

MEMORANDUM

TO: Cross Community Working Group to Develop an IANA Stewardship Transition Proposal on Naming Related Functions ("CWG")

FROM: Sidley Austin LLP ("Sidley")

RE: PTI Structure: Non-Profit Public Benefit Corporation or Limited Liability Company

DATE: May 13, 2015

Overview and Qualifications

Based on the recent discussions between the CWG and Sidley with respect to whether to structure Post-Transition IANA ("PTI") as a California non-profit public benefit corporation or a Delaware limited liability company ("LLC"), you asked that we provide the CWG with an analysis of the key differences, as well as the advantages and disadvantages between these two entity structures.

Please note that the analysis provided below is preliminary in nature, tailored to the discussions between the CWG and Sidley, and provided to help facilitate CWG's consideration of options with respect to the PTI entity structure. It should not be relied upon by other persons for other purposes. This draft memorandum reflects our preliminary independent reactions regarding these matters and has not been reviewed by any third parties.

Unless otherwise expressly stated, this memorandum is based on California and Delaware law, and in particular, the laws governing California non-profit corporations (California Corporations Code, Title 1, Division 2) and the laws governing Delaware limited liability companies (Delaware Code, Title 6, Chapter 18).

1. Governance Generally

A public benefit corporation requires greater formality and provides less flexibility than an LLC in establishing the corporate governance of the entity. As described further in section 4, some of these formal requirements are mandated by statute.

An LLC structure generally provides a great deal of flexibility in establishing an entity's governance structure. Ordinarily, the governance of an LLC would be set forth in an operating agreement. The LLC operating agreement is a contract between the members of the LLC and the LLC, and would typically outline how the entity is governed, including the rights members have to vote on certain matters and whether the LLC will be governed by the members or by a manager or board of managers that would function like a board of directors.

2. Composition of the Board

The board of a California public benefit corporation must consist of one or more directors, who are empowered to exercise oversight over the management of the affairs of the corporation. Under California law, no more than 49% of the directors may be "interested persons." "Interested persons" include: (A) any person compensated for services rendered to the corporation (other than as a director) during the previous 12 months, and (B) certain

family members of interested persons. Thus, the public benefit corporation's board could not consist solely of individuals employed by that same public benefit corporation.

An LLC is not required to have a board oversee the management of its affairs. An LLC can be managed by the member(s) or it can be managed by a manager or board of managers operating under the terms of the operating agreement. The managers may be given whatever oversight is desired and specified in the operating agreement. A board of managers could consist of representatives selected in the manner specified in the operating agreement and would oversee the performance of the LLC in much the same way that a corporate board would provide oversight of a corporation's management. However, the "interested persons" rule described above would not apply to a Delaware LLC; so there would be flexibility to determine who serves on the board of managers of the LLC.

3. **Fiduciary Duties of the Board.**

Under a public benefit corporation structure, each director is a fiduciary and has duties to act prudently (duty of care) and in good faith in the best interests of the corporation (duty of loyalty). In addition, in a public benefit corporation, a director also has a duty to carry out the mission expressed in the articles of incorporation of the corporation (duty of obedience).

A LLC organized under Delaware law does not require the managers to be fiduciaries. The operating agreement could eliminate any fiduciary duties of managers or other persons participating in the governance of the LLC (except for the implied contractual covenant of good faith and fair dealing which cannot be eliminated). Thus, in this regard, the LLC structure offers more flexibility.

4. **Responsibilities of the Board.**

Under a public benefit corporation structure, the California statute prescribes certain responsibilities of directors. These include:

- (a) adhering to the articles of incorporation and bylaws;
- (b) keeping minutes of board meetings, keeping accurate written books and accounting and keeping a membership list if there are members;
- (c) electing officers;
- (d) adopting the annual budget;
- (e) issuing annual reports and financial statements;
- (f) designating a depository institution for the funds of the corporation and authorized signatories;
- (g) bringing or defending legal actions on behalf of the corporation;
- (h) approving certain significant transactions like sales of corporate assets, mergers or dissolutions; and
- (i) if the public benefit corporation's annual revenue is in excess of \$2 million, the board will be required to have an audit committee and provide audited financial statements

in its annual report. The duties of the audit committee members include: (i) recommending auditors to the full board of directors; (ii) negotiating the compensation for auditing services; and (iii) reviewing and approving audited financial statements. There is no statutory requirement as to how often the board of directors must meet; typically, a board would meet at least once per year.

In addition, the bylaws of the corporation may impose additional restrictions or obligations on the board of directors so long as the role of the board is consistent with the statutory requirements.

There are no minimum statutory obligations of a board of managers under Delaware law with respect to an LLC. However, if desired, it is possible to impose obligations on the board of managers pursuant to the operating agreement and all managers would be required to adhere to the terms of the operating agreement. For example, an LLC structure could be utilized, but the governance structure could replicate, by contract within the operating agreement, the role of a board in a California public benefit corporation. The role of the PTI board in an LLC can be customized to be consistent with the overall strategy of accountability that is determined by the CWG to be appropriate.

5. **Tax-Exempt Status Considerations**

If PTI is incorporated as a California public benefit corporation, it will need to obtain its own determination of tax-exempt status from the U.S. Internal Revenue Service (“IRS”) and the California Franchise Tax Board (“FTB”). PTI will not simply be able to rely on ICANN’s existing tax-exemption determinations, and will have to file annual tax returns with both the IRS and the FTB.

There is a risk that the IRS may view PTI’s activities as a purely commercial “fee for service” activity, rather than as furthering a tax-exempt purpose, and deny the exemption. In our experience, it is difficult to predict the IRS’ view on whether the exemption would be granted. In light of the broad public interest served by the internet, and the U.S. Government’s current interest in its operations, we believe that a strong argument can be made that, despite ICANN’s largely fee for service revenue model, it lessens the burdens of government and therefore should be tax-exempt. However, please note that it would be necessary for Sidley to conduct additional research and also gain a more complete understanding of all aspects of ICANN’s activity to have a more accurate assessment of this issue, if the CWG determines it necessary.

In addition, there is a risk that an exemption application for PTI could cause the IRS to revisit ICANN’s exemption.

If PTI is structured as a single member LLC, PTI will be a “disregarded entity” and treated for tax purposes as part of ICANN (as is currently the case). Accordingly, no separate tax exemption would be necessary for PTI; instead, PTI’s activities would be reported to the IRS as part of ICANN’s annual tax-exempt organization returns. (A minimal filing and payment would be due to the FTB). Since no new exemption application would be required to the IRS or the FTB, there is less risk of a change in the tax treatment of the types of income that will be recognized by PTI (and ICANN).

6. **Bankruptcy Protection**

From a U.S. federal bankruptcy perspective, there are some advantages to utilizing a public benefit corporation structure as opposed to an LLC structure. The principal advantage is that the U.S. Bankruptcy Code provides certain unique safe harbors for a “corporation that is not a moneyed, business, or commercial corporation.”¹ In particular, the safe harbors:

- (a) prohibit creditors from commencing involuntary federal bankruptcy proceedings against such entities,
- (b) prevent the conversion of a U.S. federal bankruptcy proceeding under Chapter 11 (the Bankruptcy Code’s reorganization chapter) to a proceeding under Chapter 7 (the Bankruptcy Code’s liquidation chapter) with respect to such entities, and
- (c) honor certain non-bankruptcy law restrictions on the transfers of such entities’ property.

Although an LLC could be considered a “corporation that is not a moneyed, business, or commercial corporation”, the courts that have considered the meaning of this phrase have frequently looked to applicable state law concerning the entity’s corporate form. In those instances where the entity in question was formed under a non-profit statute, the courts have found this factor persuasive (although not necessarily controlling).

Accordingly, as a public benefit corporation, any argument that the safe harbors should apply to PTI will be improved, perhaps significantly so.

While a public benefit corporation structure presents some very helpful advantages from a U.S. bankruptcy perspective, either legal structure can be constructed to enhance the bankruptcy remoteness of PTI.

¹ Note: The Bankruptcy Code defines the term “corporation” to include most business entity forms, including unincorporated entities, but expressly does not include limited partnerships (not applicable here).