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Q&A With Foley & Lardner's Gabor Garai

Law360, New York (October 07, 2011, 1:45 PM ET) -- Gabor Garai is a partner in the Boston office of Foley & Lardner LLP, where he chairs the firm's privacy equity and venture capital practice. He represents venture and buyout funds in their fund formation, investment and mergers and acquisitions activities. He concentrates on technology and life science venture funds and middle market buyout funds. He is often engaged to represent a fund's portfolio companies and provides legal and strategic guidance from startup through exit. He manages efficient interdisciplinary teams to solve his clients' diverse needs.

Q: What is the most challenging transaction you have worked on and what made it challenging?

A: I have represented a life science company from nearly its inception through multiple rounds of venture financing, an initial public offering, bond financing and going private transaction. During this period, the CEO, chief financial officer and other top management changed a number of times, and I handled the transitions on behalf of the board. The most difficult of these transactions was the recent restructuring and going private transaction, effected through a Chapter 11.

We had an existing shareholder who offered to invest a substantial amount in the company and leave the existing shareholders with a residual interest. We also had a competing offer from the holders of the company's secured bonds, which initially was significantly less favorable and did not contemplate the continuation of the existing equity. We ultimately succeeded in negotiating a much-improved transaction with the bondholders. Our advice regarding financial, securities and fiduciary issues, as well as business and management considerations, was critical in achieving the final outcome.

Q: What aspects of your practice area are in need of reform and why?

A: None. I wish, however, that Congress would leave well enough alone, especially given the current fragility of the venture and PE market, where pension funds, endowments and other institutional fund investors are standing by the sidelines due to the economic uncertainty. Right now, the "reform" that is likely to upset the applecart is the proposal to tax carried interest earned by venture and buyout fund principals as ordinary income. The argument in favor of this change in long-standing tax law principles is based on two assertions.

The first one is practical: The federal government needs to close the deficit and fund managers are seen as an easy mark. The second argument is more theoretical: Proponents argue that carried interest is simply a form of incentive compensation, which should be treated as ordinary income.

No one can quarrel with the need for a solution to the deficit, though targeting fund managers' upside may well kill the goose that laid the golden egg, by driving talented people away from this highly valuable economic activity — the creation of jobs through venture capital and private equity. However, the second argument is deeply flawed. The principle of capital gains rests on encouraging investment in promising enterprises and reaping the rewards of the capital appreciation that results from smart investments. Fund managers do exactly that — and they deploy their own money, as well as the limited partners' invested capital, to realize these gains.

To argue that capital appreciation should be taxed as ordinary income if the gain in part results from the work of the equity holder would produce truly unacceptable results. After all,"sweat equity" is all about receiving capital appreciation from founders' stock and stock options. Are we to tax such appreciation as incentive compensation? Dare we squelch entrepreneurship by recharacterizing equity appreciation as ordinary income? There may be fair and equitable solutions to our tax predicament. But taxing carried interest as ordinary income is not one of them.

Q: What is an important deal or issue relevant to your practice area and why?

A:There have been a few recent court cases involving "down round" financings. These involve circumstances where due to a company's poor performance or general economic conditions, investors (who are primarily existing shareholders) buy stock at a lower valuation than prior financing rounds. As a result, the equity interest of existing shareholders is diluted — sometimes quite dramatically. In these cases, the question of self-dealing, fiduciary duties and conflicts of interest arise, especially where — as is often the case — the down round investment is approved by board members whose fund is purchasing the shares.

Without a doubt, the opportunity for mischief on the part of the director/investors is significant. However, in my experience the investors putting in the new money try to be fair and follow my advice as to the appropriate precautions to be taken in order to avoid prejudicing the existing shareholders. We must balance, however, the need for a speedy and inexpensive process for funding a company in dire financial straits against procedural safeguards that protect the rights of the existing shareholders. Clarity and simplicity in this area, whether from case law or legislation, would be highly desired.

Q: Outside your own firm, name an attorney in your field who has impressed you and explain why.

A: Paul Brountas of Hale and Dorr (now WilmerHale) was the epitome of the business lawyer who combined superb technical skills and judgment with a businessman's practicality. He created, along with Dick Testa of Testa Hurwitz, the venture capital and emerging company ecosystem in the Boston area, and represented many of the greatest technology and life science companies of the '70s and '80s. He distinguished himself from the old-line corporate lawyers of the era by eschewing conservative, risk-averse and expensive advice in favor of insightful and down-to-earth counsel.

He knew how to be a valued partner to his clients, someone that they could turn to as much for candid business advice as for sophisticated legal reasoning. His integrity was impeccable: He would resign from a client representation rather than be a party to an inappropriate legal arrangement. He mentored and worked tirelessly along young associates and junior partners, never hesitating to volunteer for the "grunt work" of slugging registration statements at the printer in the middle of the night or collating documents for a big mailing. He is now retired, but remains my role model.

Q: What is a mistake you made early in your career and what did you learn from it?

A: As a junior lawyer, I considered my most important goals to include the mastery of complex negotiations and document drafting. In the pursuit of this goal, I neglected the mundane minutiae of careful organization, spelling and follow-up. I distinctly recall an incident where a senior partner caught my error in spelling the name of a client on the signature line of a complex stock purchase agreement. I was especially proud of my work in drafting some complex provisions of this agreement, and felt that the partner's criticism of my seemingly minor error was unfounded.

However, now that I directly deal with clients every day, I realize the psychological importance of organization and precision. Clients cannot properly assess the quality of a complex set of legal documents. Instead, they rely on indicators that they know: spelling, efficient and accurate document circulation, and adherence to budgets and timelines. Accordingly, a minor spelling error or a missing page from a document could undermine a client's trust, no matter how brilliant the deal negotiations and document drafting might have been.

I now obsessively check and recheck my work product (without relying on spell-checking alone), and repeatedly caution my colleagues of the importance of focusing on the mundane but client-sensitive aspects of our work.