Rollover Equity Transactions

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Business and Tax Planning Fundamentals

During the past decade, financial buyers such as private equity firms (PE firms) have dramatically increased their participation in the M&A marketplace. PE firms and other financial buyers generally acquire companies with the intention of holding them for a three to seven-year period and then (hopefully) selling their "portfolio company" for a profit. Most PE firms look for target companies with strong management teams. PE firms also often encourage a target company's equity owners (referred to in this article as "founders") to "roll over" a portion of their equity, so that the founders own a minority equity position in the target company or its holding company after the transaction closes.

What is driving the popularity of rollover transactions?

The popularity of rollover transactions can be attributed to several factors. Foremost, having founders roll over a meaningful share of their equity into the acquired company is perceived by PE firms as a powerful tool for aligning the founders' interests with their own. Rollover equity is also a form of seller financing, reducing the PE firm's closing cash needs. Rollover equity may be a critical piece of the overall deal consideration if the transaction is aggressively priced (making the use of "soft" money consideration more useful) or where there is a substantial valuation gap between the founders and the PE firm.

How rollover transactions are structured

The typical rollover transaction involves founders maintaining between an 8% and 40% equity interest. The founders' equity may be rolled into the deal by exchanging the equity for acquirer equity or keeping a portion of the target company's equity. Sometimes founders will end up owning directly or indirectly equity in just their target company and other times they will exchange their target company equity for equity in a company that holds additional related assets or businesses (particularly where the PE firm is rolling up several similar companies into a single package). From a deal standpoint, a rollover transactions may be structured as an exchange of target company equity for buyer equity, an exchange of target company assets for buyer equity, a partial target equity sale, a merger, the contribution of target company assets to a newly-formed operating entity, or an equity investment in the acquiring company. A rollover transaction may be fully or
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partially taxable depending on how it is structured. If the rollover equity piece is meaningful from a dollars standpoint, the founders will want to ensure that the rollover transaction is structured in a way that permits them to roll their equity over on a tax-free basis (assuming that this defers taxable gain).

From an economic perspective, rolling over equity into the acquirer is similar to agreeing to an earn-out as part of the overall purchase consideration. In either case, monetizing the deferred piece of the consideration will depend on the post-sale success of the target business. But in contrast to an earn-out, monetizing rollover equity requires not only that the business succeed post-sale, but also the occurrence of subsequent liquidity event. Usually, the founders' rollover equity has the same economic rights as the PE firm's equity; neither party has a put right or other exit opportunity until the future liquidity event occurs. Although there is no guarantee that agreeing to accept rollover equity will ultimately prove to be a good investment, founders often are the best judge of whether they should place a bet on the future success of their business, taking into consideration the post-sale management team and business plan.

Succession planning for business owners

For many founders, a sale to a PE firm that includes a rollover equity component is the culmination of years of thoughtful succession planning. Meaningful succession planning encompasses tax, business and estate planning and focuses both on the founders and the business itself. Ideally, founders should begin considering succession planning issues when they start a new business, and the process should then include periodically revisiting aspects of the plan throughout the lifecycle of the business. Along the way, careful consideration should be given to whether founders want to maintain a significant management role in their company post-sale. If founders would rather move on entirely or play a limited role, then they should pay attention early in the lifecycle to the job of developing a management team that can step in to run the business post-sale. Obviously, a strong management team capable of taking the business to the next level not only adds value to the business but almost always makes it a more attractive acquisition target. Other options include selling to a strategic buyer who can bring in its own management team or transferring the business to family, management or employees (e.g., through an ESOP).

Viewing rollover equity as a minority investment by the founder

Founders who agree to roll over some percentage of their equity into the buyer's entity are making the equivalent of a minority equity investment. Founders should undertake financial and legal due diligence of the buyer's business and entity structure. Where the target business will operate on a standalone basis post-acquisition, the equity and debt structure of the buyer and the position of the founders in the buyer's governance structure (from the viewpoint of being minority investors) are usual due diligence concerns. If the buyer is combining the target business with other assets, then due diligence should include a meaningful review of the buyer's business. Founders should ask themselves what level of due diligence would they want to undertake if asked to invest the same amount of cash in the buyer's business. Of course, the degree of concern a founder may have in undertaking due diligence of the buyer will be different if the founder is being asked to roll over 40% of his sales proceeds instead of 8%.
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Founders should undertake their own due diligence investigation of potential buyers

When weighing the relative merits of PE firm offers involving rollover equity, founders should look beyond the dollars and carefully consider what their life will be like post-closing. There are many PE firms competing for deals and they have different approaches for dealing with their portfolio companies. Some PE firms take a hand-off approach, relying on the founder and his management team. Other PE firms have a substantial presence at the portfolio company and are heavily involved in decision-making. A PE firm may show up only for monthly or quarterly board meetings so long as there is expected financial performance. But some PE firms place an executive with the portfolio company for the purpose of observing how things are operating on a day-to-day basis. Some of these portfolio executives are involved in day-to-day operations. In any case, founders need to accept that they have traded complete control of their business for a minority ownership position and perhaps a management role. A PE firm will usually decide when and if the business will be sold or become involved in some other capital transaction. Important succession planning takeaways for founders are to both "know thyself" (what kind of a partner would the founder make?) and also consider the old adage that you should choose your (PE firm) partners wisely.

Founders should consider interviewing management (including selling owners) of a PE firm's other portfolio companies in an effort to see if the PE firm is the right fit for the founders. Founders should consider whether they personally like the PE firm's owners and ask themselves whether they believe that the PE firm will make a good partner and contribute to the future success of the business. Questions that founders should ask the PE firm up front include what role the PE firm sees itself playing in the target company's operations post-deal? Will the PE firm place an executive on the premises? What role does the PE firm play in its portfolio company's day-to-day management and decision making? How often will the portfolio company executives meet with its PE owners? Does the PE have the experience and resources to assist the founders in achieving this exit strategy? Does the target business have the management team in place that can support the PE firm's plans for expected growth? What is the PE firm's track record? What does the PE firm have to say about its business plan and exit strategy for the target company? If the strategy is a sale in the "short" term, does this fit with the founders' long-term plans for the business? Does the PE firm have the experience and resources to assist the founders in achieving this exit strategy? Does the target business have the management team in place that can support the PE firm's plans for expected growth?

In advance of inking a deal, founders should carefully review all management fees, other compensation payments and any affiliate arrangements that might siphon off the target company's profits. A positive aspect of being acquired by a PE firm is that founders who continue in management positions post-acquisition often participate in an equity pool established by the PE firm to incentivize their new portfolio company's management. Founders should also negotiate up-front the terms of their post-closing employment arrangements with the target business.

The financial aspects of rollover equity

One risk associated with rolling over equity is the possibility that the enterprise value of the buyer's business is inflated. Founders should consider what support the buyer is providing for the valuation placed on its business
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in calculating the founder's share of the combined business post-transaction.

"What's market" regarding the economic features of rollover equity has been evolving since 2008 as the competition among buyers for companies has heated up. At one point, typical rollover equity was common equity subordinated to the preferred equity issued to the PE firm's investors. Today, more often than not, rollover equity is of the same equity rank as the PE firm investor's equity (usually participating or straight preferred equity). The incentive equity issued to management and employees is typically common equity subordinated to this preferred equity. Regardless, the buyer entity's capitalization and debt features should be carefully reviewed by the founders in connection with negotiating their deal.

Vesting of rollover equity

Rollover equity is typically fully vested when issued in the rollover transaction. Very occasionally, rollover equity is subject to repurchase or forfeiture if specified events occur (or fail to occur). Equity that is subject to continued employment (in contrast to time or performance vesting goals) is unlikely to qualify for tax-free rollover treatment, but instead will fall within the scope of the IRC § 83 incentive equity tax regime.

Typical minority ownership issues confronting founders

Most rollover equity will be subject to rights of first refusal or first offer clauses, drag-along (forced sale) clauses in favor of the PE firm investors, and tag-along (co-sale) clauses for the founder's benefit. Depending on the percentage of equity involved in the rollover, founders may have board representation (in addition to a seat for a founder continuing on as the company's president/CEO) or observer rights. Traditional concerns of minority investors are also applicable in rollover transactions, including making sure that there is a mandatory tax distribution and no requirement to make additional capital contributions, loans or guarantees and understanding whether or not the founder's equity may be diluted by additional equity issuance. If the founder's stake in the buyer entity is substantial, the founder should consider negotiating for supermajority voting rights on key decisions. In many cases, however, buyers will not be willing to give the founder a meaningful vote on matters other an approval right for conflict of interest transactions involving the financial buyer.

Structuring a rollover transaction from a tax standpoint

From a tax standpoint, the rollover equity piece of the purchase consideration can usually be structured to be fully taxable or tax-free to the founders. Unless tax rates are expected to rise dramatically in future years, founders receiving rollover equity will usually want to defer taxes on the rollover piece. For example, founders receiving 70% cash and 30% equity expect to defer tax on the 30% equity piece until the occurrence of a later liquidity event. In a $10 million sale where the founders have little tax basis, the deferred taxes can easily exceed $800,000 at today's capital gains rates. Buyers generally prefer fully taxable transactions because they receive a cost tax basis on the taxable portion of the purchase transaction. A higher tax basis will allow the buyer to increase future depreciation write-offs of equipment and goodwill purchased in the transaction. Of course, there may be situations where a fully taxable rollover transaction is preferable, usually where the transaction involves a distressed business or one where the owners are flipping the business for a loss.
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Structuring taxable rollover transactions

A taxable rollover transaction generally involves the taxable purchase of 100% of a target company's assets or stock, followed by the founders' reinvestment on an after-tax basis in the buyer's equity. A taxable rollover transaction might also involve a stock or asset purchase or merger where a portion of the consideration is buyer equity, but the transaction fails to qualify as a tax-free reorganization.

The tax issues are straightforward in a fully taxable transaction. The key non-tax issues discussed below would remain applicable to founders acquiring their rollover equity on an after-tax basis.

Structuring tax-free equity rollovers

A tax-free rollover transaction involves the deferral of taxes on the portion of the founders' equity rolled over into equity of the buyer's entity. The cash portion of the transaction consideration will be fully taxable.

If "vesting" is imposed on the rollover equity, requiring the founder's continued participation in management, the founder's retained equity piece may be characterized as compensatory equity and therefore not qualify for tax-free rollover treatment. A possible alternative to introducing a "vesting" concept into the transaction structure would be an agreement between the founders and buyer to a purchase price adjustment (which might include equity forfeitures or buy-backs) if certain triggering events occur. The rollover equity would be fully vested at the time of issuance. There are several ways to structure tax-free rollover transactions:

Purchasing less than 100% of the target company's equity

The most straightforward way of effecting a tax-deferred rollover transaction is for the buyer to purchase less than 100% of the founders' equity. But if the founders' entity is a corporation (C or S corporation), a stock purchase would not result in any inside basis step-up to reflect the consideration paid for the founders' stock. Generally, buyers prefer structuring transactions that allow for a basis step-up. An asset purchase accomplishes the desired basis step up and usually allows the buyer to avoid the target entity's unknown liabilities and unwanted obligations. In some deals, however, regulatory issues or concerns over third party approvals may override these issues and point toward selecting a stock acquisition. A buyer's concern about target company liabilities and obligations can often be mitigated (but not eliminated) through relying on due diligence and the founders' indemnification obligations.

If the target company is an S corporation that has been taking advantage of its pass-through tax treatment, the purchase of stock by an ineligible shareholder (e.g., a PE firm's fund taxed as a partnership) would trigger the termination of the S election. An 80% to 100% purchase of an S corporation's stock can be treated as an asset purchase if the parties make an IRC § 338(h)(10) election. But the portion of stock rolled over by the founders is not tax deferred, as 100% of the target company's assets are treated as having been sold, including the percentage representing the founders' rollover equity piece.
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If the target company is an LLC taxed as a partnership, the sale of LLC equity by the founders will generally be entitled to tax-free sale treatment under IRC § 741, but a portion of the sales proceeds may trigger ordinary income if the target company holds IRC § 751 "hot assets" such as appreciated inventory, receivables and depreciated equipment. If a selling founder has a long-term holding period for his LLC equity, he will be entitled to long-term capital gains treatment even if the LLC holds capital assets with a short-term holding period. But if the founders have contributed cash to the LLC or leveraged the LLC during the 12 months preceding the sale, a portion of the sales proceeds may be short-term under the IRC § 1223 rules.

The holding company formation transaction structure

A common rollover transaction structure involves the buyer first forming a holding company ("newco"). Newco is generally a corporation. As a second step, the founders then contribute all of their target company equity or assets to newco in exchange for newco equity. The PE firm contributes its related business interests and/or cash to newco, followed by the distribution of the cash to the target company or its founders. If properly structured, the founder's contribution is tax-free under IRC § 351, except for the cash "boot" received in the transaction.

In a variation of the holding company formation structure, the buyer purchases a controlling share of the founder's equity and contributes it to newco. The founders contribute the remaining target company equity to newco. Again, the transaction is generally nontaxable to the extent of the rollover portion of the deal under IRC § 351, with the cash distributed to the founders' entity treated as taxable "boot."

In both variations of the holding company formation transaction structure, Newco will receive a tax basis step in the portion of the target company's equity or assets acquired in the rollover transaction.

The LLC "drop-down" transaction structure

In some cases, a buyer may operate in corporate form but the holding company structure doesn't work for various reasons (e.g., the deal doesn't merit forming a holding company size-wise) or the buyer is an investment fund. In those cases, the parties may utilize a "drop-down" LLC formation transaction structure. First, the target company forms an LLC subsidiary. Second, the target company contributes assets to its wholly-owned (and disregarded for tax purposes) subsidiary LLC. Finally, the buyer either purchases a majority interest in newco LLC's equity from the target company, or alternatively, the buyer contributes cash to newco LLC in exchange for newco LLC equity. The cash is immediately distributed to the target company.

The purchase or issuance of newco LLC equity will be treated as a formation of a partnership under IRC § 721 coupled with a sale by the target company of the equity interest held post-transaction by the buyer. The rules discussed above regarding the possible impact of "hot assets" in a sale of a partnership interest will be applicable here, as the transaction includes the sale of those "hot assets" generating ordinary income. Also, if the target company has a short-term holding period for any of its capital assets, the transaction will include short-term capital gain on the deemed sale of those assets. Newco LLC will receive a tax basis step up in
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portion of assets deemed to be purchased and a new holding period will commence in the purchased assets. Newco LLC will have a carryover basis and holding period in the portion of assets deemed purchased. It is possible to structure the transaction as an installment sale under IRC § 453 if the payments are spread over more than one year, but the contributing founder will be taxed on all of the gain associated with the IRC § 751 hot assets at the time of contribution, regardless of whether payments for those assets are deferred into subsequent years.

The drop-down structure is particularly useful where the founder’s entity is operated through an S corporation and the buyer is an ineligible shareholder (typical for a PE firm buyer with investments through funds operated in partnership form). The founders’ S corporation will continue post-transaction as an equity owner holding rollover equity. The LLC drop-down transaction structure allows the parties to take advantage post-transaction of the often favorable pass-through tax treatment afforded LLC owners. In some cases, financial buyers may employ a "blocker" corporation if the ultimate owners are foreign investors or tax-exempt investors trying to avoid a pass-through of active trade or business income (which generates UBIT for tax-exempt shareholders).

An important agreement in the drop-down transaction structure will be the LLC agreement governing the operation of the business entity post-acquisition. Among other issues, founders should pay careful attention to the tax allocation provisions governing their rollover equity. There are "seller-friendly" (the traditional method) and "buyer-friendly" (the remedial method) allocation methods permitted under the IRC § 704 Treasury Regulations. Under the remedial method, founders would recognize the built-in gain on their rollover equity prior to a later sale of the business. The selection of the allocation method is often dependent both on the tax sophistication of the parties and the market for businesses. In a seller-friendly market, PE firms are often willing to give founders the benefit of the most favorable tax treatment.

Tax-Free Reorganizations

If structured properly, tax-free reorganizations allow selling shareholders to defer taxes on all or a substantial portion of the sales proceeds. Founders must take a substantial portion of their consideration in the form of buyer entity equity. In a merger transaction, the usual transaction involves at least 50% of the consideration being in the form of buyer entity equity. Other reorganization provisions such as assets for stock reorganizations ("C" reorganizations), stock for stock reorganizations ("B" reorganizations) and triangular mergers require a substantially higher percentage be in the form of voting stock.

Buyers considering using tax-fee reorganizations must weigh the benefits associated with using their stock as purchase consideration against the loss of the tax basis step-up for the portion of the transaction involving buyer equity. The ability to structure rollovers using asset purchase transactions will help address the desire to avoid unwanted target company liabilities.
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Avoiding tax traps

Advisors structuring rollover transactions must be familiar with the technical tax rules for achieving tax-free treatment under IRC §§ 351, 368 and 721. There are also various potential tax traps to be avoided. For example, if a target business was in existence on or before August 10, 1993, and the founders will own more than 20% of the equity post-transaction, the target's goodwill and going concern value may not be amortizable under IRC § 197 due to the "anti-churning rules." If the buyer is an LLC, the anti-churning rules can be an issue even where the founders hold less than 20% of the buyer entity's equity after the transaction. If the target company has been operating as an LLC taxed as a partnership, the business cannot be converted into a corporation for the purpose of engaging in a tax-free reorganization. The likely result of a conversion in anticipation of a merger transaction would be the IRS' invocation of the "step transaction" doctrine, which would transform the hoped-for tax-free reorganization into a taxable sale transaction, regardless of how much of the consideration was in the form of acquirer stock.

The use of "contribution agreements" in tax-free rollover transactions

Best practices dictate the use of a "contribution agreement" rather than a "purchase agreement" if the parties intend for the rollover equity to be tax deferred for the founders. Characterizing the transaction form as a stock or asset purchase invites an IRS agent's argument that the form of the transaction dictates tax treatment. Using a contribution agreement makes sure that the form of the transaction is one where the default is tax-free treatment (subject to dealing with cash boot). It also makes sense in the contribution agreement to describe in some detail the tax aspects of the transaction, including an acknowledgement by buyer and founders that the transaction involves, at least in part, a tax-free rollover.

Earn-out arrangements

It isn't uncommon for PE firms to structure an acquisition to include both rollover equity and an earn-out provision. Earn-out arrangements make a portion of the overall purchase consideration contingent on the target company meeting negotiated post-closing financial goals. Including an earn-out in a deal may be attractive to a PE firm because it defers payment of a portion of the purchase price, it shifts some of the risk of disappointing performance by a business in its portfolio to the founders and may assist in bridging gaps between the founders' and PE firm's estimation of a target's value. From the founders' standpoint, an earn-out can increase the overall purchase consideration and defer taxes, but most earn-out formulas require good to excellent performance, which as founders more than anyone can attest, is anything but a sure thing.

Founders who are inclined to agree to an earn-out arrangement should consider whether they would be satisfied with the up-front consideration if the earn-out piece is never earned. They should view the operation of the earn-out formula realistically and work to build in whatever protections they can negotiate for to ensure that the new owners will operate the business in a way that favors satisfying the earn-out targets. For example, founders may negotiate for specific covenants that the founders will remain employed and operating the business during the earn-out period and that the earn-out vests in full if the business is sold during the earn-out period. Founders should negotiate for a covenant from the PE firm that it will not take actions that would
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adversely affect achieving the maximum earn-out amount. PE firms will try to avoid provisions that are seen to tie their hands in how they manage or operate the target business, but founders may be successful in obtaining favorable covenants if they demand them as a prerequisite for considering an earn-out.

Incentive equity pools

Many PE firms and other financial buyers establish incentive equity pools for the target company's key management team. Like rollover equity, these arrangements are seen to incentivize employees by giving them tangible "skin in the game", which aligns their interests with those of their employer. In some industries, making the benefits of an incentive equity pool available to key employees is both customary and required to be competitive in labor market. PE firms use incentive equity pools both as a retention tool for the target company's employees and as bait for attracting new management blood to their new portfolio companies.

Incentive equity pools generally average about 12.5% of the company's outstanding equity, but can range from 5% to 20% of a portfolio company's common equity. Incentive equity includes grants of restricted equity, options or profits interests (used with LLCs). A typical equity plan provides for equity that vests based on a combination of time vesting and performance-based vesting (typically return on investment capital or IRR). Founders and management who leave employment generally forfeit unvested equity and are required to sell their vested equity back to the company. Incentive equity is almost always common equity that is subordinated to a portfolio company's preferred equity (usually held by the PE firm's fund and the founders). In many cases, holders of incentive equity do not expect to receive profit distributions from day-to-day operations but are looking to participate in a liquidity event such as a sale of the company or IPO.

Structuring an equity incentive plan's tax consequences for participants is a critical part of the planning process. Deferral of compensation income is always a primary goal of participants, but this desire must be weighed against the benefits of incentive equity that allows for favorable capital gains treatment for the proceeds of a liquidity event. Although the detailed business and tax consequences of incentive equity pools are outside of the scope of materials focusing on the founders' rollover equity, those consequences should be studied and fully understood by founders, who should take into consideration the terms of the incentive equity plan and whether or not they will be included in the scope of the plan's participants.

Legal representation and disclosure issues

If a target company's ownership includes both management personnel and investors, there may be circumstances where it makes sense for the management team, the investors, or both, to have legal counsel separate from the attorneys representing the target company in the sale transaction. The reason for separate counsel is that in a sale transaction, the interests of these various constituencies may materially differ. It is not unusual, however, for target company counsel, in the interest of moving the deal forward, to handle the review and negotiation of not only the purchase documents, but also the management team's post-sale contracts, with
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the proviso that management and target company equity owners should consult with their own legal and tax advisors.

If there are minority investors on sell side of the deal, best practices would include disclosing to them all of the material terms of the management team's deal with the target company and/or the buyer post-sale. Focus on full disclosure and addressing concerns of self-dealing or conflict of interest transactions can become a significant concern and sometimes an issue where the management team and/or founders, unlike minority owners, are expected to roll over equity their equity into the acquirer, enter into new employment arrangements and/or participate in post-sale incentive compensation plans. Full disclosure of the deal terms, the approval by at least majority of the minority investors of the deal terms, and/or structuring the transaction to make available statutory appraisal rights are tools used to address these potential conflict of interest situations.