

# Examining the ‘Blocker’

*A blocker corporation is sometimes used by a PE or VC fund to invest in an LLC or partnership. Goodwin Procter’s John LeClaire and Jamie Hutchinson explain why this is used.*

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## Q: What are blockers?

**A:** A “blocker” is a corporation that an investor (e.g., a private equity fund) sets up to invest in a company that is a pass-through for tax purposes, such as an LLC. The investor puts money into a blocker corporation, which, in turn, invests in the company.

## Why put a blocker between the investor and the target company?

Taxes. Many PE/VC funds have limited partners that are pension funds or non-U.S. investors such as sovereign wealth funds. If a PE/VC fund with pension fund LPs invests directly in a pass-through, the pension fund realizes “unrelated business taxable income.” If the LP is a non-U.S. investor, making an investment in a pass-through subjects the foreign LP to effectively connected income in the U.S. Such investors typically abhor these outcomes. When you interpose a blocker between the PE/VC fund and the target company, you “block” these bad tax results.

## Does the “blocker” situation come up often?

Yes, with increasing frequency. Since the introduction of the LLC in the 1990s, entrepreneurs are increasingly choosing the LLC over the C corporation, which is the other main structural alternative for U.S. businesses. Entrepreneurs’ election of the LLC form collides with prohibitions on making direct investments in pass-throughs on behalf of UBTI /ECI sensitive investors.

## Why do the entrepreneurs want to organize as LLCs?

For various reasons, but the main ones relate to tax economics for the entrepreneur and other owners. Notably, an LLC can generate tax benefits at sale or IPO. Also, LLCs can provide current tax advantages, but there are countervailing considerations. Historically, institutional investors—especially VCs—have tended to look with disfavor on LLCs.

## Are there any detriments?

There can be. The main detriment occurs at exit. A PE/VC fund that invests in an LLC through a blocker generally must exit by selling the blocker stock. If the blocker sells the underlying LLC equity, there would be a tax inside the blocker and another tax when proceeds are distributed to the PE/VC fund. But if the fund sells the blocker stock, the ultimate acquirer generally has reduced tax advantages going forward, since selling blocker stock doesn’t create the tax benefits that selling LLC units does.

## Does the blocker owner get a lower price in that situation, or must it sell in a tax-disadvantageous way?

Usually a PE/VC fund that invests through a blocker pre-negotiates a right to exit without creating additional tax and with no price discount, i.e., all investors benefit from tax attributes of the sale, even if only some of the owners create the benefits. Failure to pre-negotiate, especially by a minority investor, could result in the investor being forced into a tax-disadvantageous exit.

## Are there PE investors who don’t need to use blockers? Do they have advantages?

Sometimes. A family office, for example, typically doesn’t need to use blockers. All else being equal, that can be an advantage when bidding.

## Are these rules you’re telling us about written down anywhere?

Not really. They are a collection of practices and knowledge that has evolved among those active in the middle market and growth equity. ■

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