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Selling to Private Equity: Not an Exit, But a New Chapter

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1. Introduction

All good things must come to an end, and that includes an entrepreneur's tenure as the owner of a successful business. If family or employee succession is not in the cards, the owner will likely want to monetize his/her interest in the business by way of a third party sale. When business owners look to sell their businesses, third party buyers can often be divided into two categories: strategic buyers and financial buyers. The differences between these two sets of buyers, and the impact those differences have on exit transactions and the seller's post-exit life, cannot be overstated.

Strategic buyers are likely to include competitors looking to horizontally integrate, and businesses in related industries or activities looking to expand or vertically integrate. They typically have their own management teams and their own ways of doing business, although small and medium sized strategic buyers may not be that experienced in the world of mergers and acquisitions. Financial buyers—typically private equity funds—on the other hand, are usually motivated not by integration, but rather investment.[1] They exist for the sole purpose of buying businesses and ultimately flipping them for a profit. "The fundamental reason behind private equity's growth and high rates of return is something that has received little attention, perhaps because it's so obvious: the firms' standard practice of buying businesses and then, after steering them through a transition of rapid performance improvement, selling them. That strategy, which embodies a combination of business and investment-portfolio management, is at the core of private equity's success."[2]

These differences in motivation on the part of the buyer can have a profound impact on the seller while a deal is being negotiated and afterwards. A financial buyer's experience in the ways of mergers and acquisitions can often expedite the transaction, but sometimes frustrate the seller if the buyer has adopted certain standard operating procedures or negotiating policies from which it will not budge. And unlike in a strategic deal, where the buyer's existing management team may be able to replace the seller and his/her team on day one, many financial buyers will look to the seller to continue providing leadership to the business—or at least substantial services—during a transition period. To incentivize the seller during this period, the private equity buyer is likely to rely on deferred and contingent consideration, including earnouts and rollover equity.

As with many things in life, COVID-19 has thrown a major wrench into the way private equity executives execute on their strategy. Sellers and private equity buyers must now engage in a delicate dance of balancing the interests of the parties while simultaneously dealing with a volatile market during unprecedented times of disruption and uncertainty due to the pandemic. Adaptation and adjustment are absolutely critical in this environment in order to close the deal.

In this article, we explore the various aspects of a sale to private equity that stand out in contrast to a strategic deal, including the expectation of post-closing services on the part of the seller and the target company's existing management, earnouts, and rollover equity. Along the way, we observe how the pandemic has changed the way these deals progress.

II. Owner's and Management's Post-Closing Relationship with the Buyer

It is a common and strategic decision for a private equity buyer to enter into employment or independent contractor agreements, effective as of the closing date, with the seller and/or key members of his/her management team setting forth the terms, conditions, and restrictions of such engagement post-closing. The private equity buyer and seller (and often others) must determine what those vital components of the engagement will be exactly, including whether the relationship will be that of "employer-employee" or if the individual will be engaged as an independent contractor (i.e., providing transition or consulting services), and each side must take an inventory of its long-term and short-term goals.

A private equity buyer may want to retain the target's key individuals post-closing in any capacity in order to take advantage of the skills and expertise of such individuals developed in the target's industry and the network of relationships built by such individuals with customers, lower-level employees, suppliers, vendors, and other third parties. All of this will need to be preserved to avoid having to reinvent the wheel during the private equity buyer's "holding period" of the target. A smooth transition and the appearance of continuity, at least for the short-term, are equally important for private equity buyers. From an optics standpoint, keeping the target's owner and certain key individuals on-board as employees for a set term post-closing may bring a sense of ease and can help with employee retention. Sudden changes at the top in addition to the ownership change may create feelings of unrest, uncertainty, and upheaval among lower-level employees—feelings that may already be present on account of the COVID-19 pandemic. From a flexibility standpoint, a private equity buyer may prefer to keep these key individuals on as independent contractors on a part-time basis, on an "as needed" basis, or for only a short duration post-closing—or if the buyer wants to be able to easily terminate the relationship, if necessary, without worrying about costly severance.

A target's owner and other key individuals may want to assist in the transition for only a short period of time, move on to other endeavors or "passion projects," or even ride off into the sunset of retirement. On the other hand, these key individuals may want to stay on for the long-haul and continue to have their hands in the company's anticipated rapid growth and success post-closing. In an employment agreement, these key individuals will likely insist that they receive compensation and benefits that are substantially comparable to (or higher than) that which they received immediately prior to the closing. Both sides, for very different reasons, may actually prefer to have an employment agreement in place to the extent there is an earnout in the deal (see more on this below). From the private equity buyer's perspective, an earnout incentivizes the target's owner to be committed to and invested in the success of the company post-closing—to have "skin in the game"—and an employment agreement with a fixed term can serve as evidence of that commitment to the company post-closing. As further incentive, private equity buyers may also offer bonuses to sellers and key individuals using similar performance metrics used in the determination of whether certain earnout milestones have been met. From the perspective of the target's owner, as an employee, he/she can still somehow be actively involved in the management of, and have a higher level of visibility into the inner workings of, the company post-closing in order to preserve and protect his/her earnout payment(s) during the earnout period.

Often a seller or chief executive who accepts post-closing employment with a buyer is in for a bit of "culture shock." An entrepreneur or CEO who has not had a boss in decades may now find him/herself needing to report "up the chain" to executives with different experiences and motivations. The transition from being the ultimate decision maker to no longer running the company can prove to be extremely difficult and even unbearable, especially if the seller or top executive built the business from the ground up or served in such capacity for an extended period of time. These individuals may find themselves looking for an exit a lot sooner than expected—well in advance of any expiration of an employment agreement term, which is why these key individuals should try to keep their employment terms (and the earnout period) as short as possible.

Regardless of the type of relationship between the private equity buyer and any key individual, each side should strive to clearly define and set forth the key individual's new role, scope of responsibility, authority, reporting structure, and any policies that such individual will be required to follow in order to properly set expectations in advance of the closing and to serve as a framework for navigating the post-closing relationship.

III. Earnouts

An earnout is a mechanism used to defer payment of a portion of the purchase price in M&A transactions, with the deferred portion being contingent upon certain performance objectives and metrics being achieved by the target company post-closing over a pre-determined period of time. In a normal M&A market, earnouts function as a tool to bridge the "value gap" between private equity buyers and sellers. During this uncertain and unpredictable M&A climate, determining the value of a target company is even more challenging, and earnouts have become a crucial component of deals in order to get to the closing table.

Earnout provisions can be particularly advantageous for private equity buyers since such buyers are able to reduce their overall up-front payment at closing and mitigate the risk of overpaying for the target company by tying the deferred payments directly to the performance of the company post-closing. When an earnout is involved, and to the extent the target's owner and key managers are continuing to provide services to the target company post-closing, either as employees or independent contractors, private equity buyers are able to ensure that the interests of all parties are clearly aligned and focused on the success of the company—a win-win scenario for the private equity buyer. To the extent private equity buyers want additional assurances that the target's owner and key employees "keep their eyes on the prize" and maximize the target's profitability, private equity buyers may also condition the earnout payments on the continued employment (or provision of services) by the target's owner and keys employees post-closing, thereby requiring the forfeiture of such earnout payments in the event such individuals resign or are terminated for cause.

Deferring a portion of the purchase price based on the target company's achievement of certain milestones post-closing may be an extreme gamble in today's market given the pandemic, but motivated sellers must be ready to adapt and adjust if they want to close. Sellers should generally try and limit the amount of the earnout to a portion of the purchase price that they would be willing to lose given the uncertainty of the market. Further, in order to increase the likelihood of achieving the earnout targets, motivated sellers and key individuals often strive to be involved in the day-to-day operation and management of the business post-closing, and reduce the buyer's ability to sacrifice short-term profit (which would increase earnout payouts) for longer term growth (which would maximize the business's exit potential for the buyer). Control of the business during the earnout period is often a serious point of contention during the earnout negotiation, and private equity buyers are reluctant to let go of the reins. Private equity buyers want little to no restriction on the operation of the target post-closing, and often resist all but the loosest covenants that sellers may seek in this regard.

From a tax standpoint, a seller will want assurances that an earnout is respected as a component of purchase price, and not treated as compensation, so that earnout payments are eligible for capital gain treatment. Making sure that earnout provisions are contained entirely in the purchase agreement and not in the seller's employment or consulting agreement, that the payments are tied entirely to performance and not any quantity of services rendered, and that there are certain scenarios in which the earnout may be paid even if post-closing services are not fully rendered (e.g., death or termination without cause) are helpful in this regard.

IV. Rollover Equity

Another useful tool available to private equity buyers, in general but particularly in this chaotic environment, is rollover equity. A target's owners can "roll" a portion of their equity in the target company into the buyer's acquisition vehicle or another entity within the private equity buyer's organizational structure in lieu of receiving some cash proceeds at closing. Yet again, private equity buyers are able to take advantage of reducing their up-front payments at closing while also offering additional incentives to ensure that sellers remain aligned with the overall goals and strategy of the private equity buyer and continue focusing on the success of the target company post-closing.

As with post-closing employment and earnouts, rollovers have their advantages and disadvantages for sellers. On the one hand, a win for the buyer is a win for the seller. If the company continues to grow following the first sale, the seller in that deal will benefit from the continued appreciation in the business when the private equity owner exits the investment a few years later. But unlike in the first deal, the original owner will lack any control over the timing of the second exit, the identity of the buyer, or the price that the private equity owner is willing to accept in that deal. Moreover, if the private equity buyer flips the company to another private equity fund, that fund may seek to condition the deal on the original seller's or management team's continued involvement in the business, which could be contrary to the seller's original goal of truly exiting the business. Even before that, if the rollover equity is in an entity holding more than just the original target business, the seller must engage in diligence to make sure the amount of equity being offered is at least equal in value to the cash consideration being given up in exchange for it.

Tax considerations are even more important for the seller with respect to rollover equity, which must be carefully structured to avoid "phantom income" to the seller—having the value of the equity included in the seller's income in the year of the original sale. Under no circumstance should the deal documentation state or imply that the seller is selling all of its interest in the target and then purchasing equity in the buyer's entity. Rather, the seller should typically contribute its equity in the target (in a stock deal, or a sale of LLC membership interests) to the buyer's acquisition vehicle, or the seller should retain equity in the target company and have the target contribute some of its assets to the acquisition vehicle (in an asset deal, where the remaining assets are sold for cash or other consideration). Moreover, if the acquisition vehicle is a corporation, the seller's contribution should occur at the same time as the buyer contributes cash or the acquired assets to the vehicle, to comply with the 80% control requirement of Internal Revenue Code Section 351. In any event, tax counsel should be involved in the planning and carefully review the documentation before signing and closing.

V. Other Considerations

When it comes to deal structure, the general rule is that sellers tend to prefer to sell stock (or membership interests, in the case of target companies that are LLCs), and buyers tend to prefer to buy assets. A stock sale is a complete exit for the seller—all liabilities essentially shift to the buyer, subject only to whatever indemnification the seller agrees to. Also, in the case of a C corporation, a stock sale avoids the double taxation the seller would generally face if the corporation sold its assets—taxation of the corporation's gain on the sale of its assets, and then taxation of the shareholder's gain on his/her disposition of the stock. Buyers, on the other hand, tend to want to leave unknown liabilities behind with the seller, and to get "stepped up" basis in the target company's assets, allowing for the purchase price to be recovered over time by way of depreciation and amortization deductions for tax purposes. Sales of corporate stock, however, do not afford buyers this opportunity.

But private equity buyers are often less deterred by these considerations than strategic buyers when it comes to sales of stock and membership interests. As they tend to have a shorter time horizon for owning the target company, tax deductions over a period of time are often of less interest to them. Also, contracts and governmental licenses and permits, which are not always transferrable in the case of an asset deal, are often of greater importance to financial buyers that lack the pre-existing customer and governmental relationships that strategic buyers may have. This can be beneficial to sellers for liability and tax purposes.

On the other hand, private equity buyers have significant leverage to push for standardization of M&A transactional documents and procedures across multiple deals. Standardization is a powerful tool to cut down inefficiencies and keep costs low, reduce risk and uncertainty, and strategically position the private equity buyer to hone in on the substantive issues and key differences between deals, thereby leading to more targeted negotiations. Sellers will usually find they have less flexibility in these scenarios as private equity buyers can point to their track record to "win" deal points.

The vast majority of sellers will be obligated to sign restrictive covenants (e.g., non-competition, non-solicitation, non-disparagement, and confidentiality) in connection with the purchase agreement. The duration, geographic scope, business scope, and any exceptions to the restrictive covenants are all heavily negotiated, with buyers pushing for the terms to be broadly drafted and construed and to last for the longest duration possible, yet be reasonable enough to be enforceable in a court of law. A private equity buyer may have an eye towards appeasing a subsequent buyer, and a private equity buyer's ability to deliver an already negotiated non-compete or set of restrictive covenants to the next buyer after the private equity buyer's holding period ends (usually within 3 to 5 years) can be a significant selling point for the next buyer—to the detriment of the original seller.

Finally, many target companies have outstanding loans under the Paycheck Protection Program ("PPP"). For the first few months of the pandemic, sellers and private equity buyers were left scrambling figuring out how to deal with these loans. While the Coronavirus Aid, Relief, and Economic Security Act, Pub. L. 116-136 (2020), which established PPP, did not prohibit the sale of businesses with PPP loans, many lenders' PPP loan documents indicated that lender consent would be required for changes of control. Moreover, the PPP affiliation rules were unforgiving of private equity funds, forcing most of them to have to aggregate their portfolio companies to determine whether they met the 500 employee ceiling on eligibility. Many funds flunked this test, meaning that, following an acquisition, a target might cease to be eligible to have a PPP loan.

The U.S. Small Business Administration (the "SBA") eventually provided some clarity by way of a Procedural Notice[3], effective as of October 2, 2020, setting forth the required procedures for a "change of ownership"[4] of an entity that has received a PPP loan. In most cases, having to get SBA consent can be avoided if the target company applies for forgiveness of its PPP loan prior to the closing. If the application is not approved before the closing, the buyer funds an escrow with the lender in the outstanding amount of the loan (typically out of what would otherwise be paid to the seller at closing), which escrow is released to the seller if the application is ultimately approved and to the lender if it is not.

VI. Conclusion

The private equity market offers business owners tremendous opportunity to make a lucrative exit from established businesses with a track record of success. But sellers in private equity deals must realize that their deal counterparties are likely to be highly experienced in M&A deals, to require some post-closing commitment on the part of the seller or key managers, and to expect that at least some of the purchase price take the form of an earnout or rollover equity, delaying the seller's ultimate exit from the business. Understanding these dynamics going into the transaction can make a world of difference in terms of whether the seller is satisfied with the ultimate outcome.

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[1] Some private equity firms will, however, engage in "roll-up acquisitions"—steering their portfolio companies to horizontally or vertically integrate, in order to better position them for sale. These roll-up transactions often have some elements of strategic deals, as there are often management teams to be merged. But the financial executives leading them on the buy-side tend to manage these deals in much the same way as they do when acquiring a portfolio company. This makes sense, as those executives' ultimate goal remains the same, regardless of whether the transaction is a direct portfolio investment or a roll-up.

[2] Felix Barber & Michael Goold, *The Strategic Secret of Private Equity*, Harvard Business Review (2007), *available at* https://hbr.org/2007/09/the-strategic-secret-of-private-equity.

[3] *See* SBA Procedural Notice 5000-20057, Paycheck Protection Program Loans and Changes of Ownership, *available at* https://www.sba.gov/sites/default/files/2020-10/5000-20057-508.pdf.

[4] For purposes of the PPP, the Procedural Notice states that "a 'change of ownership' will be considered to have occurred when (1) at least 20 percent of the common stock or other ownership interest of a PPP borrower (including a publicly traded entity) is sold or otherwise transferred, whether in one or more transactions, including to an affiliate or an existing owner of the entity, (2) the PPP borrower sells or otherwise transfers at least 50 percent of its assets (measured by fair market value), whether in one or more transactions, or (3) a PPP borrower is merged with or into another entity." *Id.*

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