force; no options need to be cashed out. The only parties to the agreement are the LLC parent and the buyer, and the agreement and actual closing can occur simultaneously if closing conditions are satisfied at the time of signing. In addition, the parent LLC would be making the representations in the agreement, providing a further level of protection to individual shareholders. Bottom line – no or fewer headaches with equity holders.

Flexibility of Process. Suppose you (venture investor) wish to fire the CEO. The CEO is a member of the board of the entity you have invested in. Technically, this requires a board vote, which can be done either by unanimous written consent or done at a meeting (with notice properly given or waived). Suppose you believe that the CEO will not sign a written consent, will not waive notice of a meeting, will insist upon a meeting, and in the worst case, may seek to enjoin the meeting and enjoin his or her planned termination. Suppose you just want to tell the CEO that he or she is fired and do not want to discuss or deal with corporate process or formalities. I appreciate that I may be overstating the problem here. That said, I have had clients tell me that they want to, and are prepared to, fire the CEO, and that they want to follow all the proper corporate procedures, but at the same time, they do not want to give notice and hold a formal meeting to effect the firing of the CEO for any number of valid reasons.

Again, consider how the firing can be effected with a properly drafted LLC structure. Action can be taken by the managing board, with less than unanimous written consent (presumably the board members other than the
There are ways to structure down rounds that provide protection to venture funds and board members from claims of breach of fiduciary duty of loyalty — outside fairness opinions; offering the down-round security to all stockholders; running a process seeking new investors and having such investors set the value for the new round by arm’s length negotiations; approval of terms of the round by disinterested board members or a special committee. All of these approaches are equally applicable to a down round done by an LLC or by a traditional corporation.

LLCs can avail themselves of an additional layer of protection. The protection is mentioned in the discussion of the Trados case. Claims by disgruntled equity holders in connection with down rounds are based upon violation of fiduciary duties (specifically the duty of loyalty). Again, these fiduciary duties can be modified or even eliminated by agreement in the LLC structure. Does this mean that venture board members are totally out from under such claims and the problem disappears? No. In my mind, a fiduciary duty waiver does not give a controlling investor complete latitude to conduct a down round at any price on any terms with impunity. It does mean that additional, meaningful protection is available and the burden for a party to pursue a successful claim is exceptionally high, as noted above.

**Information Restrictions.** The Delaware statutes on information that a stockholder or LLC member can obtain as a matter of right are similar but not identical. Suppose you have a former employee who has exercised options and left the company on bad terms, or suppose you want such a former employee to know as little as possible about the affairs of the company. Suppose also you do not want employees to know about the equity awards of other employees. The Delaware LLC statute, by agreement, permits limiting the availability of this information. The Delaware corporate statute does not permit such limiting.

There are likely other reasons to add to the above discussion in favor of choosing the LLC structure that investment professionals and practitioners have gained through their experience. In addition, I am hard pressed to think of any aspect of a venture-financed transaction that cannot be covered just as well by the LLC structure. Admittedly, there may be some additional complexity and some learning. For those not familiar with LLCs, some work is inevitably required to gain the appropriate level of familiarity. Once understood, the benefits from LLCs noted above are real. And finally, for those inclined, you can still have a full ratchet.

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13 Delaware Limited Liability Company Act Section 18-404(d).

14 Delaware Limited Liability Company Act Section 18-305(g).

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**Richard Small** is the Partner and Co-Chair of Edwards Angell Palmer & Dodge’s Private Equity & Venture Capital Group. Richard’s practice is heavily concentrated in leading attorney teams in sophisticated transaction work for private equity and venture investors, specifically mergers and acquisitions, divestitures, leveraged recapitalizations, debt and equity financings, joint ventures, mezzanine financings and venture capital investments (early and late stage) as both company counsel and investor counsel. He has also represented numerous management teams in connection with such transactions.

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