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SEPTEMBER 2017

Letter from the Editors

Words are very powerful and the language we use often frames a discussion. For example, the term “shareholder activist” sounds like a consumer friendly person who has everyone’s best interests at heart, when in fact the term “shareholder activist” is a phrase invented to cast corporate raiders in a better light. Such semantic gamesmanship often masks the reality of a particular situation.

Our first article in this edition is about SAFEs, which stands for Simple Agreement for Future Equity. SAFEs have become very popular as a legal instrument for use in the first round of funding for many enterprises, and they do indeed have a very catchy name. But the gamesmanship of this catchy name seems to mask the true nature of what the legal instrument is, when its use is appropriate, and whom it protects. Some people think they are notes (they are not); and some people think they should be used in crowdfunding (which is problematic). With all this confusion about what a SAFE is (and is not), we thought it would be useful to set out the pros and cons of this legal instrument so everyone can get a better understanding of what exactly is this pre-paid contract for future equity, which is now commonly called a SAFE.

Our featured company in this edition is QUIP. QUIP plans to revolutionize the toothbrush industry in a way similar to what Dollar Shave Club did to the shaving industry. This is a company to watch.

Additionally, we have two thought provoking articles regarding (i) the continuing challenges to entrepreneurs who are immigrants and need visas, and (ii) a recent tax court decision that may affect investment planning for non-U.S. investors in U.S. enterprises.

As always, we welcome your questions and inquiries and we invite all of you to visit our website for emerging companies @mintzedge.com.

Sincerely yours,

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SAFEs: The (Not So) Simple Agreement for (Potential) Future Equity

BY BRIAN NOVELL AND DANIEL DEWOLF

Historically, most start-up companies were funded either by the offering of equity or by loans in the form of convertible promissory notes. Recently, however, there have been some hybrid instruments created to fund start-ups. Most notably, and quite popular these days, is the use of an instrument called a SAFE. "SAFE" is an acronym for "simple agreement for future equity." A SAFE is a contract to receive an amount of equity as determined in a future priced round for which the investor pays the purchase price up front. Developed and released in late 2013 by Y Combinator, the SAFE is intended to provide a more efficient, clear, and simple alternative to convertible promissory notes, and notably lacks certain aspects thereof (including a set term, an interest rate, and a maturity date). Despite their name, SAFEs are not always as "simple" as expected, nor are they necessarily "for future equity" if conversion never occurs. Set forth below we discuss the pros and cons of SAFEs with respect to companies and investors.

Pros and Cons for a Company

SAFEs are generally very company-friendly and can provide companies with an effective financing option.

Pros:

- SAFEs may provide efficiency and expediency by use of a simple form. With fewer variables to understand and negotiate, terms can potentially be agreed upon more quickly.
- Decreased negotiation time can lead to savings on transactional and legal costs.
- SAFEs do not require that interest be paid on the principal amount.
- There is no requirement that the company shall repay the investment or guarantee that the investor shall receive equity. The investment shall convert into equity if, and only if, the SAFE's conversion trigger is achieved pursuant to a subsequent qualified financing by the company.
- Unlike convertible promissory notes, there is no deadline for conversion and this provides the company with tremendous flexibility as to timing for a true equity round.

Cons:

- Given the possible need for more extensive review and negotiation, the associated fees of a SAFE financing may be on par with a convertible promissory note offering.
- Sophisticated investors may object to using a SAFE. Depending on the respective bargaining power of the parties involved, a company may need to instead offer a convertible promissory note or other financing option.

Pros and Cons for an Investor

A SAFE is not investor-friendly and may be the least "safe" investment tool available to an early stage investor. With no certainty that an investment will ever convert into equity or otherwise be returned, investors should carefully analyze whether their investment decision falls within the range of situations in which the use of a SAFE may make sense for an investor.

Pros:

- Similar to the potential benefits of simplicity to a company, SAFEs may allow investors to incur lower transactional fees and increase the expediency of their investment.
- SAFE investors do still receive the benefit of a discount and/or valuation cap (similar to convertible promissory notes), which can add significant value to an investment.

Cons:

- SAFE investors assume most, if not all, of the risk, in that there is no guarantee of any equity ownership in the company. An investor exchanges cash for a hope that a conversion event occurs.
- A SAFE holder is not entitled to any company assets in the event of a liquidation.
- A SAFE investor cannot declare a default under the SAFE, and therefore has no leverage to force a repayment or a conversion on favorable terms if a company is not performing well.

- A SAFE is not eligible for 100% exclusion of tax on gains under Section 1202 of the Internal Revenue Code for qualified small business stock. In the event that the company is not successful, a SAFE would not be considered “stock” that could be written off as an ordinary business loss under Section 1244 of the Internal Revenue Code.
- In addition to the negative reasons why a SAFE investor may never receive equity in the company (such as the company going bankrupt before ever consummating a qualified financing), if the company does extraordinarily *well* and never needs to conduct a financing that meets the conversion trigger threshold, a SAFE investor may also never receive equity in the very most *successful* start-ups that are capable of self-funding.

Summary

SAFEs are certainly a potential fundraising tool for companies, but they include certain attributes that make them very company-favorable and, conversely, not so favorable to investors. While SAFEs have become increasingly popular among companies seeking fundraising efficiency, investors should be wary of becoming SAFE holders when other investment options may be available. However, depending on the situation, the use of a SAFE can be an acceptable choice based on the context and variables in play. Mintz Levin has great expertise in helping our clients develop strategies with regard to SAFEs and the other potential financing options available to companies and investors. Please consult with your legal advisor at Mintz Levin to discuss whether SAFEs makes sense for your next capital raising or investment event.

Innovator Profile: **quip**

quip

Since its beginnings in early 2015, **quip**, the Brooklyn-based dental start-up co-founded by former industrial product designers Simon Enever and Bill May, has swiftly reinvented the archaic dental healthcare industry. From its superbly designed electric toothbrushes to its subscription toothbrush-head and toothpaste replacement service, and its “dental connect” digital platform for customers and dental professionals, quip has made it easier, more enjoyable, and more affordable for customers to keep their smiles bright and healthy. For these achievements, quip has received unprecedented dental industry and press coverage, including recognition as one of *TIME Magazine’s* 25 Best Inventions of 2016, a place on the *O, The Oprah Magazine* “O-List,” and a 2016 *GQ* Grooming Award. With such accolades and its robust social media following, quip is revolutionizing the way people around the world approach oral healthcare.

quip’s service begins with its innovative toothbrush. Rejecting flashy pharmacy aisle gimmicks, quip has developed an ultra-slim brush designed to improve the brushing habits that truly matter. Vibrating bristles and a 2-minute timer with 30-second pulses guide users through a dentist-recommended 2-minute brushing technique, and twice daily brushing is encouraged through the slim metal handle design and a travel cover that doubles as a suction mirror mount to keep up with a modern, active lifestyle.

quip’s active customers never have to worry about replacing their worn out, ineffective toothbrushes. With quip’s first-of-its-kind toothbrush subscription service, a fresh brush head, new battery, and optional Anticavity Toothpaste (available in both “travel” and “home” sizes) automatically arrive at their doorsteps every three months. This service, which includes free international shipping, gives customers an easy way to make sure they’re always using a new, effective toothbrush.

And the benefits of quip’s subscription service don’t stop with brushes and toothpaste. quip educates users about oral healthcare at every touch-point. New customers receive a curated welcome pack with their first order, and existing customers get a quarterly magazine in every refill pack. In addition, quip also sends out a monthly newsletter, weekly blog additions, and daily social media posts that are accessible to existing customers and potential customers alike.

Finally, quip’s “dental connect” platform, which boasts a network of almost 10,000 dental professionals nationwide, works to simplify the process of scheduling regular dental checkups, making them both more affordable and more enjoyable. This platform is currently in beta with a service that connects users to their personal dentists and sends a reminder when it’s time for a six-month cleaning. With just one click, the service allows dentists to pay for an ongoing quip subscription as a reward for timely visits. Through this 24/7, all-inclusive digital site, quip smoothly combines its inspiring products with engaging oral healthcare education and a seamless professional services platform, making it the only service a family will require for its oral healthcare needs.

Industry Update: Tax Court Decision Provides Opportunities for Foreign Investors Investing in the U.S.

BY DAVID SALAMON

On July 13, 2017, the U.S. Tax Court issued its opinion in *Grecian Magnesite Mining, Industrial & Shipping Co., SA v. Commissioner*, in which the Tax Court held that a non-U.S. person who sells an interest in a partnership engaged in a U.S. trade or business generally is not subject to U.S. federal income tax, except to the extent such interest is attributable to the non-U.S. person's share of the partnership's U.S. real property interest. The Tax Court declined to follow the IRS's position in Revenue Ruling 91-32 that a foreign person's gain from the sale of an interest in a partnership engaged in a U.S. business is itself treated as effectively connected income (ECI), causing the foreign person to be subject to U.S. federal income tax on such gain. The Tax Court's decision may provide significant structuring opportunities for foreign investors investing in U.S. businesses that are in pass-through form.

The Tax Court Decision

In 2001, Grecian Magnesite Mining, Industrial & Shipping Co., SA (GMM), a Greek Corporation engaged in the business of extracting, producing, and commercializing magnesite, invested in Premier Chemicals, LLC, a Delaware LLC that is treated as a partnership for U.S. federal income tax purposes and engaged in a U.S. trade or business. In 2008, the LLC redeemed GMM's interest in exchange for cash. GMM conceded that a portion of the gain on the redemption was attributable to U.S. real property interests held by the LLC and taxable under Section 897(g) of the Code. At issue before the Tax Court was whether the remaining gain from the redemption of GMM's interest was ECI and therefore subject to U.S. federal income tax.

Based on Revenue Ruling 91-32, the IRS held that the remainder of the gain should be taxable as ECI and therefore subject to U.S. federal income tax to the extent attributable to property of the partnership that was used or held for use in the partnership's U.S. trade or business.

Whether a foreign person's sale of a partnership interest results in ECI is largely dependent on whether an interest in a partnership is treated as an interest in an entity (the "entity approach") or whether an interest in a partnership is treated as an aggregation of assets held by the partnership (the "aggregate approach"). U.S. taxation of partnerships adopts an entity approach for some purposes and an aggregate approach for others.

Revenue Ruling 91-32 applied the aggregate approach and therefore held that the sale of a foreign person's interest in a U.S. partnership would be treated as if the partner sold its proportionate share of the property held by the partnership. This would result in the foreign seller's gain to be subject to U.S. income tax if such gain is attributable to the partnership's underlying property that is used in a U.S. trade or business. The Revenue Ruling was widely criticized for adopting the aggregate approach without the support of any statutory or regulatory authority.

The Tax Court criticized the Revenue Ruling's analysis as cursory and stated that as a general rule, the Code applies an entity approach when dealing with the transfer of partnership interests unless an exception exists. Therefore, the Tax Court declined to follow Revenue Ruling 91-32 and held that the entity approach should control so that the redemption of GMM's interest in the LLC should be treated as the sale of an interest in an entity (not the underlying assets) by a foreign person. As such, the gain recognized by GMM should be treated as foreign sourced income under the default rule of Section 865(a) of the Code and not ECI.

Planning Opportunities

If the Tax Court's decision is not appealed or is sustained on appeal, the decision may have significant implications for how non-U.S. investors structure their investments in partnerships and LLCs that operate a business in the U.S. Many private equity fund structures insert a U.S. "blocker corporation" between a U.S. partnership and the foreign investors to block ECI, thereby preventing attribution of a U.S. trade or business to the foreign investor and relieving foreign investors from U.S. tax reporting obligations. However, the blocker corporation structure is not ideal because the blocker corporation will pay tax on its income. The Tax Court's holding will allow a foreign investor to invest in a U.S. partnership without inserting a blocker corporation where gain is not expected to be attributable to U.S. real property.

Note, however, that the Tax Court's decision only affects the treatment of gain on a non-U.S. person's disposition of an interest in an LLC or partnership. It does not change the general rule that a non-U.S. person is subject to U.S. federal income tax with respect to its distributive share of an LLC's or partnership's U.S. source of current income.

Opportunity Foreclosed: The International Entrepreneur Parole Rule May Die Before it Gets Out of the Gate

BY SUSAN COHEN

The U.S. and worldwide entrepreneur community had been looking forward to July 17th with great anticipation. This was supposed to be the effective date of the new International Entrepreneur Parole immigration regulation. This refreshing and innovative immigration option for foreign entrepreneurs would solve an enormous problem in the U.S. immigration system: the non-existence of a visa for start-ups founded by or being driven by talented foreign nationals. Yet on July 11, 2017 the Department of Homeland Security published a notice in the Federal Register seeking comments on its desire to rescind the rule.

This entrepreneur parole process would not have been a cakewalk for applicants: only those who could meet the stringent requirements associated with it would be able to qualify (to be approved, entrepreneurs would have to own at least 10% of the enterprise and would have to have raised significant capital from established U.S. investors or government grants). Applications would be very strictly reviewed, and only applicants who clearly qualified and passed required government background checks would be approved for this temporary status.

Yet despite the strict criteria, the entrepreneur community was delighted that the U.S. government (during the Obama administration) had finally rolled out an immigration solution to the enormous talent crisis facing the U.S. technology sector.

The technology industry is fueled in large part by immigration. As of January 2016, immigrants had started more than half (44 of 87) of America's start-up companies valued at $1 billion dollars or more, and they are key members of management or product development teams in over 70% (62 of 87) of these companies.* Immigrants play vital roles in the technology industry in job creation, innovation, and leadership.

The data shows that these immigrants are not taking jobs away from native-born Americans – instead they are creating jobs for Americans. For years the U.S. has not graduated enough graduates in STEM fields to fill even a fraction of the open positions requiring STEM skills. By 2020, projections indicate that 1.4 million computer specialist positions will be open in the U.S. but domestic universities will only produce enough graduates to fill 29% of those jobs. As an example, in Massachusetts today, there are 17 technology jobs for every person who graduates with a college degree in computer science or information technology. And international students are disproportionately more likely to get their degrees in a STEM field – they make up over 30% of the post-baccalaureate degrees in STEM fields. These immigrants are not just studying STEM subjects – they are innovating and inventing technology, pharmaceutical, and engineering solutions at a rapid pace. In 2011, 76% of patents awarded to the top 10 U.S. patent-producing universities had an inventor that was foreign-born. In recent years, foreign nationals contributed to more than three quarters of patents in the fields of information technology, molecular biology and microbiology, and pharmaceuticals. Many of these inventions are making all of our lives better. In 2016, all six American winners of the Nobel Prize in economics and scientific fields were foreign-born.

To remain competitive in the global marketplace, the U.S. needs to be able to attract and retain the best talent, the sharpest minds, and those who are passionate about building solutions, building companies, and building community. While we have many home-grown entrepreneurs who fit this description, we do not have enough of them. We need, and should be welcoming, not turning away, brilliant, hard-working, upstanding foreign entrepreneurs.

Despite paying lip service to the need to create jobs and economic growth, the current administration seems bent on ending the International Entrepreneur Parole solution without focusing on or acknowledging the myriad positive contributions of immigrants to our country.

Other countries will benefit from the vacuum that will be created by the dissolution of this rule. Canada, for example, has a very entrepreneur-friendly immigration option. If this fledgling International Entrepreneur Parole program is not revived, the U.S. will have lost a major battle in the highly competitive, global war for talent.

**All statistics cited in this post are from The Economic Impact of Immigration on the U.S., published by the Mass Technology Leadership Council, June, 2017.*

Upcoming Events

New York

Sept. 28: The LAVCA Venture Investors Annual Meeting

Sept. 28: Selling to Cities: Strategies for B2G Startups

Sept. 28: TAP 2017
Oct. 2-4: O'Reilly Velocity
Oct. 11: Fintech Rising Summit
Oct. 16-20: Techweek New York
Oct. 18: Maverick's Dinner
Oct. 18: Products That Count: TransferWise US Product Lead on Building Products with Distributed Teams
Oct. 25-26: Programmatic I/O
Oct. 26: GCV Synergize
Oct. 26-28: New York VR Expo
Oct. 29-Nov. 1: O'Reilly Security
Nov. 1-3: ONWARD
Nov. 2-3: Women's Alternative Investment Summit New York
Nov. 7: NVCA Growth Equity Reception
Nov. 16: The Brand Safety Summit
Nov. 30: Tearsheet Hot Topic: Mobile Payments

Boston

Sept. 28: Boston's Life Science Disruptors
Sept. 28: Why Every Startup Needs a Culture of A/B Testing
Sept. 28: Think Like an Entrepreneur (Series): #1 Define the Problem
Sept. 28: Venture Cafe's Robotics and Artificial Intelligence (AI) Mini-Conference: "Building Markets for Artificial Intelligence"
Sept. 29: Startupapalooza
Sept. 30: E3PowerUP2017 Women Entrepreneurs Conference
Sept. 30: Product Management Bootcamp
Oct. 3-4: InsureTech Connect
Oct. 5: AR/VR Studio Showcase
Oct. 10: Think Like an Entrepreneur (Series): #2 Find Your Customers
Oct. 11: Harvard Innovation Labs Startup Stories and Showcase: "The Power of Telling a Great Story"
Oct. 12: MITX After Dark Featuring Customer Portfolios
Oct. 17: Creating a Game Plan for Your Digital Transformation
Oct. 25: MITX Talent and Career Development Summit
Nov. 1: Creating a Healthy, High Performance Culture
Nov. 2: Xconomy Presents: Healthcare + A.I.
Nov. 9: MITX Influence(her) Off the Record
Nov. 15: QRCC Seminar 2017

San Francisco

Oct. 1-5: Oracle OpenWorld 2017
Oct. 1-5: JavaOne
Oct. 4-5: Private Fund Finance & Compliance Forum
Oct. 5: issuu Generators Summit
Oct. 10: NVCA Impact Investor Reception
Oct. 10-12: GitHub Universe
Oct. 10-12: BoxWorks 2017
Oct. 17: SF MusicTech Summit
Oct. 17-18: LAUNCH Scale
Oct. 18-19: Tech Inclusion
Oct. 18-19: Samsung Developers Conference
Oct. 20: The Information Subscriber Event

Oct. 23-26: IT/Dev Connections
Oct. 24: 500 Startups Demo Day
Oct. 25-26: Virtual Reality Strategy Conference
Oct. 29-Nov. 3: LISA17
Nov. 2-3: KotlinConf
Nov. 5-6: droidcon SF
Nov. 6-9: Dreamforce
Nov. 13-14: Virtuous Circle Summit
Nov. 13-17: DevOps Enterprise Summit
Nov. 14-15: Structure
Nov. 29-30: The Open Mobile Summit

San Diego

Sept. 28: ISSA San Diego Luncheon September 2017 – Women in Security Panel
Oct. 2: San Diego Big Data Analytics & Hadoop Training – Omni212
Oct. 9: 2017 DOE Peer Review & EESAT Conference
Oct. 12: USD Legacy Entrepreneurship Conference 2017
Oct. 12: 2017 ACE Women's Conference Leadership Forum
Oct. 17: RESO DataComp
Oct. 19: CRASD Networking Event – The Future of Technology in CRE
Oct. 23: ResponseCon San Diego
Oct. 27: SOHL Annual Conference
Nov. 2: ACH Risk Management (com) A
Nov. 8-10: AbacusMaximus 2017

Washington, DC

Oct. 2-3: Kayo Women's Private Equity Conference
Nov. 1: Strategic Operations & Policy Summit (FKA CFO Boot Camp)

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