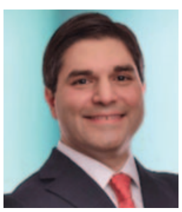
TWO DEALS IN ONE

Sales of Less than the Whole of a Business



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By Jason D. Navarino and Hannah J. Greendyk

It is common to think about the sale of a business as a single transaction—the seller is selling its equity or business assets, and the buyer is purchasing such equity or assets. However, depending on the structure of the transaction, the deal may actually contain two separate but related transactions. This "double" transaction structure often arises in mergers and acquisitions (M&A) with a rollover component, where a portion of the deal consideration is comprised of equity in the buyer or the buyer's holding company. It also occurs when a buyer is looking to get into a business in a significant way but without acquiring complete ownership, at least up front. In both situations, not only must the parties navigate the complexities of the sale of the business, but they must also focus on the structure of rollover equity and the parties' post-closing relationship with buyer and seller remaining as partners or co-owners.

This article will describe the unique considerations that go into selling a substantial interest in a company, but where the seller retains a substantial interest as well, either by retaining partial ownership of its existing business or through receipt of rollover equity from the buyer. In particular, this article will discuss the liability, due diligence, decision-making, exit planning, and structural and tax considerations that come into play in these transactions.

M&A Transactions with Rollover Equity

Rollover equity is common in acquisitions by private equity funds, where the fund sponsor is often looking to the seller and existing management to continue running the business post-closing. In any rollover structure, whether it be a private equity acquisition or a strategic buyer, the deal consideration is comprised of cash plus a percentage of equity in the buyer or the buyer's holding company. This incentivizes rollover equity recipients—generally sellers and key management—to participate in the growth of the company post-closing. This structure also means that the buyer has to bring less cash to the table.

Liability

In the M&A context, the parties generally negotiate seller indemnification for pre-closing liabilities and, to a lesser extent, buyer indemnification for post-closing liabilities. Accordingly, the allocation of liability is generally clear as between the seller for pre-closing liabilities and the buyer for post-closing liabilities. The seller may indirectly bear a portion of the buyer's liability as a co-owner of the buyer, but that is consistent with the overall deal structure.

Due Diligence

Although due diligence is generally performed by the buyer in any acquisition, the seller in a rollover transaction will also want to perform due diligence, including reviewing the buyer's financials and performing a lien and judgment search on the buyer. The seller should also request a valuation if the buyer is privately held to ensure that the amount of the rollover equity is adequate, meaning that the equity is actually worth what the buyer says it is worth.

Decision-Making

The seller will hold equity in the buyer or the buyer's holding company post-closing. Accordingly, the parties must give thought to the seller's decision rights as set forth in the buyer's governing documents (usually a shareholders' agreement if the buyer is a corporation, or a limited liability company agreement or operating agreement if the buyer is an LLC). The seller will sometimes have the right to appoint a certain number of directors to the buyer's board. If the seller holds a minority position, as is often the case, the seller is likely to have, at minimum, a limited list of "major decision" rights on topics such as sales of the company or its assets, capital contributions, admission of new members, etc. These rights often range from mandatory consultation to veto power.

Transfers and Exit Planning

The seller's counsel should ensure that the buyer's governing documents provide the seller with an exit route and address the subsequent sale of the company, particularly in the private equity context where the company is generally resold within three to five years. In light of this, the seller's counsel should review the transfer provisions of the governing documents, including any drag-along (requiring minority owners to sell alongside the majority, usually on the same terms) and tag-along provisions (allowing minority owners to elect to participate in sales by majority owners, again usually on the same terms), to ensure that the seller will be entitled to proper distributions upon sale or transfer of the equity. Given that the rollover equity is in lieu of cash consideration at closing, it is incumbent on the seller's counsel to ensure that the seller can properly cash out and realize the value of such equity at a future date.

Additionally, a buyer will often not permit a seller to freely transfer its rollover equity (and the equity may even be subject to a lock-up period during which the seller cannot transfer its equity at all), but the seller's counsel should try to negotiate the ability to transfer to a seller's affiliates, family members, and certain other estate planning-related transfers, if possible.

Structural and Tax Considerations

If properly structured for tax purposes, the rollover portion of the deal consideration can often be shielded from tax, meaning that the seller only has to pay tax on the cash portion of the consideration for the year of the closing. In a properly structured part-sale, part-contribution, the seller is treated as selling a portion of the company's equity or its assets for cash and contributing the balance of the equity of the company or its assets to the buyer in exchange for equity in the buyer. In the partnership context, the contribution in exchange for equity is tax-free under Section 721 of the Internal Revenue Code of 1986, as amended (Code).[1] Also in the partnership context, the seller's counsel should carefully review the buyer's limited liability company or operating agreement to ensure that there are no disguised sale issues with the rollover equity.[2] For example, the entitlement to disproportionate distributions, particularly within two years of the closing, can give rise to a rebuttable presumption of a disguised sale.[3]

If the buyer is a corporation, the contribution must meet the requirements of Section 351 of the Code in order to be tax-free. Among other things, Section 351 requires that the contributing shareholders must possess at least 80% of the voting power and value of the corporation immediately following the contribution.[4] This 80% requirement can be difficult to achieve unless the buyer is a newly formed entity being capitalized concurrently with the rollover. If the buyer is a foreign corporation, the rollover is likely to be taxable, absent creative and possibly less certain tax planning.[5]

Acquisitions of Partial Ownership Through a Substantial Investment

The other common type of transaction where there is the sale of less than the whole occurs when a buyer is looking to make a substantial investment in a company without purchasing the entire company. In this situation, the arrangement is essentially structured as a joint venture with the existing owner or owners and the buyer as partners in the business on a go-forward basis. Although not technically an M&A transaction, the same considerations generally apply.

> The delineation of liability is sometimes not as clear here as in the M&A context because the buyer is stepping into partial (as opposed to full) ownership of an existing company. The buyer will often require the company and existing owners to indemnify it for actions taken prior to the date of its investment, but this indemnification is often limited on account of the buyer's partial ownership...

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Due Diligence

Due diligence efforts in this type of transaction are often significant. The buyer will want to perform due diligence on the company to ensure its viability and continued economic success. Similarly, the existing owner or owners will want to investigate the buyer as a potential partner.

Decision-Making

Governance is as important here as in the M&A context, given that the parties are essentially operating as a joint venture following the investment. Consideration must be given to the decision rights of the buyer and existing ownership, including the scope of the minority owners' decision rights and entitlement to appoint board members or managers. If the buyer holds a majority interest, it will want to limit the minority owners' decision rights as much as possible, and the minority owners will want to expand their rights as much as possible.

Transfer and Exit Planning

The same considerations here apply as in the M&A context. The buyer will likely seek to limit transfers of the minority members' equity as much as possible, to ensure that it is doing business with the parties it intended to do business with. The buyer may also want to set itself up for the ultimate acquisition of 100% of the business. For example, the buyer could include a right of first refusal requiring the other owners to present any third party offers to the buyer prior to accepting such offers. Finally, the buyer may wish to include drag-along provisions in a shareholders' agreement or limited liability company or operating agreement enabling it to require the minority owners to participate in an ultimate sale (and corresponding tag-along provisions permitting the minority owners to participate if the buyer/majority owner sells its equity).

Structural and Tax Considerations

In these types of transactions, the primary question is whether (1) the buyer is contributing money into the target company to fund its growth and expansion, or (2) the buyer is paying the seller - and the seller is taking money off the table - in exchange for some of its equity. If the transaction is drafted as a contribution, but it is really a sale in practice, the disguised sale rules are likely to bite in the partnership context.

In the first scenario, the buyer's contribution of cash in exchange for equity of a company that is taxed as a partnership will be tax-free under Section 721 of the Code.[6] If the company is a corporation, the contribution of cash in exchange for shares of stock will only be tax-free if the buyer acquires at least 80% of the vote and value of the corporation and the other requirements of Section 351 of the Code are met.[7] In the second scenario, non-recognition treatment will not be available and the transaction will generally be a capital gain transaction, except to the extent of "hot assets" (i.e., unrealized receivables, inventory, and recapture of previously taken depreciation and amortization deductions) in the case of a partnership.[8]

Conclusion

As noted throughout this article, transactions appearing at first glance to be a simple sale of a business can really be two distinct transactions with many layers and facets. Recognizing these complexities going into the transaction can make a world of difference in terms of whether the parties are satisfied with the ultimate outcome. ■

Endnotes

1. *See* Code § 721.
2. *See* Treas. Reg. § 1.707-3.
3. Treas. Reg. § 1.707-3(b)(2)(ix).
4. Code § 351(a) and Code § 368(c).
5. *See* Code § 367.
6. *See* Code § 721.
7. *See* Code § 351.
8. *See* Code § 751.