Equity Rollovers in M&A: Bridging the Finance and Valuation Gap
Negotiating and Structuring Seller Rollovers; Tax Considerations for Buyers and Sellers

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Equity Rollovers in M&A
Bridging the Finance and Valuation Gap

May 14, 2015
Equity Rollover

- Financial vs. strategic buyers
- Non-control, post-closing equity participation by seller’s management team/founders
  - Non-control
    - Typically 10 - 40%
      - 20% tax threshold
      - Up to 49%
  - Type of security
    - Equity
      - Same rights as buyer or junior in rights
    - Debt - subordinated Seller Note
- Anchor Investment vs. Tag-on portfolio acquisition
Sample LOI Provisions

• Example 1
  – 8-12% of the equity post transaction allocated/reserved for senior management

• Example 2
  – Pursuant to a merger, or other mutually agreeable form of transaction, (x) one or more Investor(s) will acquire all of the equity of Target currently held by Old PE Fund, (y) the Phantom Equity (defined below) of Target will be redeemed by Target so that it is no longer outstanding and (z) substantially all of the equity currently held by the management team and management companies owned by the management team (the “Management Companies”) will be “rolled forward” so that the management team and the Management Companies will remain equity holders in Target post-Transaction. (20% pre-closing management participation)

• Example 3
  – Seller Note: If the Company’s ratio of indebtedness divided by LTM EBITDA will be less than 4.5 immediately as of the closing, then the Seller, or an affiliate of the Seller, will lend to the Company an amount in cash equal to the amount required to cause such ratio to equal 4.5. The definition of LTM EBITDA will be mutually agreed between the parties. Such loan shall be made pursuant to a promissory note on terms and conditions to be mutually agreed by the parties and will be subordinated to all other debt of the Company, and will be subject to a subordination agreement satisfactory to the lenders.
  – Seller Co-Investment: Due to the importance of the Seller to Target, Seller has the option to co-invest up to 49% of the closing equity value of the Target in order to share in the future equity appreciation.
Advantages

- Incentivizes on-going management
- Management participation in future appreciation
  - Subsequent PE exit (IPO or sale)
- Aligns management with acquiror
- Bridges financing and valuation gaps
Financing and Valuation Gap

- Representative deal terms from a recent PE term sheet:
  - Enterprise valuation = 6.1 x LTM historic EBITDA + 6.1 x post-closing annualized, normalized quarterly EBITDA
  - Debt financing
    - Senior or mezzanine debt – up to 4.5 x LTM EBITDA
    - Seller note = shortfall of senior/mezz debt to 4.5 x multiple
  - Equity roll – co-invest up to 49% of closing equity value
Disadvantages

- Potential conflicts of interest
  - Fiduciary duty of rolling persons
  - Decision by conflicted members of board
  - Alignment with buyer vs. seller
    - Use Rep and Warranty Insurance to mitigate issue?
- Selection of only certain rollover participants
- Complication of negotiations
  - Rights of the rolling management vs. buyer.
  - Equity vs. non-equity members of management
- Equity of buyer and founders may not be of same class
Structuring Rollover Provisions

• Type of equity
  – Common vs. participating preferred (PIK dividends)

• Tax considerations
  – Stock vs. asset deal
  – Buyer’s basis step up vs. taxable to roll-over parties

• Acquisition at holdco or subsidiary level

• Domestic vs. cross-border considerations
  – e.g. Luxembourg CPEC structure
Preemptive Rights

- Maintain percentage of equity
- Maintain percentage of debt equal to equity percentage
- Exceptions:
  - Options and incentive plans to directors, employees and consultants
  - Redemption from majority shareholder (not to exceed 10%) for resale to new investors
- Minority may not have financial wherewithal to buy
Distribution Waterfalls

• Priority of Payment to Rollover participants
  – Pari passu
  – Preferred return to PE fund/Fund and management
    • On IPO, Fund typically receives preferred return
  – Promote style compensation to management?
  – Liquidation preference to preferred?

• Example 1
  – First, PE fund receives return of equity investment without any return on capital
  – Second, co-investors receive return of co-investment (based on closing value) without return of capital
  – Third, distributions pro rata

• Example 2
  – First, PE fund and co-investors receive pro rata distributions until capital and deemed capital is returned
  – Second, PE fund and co-investors receive distributions equal to 10.1% IRR
  – Third, co-investors receive a promote of 17.5% and PE fund and co-investors share pro rata in 82.5% balance

• Example 3
  – Pro rata distributions to PE fund and management
Tag-Along, Drag-Along, Other Rights

- Tag along with debt or equity – pro rata
  - Substantially all deals
- Bear pro rata price adjustment, indemnity obligations
- Exceptions to Tag
  - Sale to shareholders,
  - less than 10% Equity or Debt,
  - per registered offer
- Drag along on sale of company or substantially all assets
  - Any minimum price to require drag
- Rights of first refusal / first negotiation
  - More limited than Tag along/ drag along
  - Possible lock-up period
    - Three years, except for Permitted Transfers, vs. immediate right to sell
- Board/Observer Seats
Registration Rights

• S-1 Demand
  – Number
  – By whom
  – When – anytime, after qualified IPO

• Piggyback
  – Against whom – anyone, issuer only
  – Proper notice
  – Priority

• S-3
Voting and Dividend Rights

• Voting Rights
  – Board seat
  – Supramajority rights
    • Amend charter or capital structure
    • Change business
    • Change auditors or accounting principles
    • Make non cash distributions of profits
    • Merger or sale of business
    • Enter contracts or capital expenditures in excess of $
  – Veto rights
    • Wind-up or liquidate
  – Merger or sale of business

• Dividends
  – Rarely paid currently, accumulated and paid at liquidity event

• Voting with majority on transfers of assets, acquisitions, election of Board
Transfer Restrictions and Covenants

- Vesting – say three years
- Permitted transfers
- Right to initiate a sale, including engage advisors and require rollover to participate in marketing efforts
- Right to force partial sale of a development project
- Rights regarding corporate opportunities:
  - Side by side fund---
- Non-compete and customer/employee non-solicit covenants
  - Term following rollover equity no longer having securities
  - Buyer having de minimis amount (10%)
- Rights of redemption
- Equity transfer restrictions
- Access to financial statements and other information and personnel
Seller Note

• Subordination
  – Fully subordinate vs. pari passu
• Secured
  – Second lien
  – Unsecured note
• Acceleration on sale or change of control
• “AHYDO” (accelerated high yield discount obligations) interest provisions
  – Avoid adverse tax effect
PE Fund Consulting Agreement

• Mechanism for Fund to charge fees to target
• Term – ten years, thereafter automatic annual renewal but terminable by PE fund
• Consulting Fee - 2% EBITDA or annual minimum
• Expense reimbursement including counsel and auditor fees
• Transaction Fees – 1% of consideration for refinancing's, equity or debt offering, dividends recaps
• Fees violative of financing agreements will accrue and be payable when allowable.
Documentation

• Mechanism for Fund to charge fees to Letter of Intent
• Rollover Agreement
• Securityholders’ Agreement
• Registration Rights Agreement
• Certificate of Incorporation
  – Rights, Preferences and Designations
• Seller Note
• Employment Agreement
  – Non-solicit and non-competes
    • 3-4 year average non-compete
• Consulting Agreement for Fund
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Areas of Practice
• Mergers and Acquisitions
• Venture Capital/Emerging Company
• International
• U.S. Inbound Investment
• Energy
• Corporate Strategic M&A
• Investment Funds and Private Equity
• Private Equity - M&A
• Public Company Transactions

Education
• J.D., Cornell Law School, 1978
• M.S., Massachusetts Institute of Technology, 1975
• B.S., Cornell University, 1973

George H. Wang concentrations on private equity transactions and domestic and cross-border mergers and acquisitions for multinational and U.S. businesses, corporate and securities, private equity and venture capital, joint venture, strategic alliance and related matters. George has assisted private equity funds and family offices in acquiring North American, Asian and European platform companies, portfolio companies and strategies in serial acquisitions, multi-continent M&A transactions, acquisitions of U.S. public companies and “going private” transactions.

George led the New York corporate team in advising Grupo Fermaca S.A. de C.V. in connection with the $750 million acquisition of a control position in Grupo Fermaca by Zug, Switzerland–based Partners Group from New York private equity firm, Ospraie. In August 2014, the Fermaca transaction was recognized as 2014 Cross-Border Deal of the Year by Global M&A Network. George also led the New York corporate team in the 2013 acquisition for $1.7 billion by Afore XXI Banorte from Banco Bilbao Vizcaya Argentaria of Afore Bancomer which was awarded 2013 Domestic M&A Deal of the Year by LatinFinance.

George is a director of the Asian American Federation, the leading pan-Asian advocacy organization in the New York metropolitan area working to advance the civic voice and well-being of Asian Americans. He was named 2014 Cornell Asian Alumni Association Honoree of the Year by his alma mater, Cornell University and The Cornell Law School. For more than 15 years, George also served as an Educational Counselor to the admissions committee of The Massachusetts Institute of Technology.

Representative Experience
• Equity roll-over transaction for leading Canadian and United States supplier of foam spray insulation products, with an enterprise value of $350 million, to a major United States private equity firm
• Numerous acquisitions for a European-based private equity firm to establish a multi-billion dollar platform business located in the United States with operations in North America, Europe, Asia and Latin America
• Represent South Korean solar panel manufacturer in auction bid for $300 million greenfield solar farm in Southwestern United States
• Various tender offers and tender offer-merger transactions for United States, European and Asian-based acquirers
• Sale of aviation assets by a European group to a Chinese investment fund.
Primary questions to ask when determining a structure:

- **Target (T) tax entity type?**
  - C Corp, S Corp, Partnership or Disregarded?

- **If T is an S Corp is rollover ratable with existing ownership?**

- **If T is a C Corp are there NOLs?**

- **What is the value of the step-up in basis?**
  - How important is basis step-up to purchaser (P)?
  - Pre-’93 business? Anti-churning concerns?

- **How important is it that the entity survives?**
  - Contracts, licenses and leases
  - Retention of EIN #
  - Overall ease of operation
Achieving a Tax Deferred Roll & Basis Step-up

Basis step-up is often critical to the value of the deal

- S Corp, Consolidated corporate subsidiary, Partnership/LLC and Disregarded entities (DRE) are generally ideal targets for a tax deferred rollover and step-up in basis
  - Single level of taxation
  - Beware of S Corps with §1374 BIG tax exposure
  - Non ratable rollover may reduce benefit of S Corp transactions
  - Ordinary income recapture must be considered
  - State tax differences must be considered
  - Will the buyer make the seller whole?
Achieving a Tax Deferred Roll & Basis Step-up

Basis step-up is often critical to the value of the deal (cont.)

- C corporations (other than consolidated subsidiaries) are generally not viable targets for a step-up
  - Double level of taxation on gains
  - Would require significant NOLs at T for an asset transaction
  - May look to non compete and personal goodwill to obtain partial tax shield
Achieving a Tax Deferred Roll & Basis Step-up

How about §§338(h)(10) and 336(e)?

- Both provide for the acquisition of S Corp (or corporate subsidiary) stock with a joint election to treat as an asset sale
- Tax deferred rollover is impossible with either
  - Both include a deemed sale of 100% of the assets of “old T” to “new T” resulting in full gain even if selling shareholders retain an interest in T or receive an interest in purchaser (P)
S Corp Rollover Transactions
Current Structure

- T is an S corporation that began operations in 2000 with significant self created intangibles and goodwill
- T has been an S corporation from inception
- P is a private equity firm looking to acquire 70% of T
- P requires a step-up in basis in the assets
- SHs require a tax deferred rollover
- SHs rollover will be ratable
- It is critical that T remain in existence as the operating entity
- T and P wish to retain flow through taxation
- P has agreed to make SHs whole for any tax differential
F Reorganization Transaction

- Newco is formed by SHs and T is transferred to Newco followed by a QSUB election ("F" Reorganization)
- Newco is, for tax purposes, a continuation of T
- Following the "F" reorganization T converts into an LLC under state law (converts or merges)
- T retains EIN as an LLC
- Conversion is a non-event for federal income tax purposes
- T is now considered a division of Newco for tax purposes
Acquisition of S Corp Business

- P acquires 70% of T from Newco
  - Blocker used if desired
- Newco distributes sale proceeds to the shareholders (shareholder discretion)
- Treated as a taxable asset acquisition (other than rollover) of assets by P followed by a transfer of assets to T LLC (taxed as a partnership)
  - Beware that a portion of the gain could be subject to ordinary income recapture under §1245 and similar
- Gain is deferred on 30% retained interests
  - Newco must remain the holder of T interests
- If retaining T as the operating entity was not critical this could be accomplished simply by transferring the assets to a new LLC prior to the sale
S Corporation transactions

- Change the facts and assume that the rollover is not ratable
  - Assume SH1 is to receive $30 stock and $20 cash
  - Assume SH2 is to receive $50 cash
  - Assume gain on sale is $70
  - Gain is allocated $35/each as opposed to $20/$50

- Fairest economic result would appear to be:
  - Distribute $28 (40% tax rate) ratably as a tax distribution
  - Distribute remaining $42 in redemption of shares in proportion to the $20/$50 split or $12 to SH1 and $30 to SH2
  - Total distribution of $26 to SH1 and $44 to SH2
S Corporation transactions

- Change the facts and assume that T began business in the 1980s and the anti-churning provisions would apply to a significant portion of the step up
- The previous transaction would subject the step-up from amortization
- Prior to P’s acquisition SHs (or a 3rd party) acquires an interest in T that causes T to become a partnership
  - Query how long before this should occur?
- While a partnership P acquires the 70% interest and receives a step-up via §§743/754
- Trap for the unwary: The use of leverage in this transaction could be problematic due to the disguised sale provisions
Acquisition of S Corp Business

- P acquires 70% of T from Newco
  - Blocker used if desired
- Newco distributes sale proceeds to the shareholders (shareholder discretion)
- Treated as a taxable asset acquisition of interests in T eligible for a §754 election and §743 adjustment
- Gain is deferred on 30% retained interests
  - Newco must remain the holder of T interests
C Corp Rollover Transactions
Current Structure

- T is an C corporation with significant self created intangibles and goodwill
- P is a private equity firm looking to acquire 70% of T
- P wants a step-up in basis in the assets
- SHs want a tax deferred rollover
- Inside gain is too great to allow an asset transaction
C Corp Holding Company Acquisition

- P creates Holdco and invests cash
- Holdco utilizes cash and any leverage taken on to acquire the stock from SHs other than the rollover shares
- SHs transfer their shares to Holdco in a tax deferred §351 transaction
- Trap for the unwary: This is not a proportionate sale of stock
- Gain recognized to the extent of boot received:
  - SHs have $50 in basis in T
  - SHs receive $70 in cash in $30 in stock
  - Recognized gain is $50
  - $20 of gain is deferred
- Rollover becomes much more difficult if Holdco is an existing C Corp and a new holding company is created
LLC/Partnership Rollover Transactions
Current Structure

- T is an LLC that began operations in 1980s with significant self created intangibles and goodwill
- P is a private equity firm looking to acquire 70% of T
- P requires a step-up in basis in the assets
- Partners require a tax deferred rollover
- Partner rollover will not be ratable
- It is critical that T remain in existence as the operating entity
- T and P wish to retain flow through taxation
- P has agreed to make SHs whole for any tax differential
Option 1: LLC Acquisition

- Simplest transaction from a tax perspective
  - P often wants a new holding company which may make this transaction unlikely
- P acquires interests in T from T partners
- Step-up received under §§754/743
  - No anti-churning concerns
- Partners retain their interests tax deferred
  - Non ratable is fine
- Use of leverage does not generally bring disguised sale provisions into play
Option 2: New Holdco LLC

- Creation of new Holdco brings some uncertainty into play as to the type of transaction
- Partners transfer T in exchange for cash and Holdco units
- Is this a partnership merger under §708?
  - If so then cash proceeds may be designated as for the sale of interests
- Is this a Rev. Rul. 99-6 transaction?
  - Asset acquisition by Holdco and equity transfers by Partners
- Leverage in transaction brings disguised sale risks
  - Anti-churning concerns
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Summary of Experience

Nick Gruidl is a Partner in McGladrey’s Washington National Tax office. Nick has experience working with both publicly held and privately held businesses. Nick’s client service focus is in advising clients and firm personnel on corporate merger and acquisition activity; spin-offs, bankruptcy and debt restructuring, private equity transactions, consolidated group issues; analysis of net operating loss issues, and partnership taxation. Nick develops and delivers internal and external training on corporate tax and transaction related issues. Nick has authored numerous published articles in the corporate tax and M&A area. Examples of services Nick has provided include:

• Structuring private equity acquisitions.
• Structuring IPO transactions involving the use of a tax receivable agreement (TRA)
• Transaction cost analyses
• Issuance of tax opinions to publicly held corporations as to the qualification of transactions pursuant to sections 332, 351 and 368.
• Issuance of tax opinions and calculations with respect to section 382 ownership changes and of the section 382 limitation. Issuance of tax opinions as to the ability to claim ordinary worthless stock deductions on foreign and domestic subsidiaries. Determinations of whether certain debt modifications are significant and the corresponding tax consequences.
• Determination of tax attribute reduction following a bankruptcy or debt restructuring.
• Determination on the application of the applicable high yield debt obligation rules and alternatives to alleviate their impact.
• Determination of the impact of the consolidated return regulations on intercompany transactions, obligations and subsidiary dispositions.
• Preparation of private letter rulings, audit defense and comment letters.

Professional Affiliations and Credentials

• Named to the M&A Advisor 2013 “40 under 40” Service Providers
• American Institute of Certified Public Accountants, past chair of the AICPA Corporations and Shareholders Technical Resource Panel
• American Bar Association and ABA Corporate Tax Committee

Education

• BA, Augsburg College (Minneapolis, MN)
• MS in Business Taxation, University of Minnesota