TechConnect

Your Law Firm Link to Industry News

FEBRUARY 2016

Letter from the Editors

As the Northeast begins (hopefully) to thaw out and we head into an early spring (so said the Groundhog), we are excited to deliver our new issue of *TechConnect* — our bimonthly newsletter on “all things technology” in the legal and business world, from our perspective, of course.

A few thoughts first. There has been significant “chatter” lately about what 2016 will bring from a deal flow perspective. And while no one has a crystal ball, the consensus is that there will be a bit more caution from investors as we witness the choppiness of our public capital markets, the decline in oil prices, the uncertainty in the Chinese economy, and the reality TV show masquerading as an election process here at home. As a result, deals may take longer to close and valuations may see a downward shift from the past 2+ years. However, here at Mintz Levin we have not seen any slowdown in the deal pace thus far, although we have noticed some investors asking for “harsher” terms and a new discipline in terms of valuations. But all of this may very well create significant opportunities for investors with funds to deploy and companies looking for acquisition targets. We have seen it before. As the year unfolds and we head toward the end of Q1, it will be interesting to see how things play out.

This issue contains some key industry news, a profile on an amazing tech company (Conduce), an article about what’s flying over our heads (drones and UAS), some key insights from our tax gurus, and, of course, a list of events taking place in key start-up hubs around the country.

As always, feel free to reach out to the team with inquiries or suggestions and please pass this along to your friends and colleagues. Also — don’t forget to check out our website focused on start-up and emerging companies: www.mintzedge.com

More to come in 2016 – stay tuned!

Leaders in the News

2016 MIT 100K Entrepreneurship Competition

Mintz Levin is proud to be one of the exclusive legal sponsors of the 2016 MIT 100K Competition providing

EDITORS

- Daniel I. DeWolf
- Evan M. Bienstock

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mentorship to semi-finalists and support for the many events during the course of the competition. The competition culminates in the “Launch” contest in May, when semi-finalists are expected to present not just prototypes but full business plans after receiving funding and elite mentorship along the way. Finalists present onstage to a 1,200+ live audience from Cambridge, Boston, and beyond. The Grand Prize is $100,000. Companies worth more than $16B in market capitalization have walked the stage before them, including Mintz Levin client, Sanergy, Inc., the 2011 MIT 100K winner. Applications will go live February 21, and be due on March 10 by midnight.

Interested in finding a team or co-founder? Attend the Launch Mixer February 23rd hosted by InTeahouse at 6pm in Central Square. Sign up here to join the invite list.

Innovator Profile

This month we turn the spotlight on Conduce, our client in beautiful Carpinteria, California, that is transforming the way companies see and understand all of their data to make better decisions. Conduce gives leaders a single pane of glass where they can see internal and external data from any source, and explore it any way they want — any data from any source in a single intuitive interface. It puts people in the middle of their data.

Kevin Parent, Christian Rishel, and Chris Harper founded Conduce in 2013. At the time, Parent and Rishel had been working at Oblong Industries, a company serially successful entrepreneur Parent co-founded in 2006. Rishel previously held marketing and executive roles at Google and JetBlue Airways and was also a consultant with McKinsey & Co. Before Conduce, Harper was part of the Enterprise Technology Strategy Group at Boeing after earlier technology and program management roles with IBM and Citicorp. Rounding out the initial management team are Founding Members Paul Botto, a tech veteran and also a former Google exec, and Ben Collins, a decorated former US Army Special Forces officer and frequent cable news talk show commentator on military intelligence issues.

Because Conduce works with any and all data sources, the breakthrough technology offers significant operational advantages across complex enterprises. Through instant situational awareness and transparent dissemination of critical insights to decentralized decision makers, Conduce enables leaders and teams to exercise more fully informed, smarter judgment. The company likens this dynamic to the principles of “battle management” in military operating environments where real time intelligence and best practices from the smallest units proliferate across the larger operating environment, rather than from the top down.

In fact, Conduce’s underlying technology was built for and further developed in the world’s most demanding military and commercial operating environments and the company brings unprecedented versatility and power to the “big data visual analytics” category. Conduce does indeed offer advanced visual analytics capabilities, but the category that includes the usual dashboards and business intelligence capabilities fails to fully capture the true value of Conduce technology. The term “analytics” serves as a convenient catchall, but also implies a retrospective examination of past events while one of the greatest advantages Conduce offers its customers is “observational insight” — the ability to see what is going on right now and instantly act on it operationally.

Following successful deployments across government installations and defense contractors, Conduce has partnered with Intel® as a member of its Internet of Things Solution Alliance to scale more rapidly. Conduce continues to actively pursue opportunities in retail, travel, health care, energy, manufacturing, defense and intelligence, and consumer packaged goods, along with partnerships with technology leaders, systems integrators, and management consultancies.

Mintz Levin worked with Conduce from its inception and has continued on not just as legal counsel, but also as trusted advisor during the company’s product development and expansion. “Every step of the way and almost every day, the Conduce management team has benefitted from the deep technology experience, seasoned business and legal judgment and absolute integrity of Dan DeWolf and the Mintz Levin team," noted Parent. "We consider them full and essential members of the Conduce team." As the world begins to catch up with what Conduce offers, we expect that Conduce will enjoy accelerating adoption and impressive growth.

Industry Update

Looking Above and Beyond: The Evolving UAS and Drone Regulations

By Sahir Surmeli and Jonathan Cain

There's a lot going on in the world of drone or unmanned aerial system (UAS) regulation in the United States. Companies from start-ups to large defense contractors are pursuing commercial opportunities to develop drones and drone technology. At Mintz Levin we are working with companies engaged in UAS manufacturing, aerial survey, and commercial cinematography to help them navigate the complex of regulations.

By law, any aircraft operation in the United States national airspace is subject to regulation by the Federal Aviation Administration (FAA). The FAA has established two regulatory schemes, the application of which depends upon whether a drone operation is commercial (i.e., for financial compensation) or for uncompensated, hobbyist use. Drones used for commercial purposes must either be certificated and registered aircraft or obtain a waiver from these regulations from the FAA and must be flown by a licensed pilot. Small drones used by hobbyists may be flown by unlicensed pilots, but the aircraft still must be registered.

If you own a small, non-commercial drone, it must be registered with the FAA's UAS registry, as of December 21, 2015. Under the rule, drone operators need to provide their name, home address, and email address. Upon completion of the registration process, the web application generates a Certificate of Aircraft Registration/Proof of Ownership that includes a unique identification number for the owner, which must be marked on the aircraft. Drone operators are subject to civil and criminal penalties if they do not register, including fines up to $250,000 and up to three years in prison. Providing false information on registration records is a serious federal offense. The new registration rule does not apply to super light drones — those weighing less than 0.55 pounds (250 grams) including payloads. Non-commercial drone operators are required to have a copy (paper or electronic) of the FAA registration certificate while operating the unmanned aircraft.

Commercial operators have different requirements. To carry out commercial operations "in low-risk, controlled environments" in the United States, a drone operator must apply to the FAA for a waiver under Section 333 of the FAA Modernization and Reform Act of 2012 (FMRA). Waivers under Section 333 are granted on a case-by-case basis. Obtaining a Section 333 waiver requires the commercial operator to develop a flight operations and maintenance manual for the aircraft and a flight procedures manual for the proposed commercial operations to demonstrate that the operation can by conducted safely in national airspace. Our team has obtained Section 333 waivers for our clients and can help with your application. Commercial operations rules currently require that flights be conducted by a licensed pilot during daylight conditions and that the aircraft be operated within the line of sight of the pilot.

The FAA is expected to issue a new rule regarding commercial drone registration and operations later in 2016.

Certain authorizations for experimental operations are also available. However, although these can allow privately owned drones to perform research and development, crew training, and market surveys, they do not permit carrying anything in exchange for compensation.

We have seen some commercial operators attempting to persuade potential customers that they have all required FAA authorizations when in fact they fail to possess the required authority. Customers in the market for commercial drone operators need to be aware of the requirements imposed upon these operators because while the customer may not be liable to the FAA for an unauthorized operation, the hiring of an operator to conduct an unauthorized operation may void the customer's liability insurance if the unauthorized operation resulted in damage to a third persons or their property.

There will be a huge opportunity for commercial drone operators in the coming years. There is a lot going on out there in the world of drone regulation, so if you need some guidance, let us know.

In the Spotlight

Excluding Your Gains on Small Business Investments

By Dan DeWolf and Rachel Gholston

2016 promises to be another very good year to invest in start-ups because of the extension of significant tax breaks for investors who invest in early stage companies. Investors who invest in small businesses can exclude capital gains realized on the sale of stock in such businesses if they choose the right type of company. The Section 1202 exclusion of 100% of gains on qualified small business stock has recently been extended, but this time there is no end in sight for this extension. When enacted, Section 1202 of the Internal Revenue Code provided a 50% exclusion from income of gains on the sale of stock of a qualifying small business held by an investor for more than five years. In recent years, this exclusion amount has been increased to 75% and then to 100%, but these higher exclusion rates have only been extended in short intervals. Now, thanks to the Protecting Americans from Tax Hikes Act, the “PATH Act,” signed into law in December of 2015, gains on qualifying small business stock obtained any time after December 31, 2014 and onward are eligible for the 100% exclusion. (See article below for more information.)

To take advantage of this exclusion investors have to invest in the right type of company. Investors should look for C-corporations with assets under $50 million to be eligible for this exclusion. Companies providing services in certain sectors, however, such as finance, law, health, and hospitality, are not eligible for this exclusion. Asking the right questions and doing your due diligence is crucial to determining whether an investment will allow you to take advantage of the 100% gains exclusion.

Under the rules as recently modified, if an investor invests in eligible qualified small business stock, and holds that investment for five years, then 100% of his or her gain is excluded from income up to the greater of ten times the basis and $10 million. Consulting with your legal and accounting advisors is recommended to see if you are eligible to take advantage of this major tax break.

While the exclusion extension is a step in the right direction for encouraging small business investment, we note that the incentive for investing in start-ups would be greatly increased if Congress chose to shorten the five-year holding period to a more reasonable duration such as a two-year holding period. But we leave that proposal for the next legislative session.

Featured Article

Two Tax Law Changes Favorable to Venture Capital and Private Equity Investors

By Roy W. Gillig and Sohail Itani

The “Protecting Americans from Tax Hikes” (PATH) Act was signed into law this past December, and two provisions in particular benefit venture capital, private equity, and other investors owning or planning to purchase a corporation.

1) Qualified Small Business (“QSB”) Stock: A tax break for those who invest in certain early stage or “start-up” companies.

Background. Non-corporate taxpayers who acquire QSB stock in a C-corporation at original issuance, hold such stock for more than 5 years, sell such stock at a gain, and meet certain other requirements, may exclude all or a portion of that gain from taxable income. Without this exclusion, gain from the sale of the stock will generally be subject to capital gains tax.

The change—complete tax exclusion extended. The percentage of the gain excludable is 50%, 75%, or 100%, depending on the date on which the QSB stock was acquired. With the enactment of the PATH Act, the 100% exclusion percentage is extended indefinitely, and is no longer scheduled to "sunset." The full exclusion previously applied on a temporary basis to stock acquired after September 27, 2010 and through 2014, but now applies indefinitely to stock acquired in 2015 and thereafter.

Requirements / limitations. Certain other requirements must be satisfied in order to qualify. For instance, the corporation in question must not be engaged in a variety of ineligible businesses (e.g., many service businesses, financial businesses, farming, natural resources, hotels, and restaurants). In addition, the corporation's aggregate gross assets must not exceed $50 million (measured using special rules) at any time up until and immediately after the original stock issuance. With respect to each taxpayer qualifying for the income exclusion, the amount of gain that can be excluded is generally limited to the greater of $10 million or ten times the tax basis the taxpayer had in the QSB stock when it was first acquired.

The $50 million limitation, coupled with the 10 times basis limitation, yields a potential exclusion of up to $500 million of gain for each eligible shareholder, making the QSB stock exclusion quite attractive for some.

Recommendation. Non-corporate investors in small businesses should be aware of this potential tax advantage, and may want to consider structuring investments with an eye on the QSB stock gain exclusion, including weighing the benefits of the exclusion against the benefits of flow-through taxation when choosing entity structure. In addition, investors should consider whether a currently held investment might qualify under the rules in the event of a sale of stock.

2) S-Corporation Built-in Gains Tax: Tax planning opportunity when acquiring a C-corporation with built-in gain assets

Background. Unlike a C-corporation, an S-corporation is generally not subject to entity-level taxation, but rather its income flows through to its shareholders. Therefore, while a C-corporation must pay tax on its sale of any appreciated assets (and then its shareholders must pay a second level of tax on a dividend distribution by the C-corporation), an S-corporation does not pay such tax (and thus there is no "double" taxation).

The Change. To prevent avoidance of the entity-level tax applicable to a C-corporation, a corporation with appreciated assets that elects to convert from C to S-corporation status is taxed on a post-conversion sale of any such appreciated assets, to the extent of built-in-gain at the time of conversion, if the sale occurs within a prescribed period after conversion. The law initially set the period at 10 years, but the period was temporarily reduced to 7 and then 5 years during the economic downturn. The 5-year recognition period has been extended indefinitely.

Recommendation. C corporations that are eligible to elect S status, or that would be eligible to make an S election if they restructured, should consider the benefits of the new rule in deciding whether to convert to an S corporation, or restructure to enable conversion. S status can be particularly beneficial to corporations that pay regular dividends or if a sale of the business is expected.

In addition, the previous 10-year period was usually beyond the planning horizon of most investors, and thus there were probably few acquisitions made with an eye on avoiding the corporate level income tax. With the adoption of the 5-year period indefinitely, investors purchasing a corporation should consider the potential advantage of structuring for S corporation eligibility. For instance, investors may purchase a C-corporation holding assets with a low tax basis, convert the target to an S corporation, and sell its assets after 5 years, avoiding entity-level tax attributable to any built-in gain in the assets that existed at the time of the conversion to S-corporation status, while still providing the buyer with a step-up in basis at no additional cost to the seller.

Upcoming Events

New York

February 23: NY Venture Capital Association's Digital Health & Bio Summit

February 24: Equities.com's Equities Emerging Growth & Innovation Forum

February 25: Diversity in Tech Awards Ceremony presented by Code Interactive

February 25: NYC Venture Capital and Angel Investor Conference sponsored by McCarter & English, LLP, WeiserMazars, Nolcha, FP Angels

March 1 – 2: Agility First! Forum: Hacking Leadership in Execution

March 3: Innovation & Investment 2016: 59th National Angel-VC Summit and Growth Capital Forum

March 3: Starlight Capital's New York Private Equity Forum

March 22: NY Venture Capital Association's Fintech Rising 2016

April 21: 5th Annual TechDay, sponsored by The Startup Companies, Inc.

April 24 – 29: Venture Out's Fintech Founders Club

April 26: Empire Startups NY FinTech Conference

Boston

February 23: TechCrunch Meetup and Pitch-off

February 23: The Other Side Speaker Series w/ Maria Thomas

February 23: VIP Roundtable: Creating SEO Magic

February 26: MIT Crowdfunding Do's and Don'ts: How to Leverage the Wisdom of the Crowd for your Startup

March 2: Testing your Social Venture: Iterating Based on Market Feedback

March 5: VCPE HBS Conference 2016

March 10: BostInno's Tech Madness 2016

March 23: 5th Annual M2D2 100K Challenge: Final Presentations

March 31: Xconomy Forum: Robo Madness: The A.I. Explosion

April 4 – 6: PartnerConnect East 2016

April 6: Xconomy's EXOME Presents: What's Hot in Boston Biotech

April 6: 5th Annual M2D2 100K Challenge: Winner Ceremony

April 7: MIT Starr Forum: Bitcoin and the Global Economy

San Francisco

February 23: Startup Grind's Global Conference

February 29 and March 1: AGC's 2016 Information Security & Broader Technology Growth Conference

March 1 – 2: Venture Summit West by youngStartUp Ventures

March 2: LAUNCH Festival 2016

March 9 – 11: Women's Private Equity Summit (Falk Marques Group)

May 5: The Second Annual NVCA Leadership Gala & Summit

May 5: TiEcon 2016

San Diego

February 23: Mintz Levin's Growing a Craft Brewery Panel Discussion

February 23: SGDVG VC Outlook 2016Growing

Washington, DC

February 29 – March 2: ARPA-E's Energy Innovation Summit

March 9: DC Inno's Tech Madness

May 9 – 12: IFC's Global Private Equity Conference

Mintz Levin Webinars

February 25: Biosimilars/Biologics Webinar Series – Part III: BPCIA Patent Litigation

March 17: Biosimilars/Biologics Webinar Series – Part IV: Transactions and Patent Portfolios

April 7: Biosimilars/Biologics Webinar Series – Part V: Post-Market Legal and Regulatory Issues

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