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Equity Rollovers in M&A Transactions

During the past decade, private equity investors and other financial buyers (referred to generally in this article as financial buyers) have dramatically increased their activity in the M&A marketplace. These financial buyers generally acquire portfolio companies with the intention of holding them for around five years and then selling them for a substantial profit. Unlike strategic buyers operating in a target company's industry who often intend to replace or consolidate the target company's management team, most financial buyers are looking for companies with strong management teams who can help them work towards a successful exit. A study of PE investors found that almost 70% invest in existing management teams rather than recruit their own senior management teams before the investment.^[1]

Financial buyers often expect some of the target equity owners to receive a portion of their sale consideration in the form of equity (equity received or retained by some of the target company owners in a sale transaction is often referred to as "rollover equity"). Rollover participants usually include key management team members, and sometimes include founders and investors. When the sale closes, rollover participants shift from holding a controlling interest in the target company to filling the shoes of a minority owner in the continuing business. This article focuses on tax and business aspects of structuring equity rollovers in sale transactions involving financial buyers.

What is driving the popularity of equity rollovers in sale transactions?

The popularity of equity rollovers in sale transactions can be attributed to several factors. Financial buyers believe that having the target's management team take equity as a meaningful share of their deal consideration is a powerful tool for aligning their interests with those of the financial buyer. Financial buyers refer to management with rollover equity as having "skin in the game". They believe that rollover participants will be personally invested in working towards a profitable exit.

There are several other reasons why financial buyers favor equity rollover transactions. The inclusion of an equity rollover in a transaction can function as a form of seller financing, reducing the buyer's up-front capital investment. Rollover equity can also serve as critical part of the overall deal consideration if the transaction is aggressively priced (making the use of "soft" money consideration a valuable tool for the buyer), or where there is a substantial valuation gap between buyer and seller (here working as a proxy for an earn-out). Finally, a financial buyer may view rollover equity as a part of the overall post-closing compensation package, possibly reducing the pressure to provide a generous incentive equity or bonus plan.

How equity rollovers are typically structured

Equity rollover transactions typically involve rollover participants taking between 8% and 40% of their sale consideration in the form of equity (excluding any equity acquired through the buyer's option or other incentive equity plan or through a co-investment arrangement). Rollover equity may represent either a continuing equity interest in the target company or an equity interest in a holding company organized by the buyer to hold interests in other portfolio companies. Asset or stock purchase transactions, mergers and joint venture formations can be structured to include an equity rollover component. The tax provisions applicable to an equity rollover will differ from deal structure to deal structure. In some transactions, buyers ask rollover participants to "roll over" their equity by first selling 100% of the target company's equity in a fully taxable transaction and then purchasing buyer equity with after-tax sales proceeds. But in most cases, an effort will be made to structure the equity rollover transaction on a tax deferred basis.

A target company's owners may include one or more founders who plan on retiring, the management team, passive family members, outside investors, holders of convertible debt and employees holding options or other incentive equity. A rollover transaction would be simplified from a tax standpoint if all of the target owners rolled over a portion of their equity on a pro rata basis. But few equity rollover transactions are that straightforward. In most cases, only certain target company equity owners take a portion of their

sale consideration in the form of rollover equity. In many transaction, rollover participants are limited to target company management team members who will continue on with the buyer.

A typical equity rollover transaction involves rollover participants exchanging their equity for buyer equity and cash. The deal consideration may also include indemnification and working capital escrows, long or short-term debt instruments, deferred consideration payments and earn-out arrangements. Debt is usually straight buyer debt but can include mandatory or optional convertible debt provisions. Earn-outs may be paid in cash or in the form additional buyer equity, or a combination of both. “What’s market” regarding the economic features of rollover equity has been evolving since 2008 as the competition among financial buyers for companies has heated up. At one point, the typical equity issued in a rollover transaction was common equity subordinated to the preferred equity issued to a financial buyer’s investors. In today’s heated M&A marketplace, rollover equity often has the same economic rights and preferences as the equity held by the buyer’s investors (usually participating or straight preferred equity, or common equity if the buyer doesn’t have classes of preferred equity). But some transactions, the class of equity issued to rollover participants will be subordinated to the buyer’s senior and subordinated debt and one or more classes of preferred equity. Incentive equity issued to management and employees post-closing is often subordinated to this rollover equity.

In some transactions, the target company will be asked to recapitalize its equity structure prior to closing the sale transaction. A typical LLC recapitalization involves the creation of an equity structure that includes one or more preferred classes of equity (these preferred units may have senior liquidation preferences, preferred returns and participation rights) and a common class of equity (which can be structured to include “profits interests” under Revenue Procedure 93-27). The financial buyer will acquire the senior preferred equity and rollover participants will “roll over” (retain) one of the preferred or common classes of equity. The financial buyer will usually draft and install an amended and restated LLC agreement that includes its desired economic, buy-sell and governance provisions. Exactly what the rights and

preferences are of the class of equity held by the rollover participants versus those of a PE sponsor, the PE fund, other investors and the management team will differ from deal to deal, making it critical to review in detail the terms of the LLC agreement or certificate of incorporation setting forth the distribution and tax waterfalls.

Rollover equity is usually fully vested, although we have seen rollover equity with time and/or performance vesting requirements. Be careful with this, because the inclusion of vesting requirements tied into future employment exposes rollover equity to treatment as taxable compensation by the IRS, which would result in a taxable rollover. The buyer will also often include a right to redeem rollover equity if the holder ceases to provide services because of death, permanent disability, termination for "cause" (less often but sometimes without cause) or voluntary termination, but to preserve favorable tax treatment the buy-out price must not amount to a forfeiture by the former employee.

In most rollover deals, the rollover participants will have no opportunity to exit from equity ownership unless and until a second sale occurs. In the rare case, a founder rolling over a portion of his or her equity will negotiate for a put that can be triggered after several years or upon termination of employment.

As discussed below, potential rollover participants should carefully review the buyer's capitalization structure (debt, equity and equity rights), and study the rollover equity's features. Finally, shifting into a minority owner role can be a jarring experience for the former target company's owners. How this change can impact the success of a rollover arrangement is discussed in more detail below.

Tax treatment of equity rollovers

In most sale transactions that include an equity rollover component, the parties have the flexibility to structure the rollover on a fully taxable or nontaxable basis. Not surprisingly, rollover participants usually want to defer taxes. For example, if the rollover participants are receiving 70% of their consideration in cash and 30% in rollover equity, they reasonably expect to defer taxes on the 30% rollover

piece. In most deals, the interests of rollover participants with respect to the desired tax treatment will differ from those of the financial buyer. Buyers often prefer a fully taxable asset purchase because the buyer's tax basis in the target company's assets will be stepped-up to the amount of purchase consideration for future write-off purposes (including amortization of goodwill over a 15-year period). Sellers generally prefer an equity sale to maximize their long-term capital gains, and a transaction structure that allows them to rollover their equity on a nontaxable basis. It isn't unusual for the parties to include a reference to an equity rollover as part of their early negotiations and the letter of intent without considering the tax aspects of the transaction. While it is fair to say that "market" today is to cooperate to accomplish the rollover piece of a sale on a nontaxable basis, there are buyers who won't cooperate to structure the rollover on a nontaxable basis. There are also situations where the agreed-upon structure of the deal won't fit within any of the available nontaxable rollover strategies discussed below.

The best advice is for potential rollover participants to negotiate for a nontaxable rollover early in the transaction (preferably before the letter of intent is signed). Ideally, the target company's tax advisors will have an opportunity to review the proposed transaction structure in advance of signing a letter of intent, in order to confirm that the proposed deal structure will allow for a nontaxable equity rollover. While the typical deal can and should be structured to allow for a nontaxable equity rollover, our experience is that the target company's attorneys must often take the lead in negotiating for a favorable structure, and it is important to follow through to make sure that the buyer's transaction documents reflect a nontaxable rollover structure. We have seen transactions where the buyer's first draft of transaction documents don't include a nontaxable rollover structure, sometimes directly contradictory to the intent expressed in the parties' letter of intent.

If the target company's rollover participants agree to a fully-taxable rollover, they will need to pay taxes out of the purchase consideration. Unless a nontaxable rollover structure is adopted, buyer equity received as sale consideration may be taxable in a rollover transaction in spite of the fact that it may be worthless

down the road. Here are key tax and business issues associated with several of the most commonly employed ways of structuring an equity rollover:

Fully taxable rollovers. A taxable rollover typically involves the sale of 100% of the target company's equity or assets, followed by the reinvestment of a portion of the consideration in the buyer's equity. A common reason voiced by buyers for a taxable rollover is that it either isn't possible or practical to structure the transaction as a nontaxable rollover. It isn't uncommon to see a taxable rollover where the whale buyer is swallowing a minnow target company. In that case, the buyer often doesn't want to structure the deal to accommodate the sellers' interests. A fully taxable rollover is usually an undesirable tax result for the target company's rollover participants. If there is a way to structure a nontaxable rollover, counsel for the target company should make a persuasive argument that both the interests of the sellers and the buyer can be accommodated.

Purchase of less than 100% of the target company's equity (a partial equity acquisition). In the simplest "rollover" transaction structure, the target company's owners sell less than 100% of the target's equity to the buyer. From a tax standpoint, the target company might be a corporation, a partnership (usually an LLC), or a disregarded entity. Using a partial equity acquisition structure allows the parties to pick and choose among who will be a rollover participant. Key target company managers are often required to rollover all or a substantial percentage of their overall target equity.

A partial equity acquisition permits optimal tax treatment from a seller's standpoint – the retained target company equity isn't treated as having been sold. Assuming those target owners who do sell have a long-term holding period for their equity, gain on the sale will generally be taxed at favorable long-term capital gains rates. There are several possible tax problems associated with structuring a partial equity acquisition. If the target is an S corporation, the sale of S corporation stock triggers a termination of the S election if the buyer is an ineligible shareholder (e.g., corporations, partnerships and some trusts). If the target company is a C or S corporation, a stock purchase won't trigger an inside tax basis step-up supporting

future depreciation and amortization deductions. A purchase of 80% to 100% of an S corporation's stock can be treated as an asset purchase if the parties make the appropriate tax election. But if this election is made, stock retained by rollover participants will not be rolled over on a nontaxable basis, as 100% of the target company's assets will be treated as having been sold.

If the continuing business is taxed as a partnership (e.g., an LLC with multiple owners), then the sale of LLC equity by rollover participants will generally be entitled to capital gains treatment, although some of the gain may be taxed at ordinary income rates if the target holds IRC § 751 "hot assets" such as appreciated inventory, receivables or equipment where depreciation recapture is triggered by the sale. If rollover participants 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 holding period rules. Sellers may have "phantom income" (i.e., where income triggered by the sale exceeds the sale consideration) if they have taken write-offs before the sale in excess of their capital investment (usually resulting from sharing in liabilities under IRC § 752). If the target is a single member LLC, then the sale of all or a portion of the membership interest will be treated as an asset sale. If the sale involves LLC interests, a partial equity acquisition would defer taxes on the retained portion of an owner's LLC interest. The LLC can make an IRC § 754 election to permit the basis step-up of a portion of the LLC's assets (reflecting the percentage interest in the LLC purchased in the transaction).

A partial equity acquisition may be an installment sale under IRC § 453 if the payments are spread over more than one year, subject to certain limitations.

One potential issue with a partial equity acquisition is that rollover participants merely retain an equity interest in the target. If the parties want post-closing ownership of buyer equity by the rollover participants that includes not only the indirect ownership of the target company but also the buyer's pre-transaction business, the partial equity acquisition will fail to accomplish this basic deal requirement.

A partial equity acquisition is by its nature an equity rather than asset purchase. In many transactions, buyers will gravitate towards an asset acquisition for tax and business reasons. Except for limited instances where successor liability principles apply, purchasing the assets of a target company rather than its equity avoids taking a business subject to its unknown and unwanted liabilities and obligations. The fact that an equity purchase may be required for regulatory reasons (e.g., certain insurance and bank deals), or the fact that an equity purchase may allow the parties to avoid the need to obtain difficult third-party consents should also be taken into account when considering whether to structure the transaction as a partial equity acquisition.

The LLC “drop-down” equity rollover transaction (a drop-down transaction). Equity rollovers are often accomplished through a drop-down transaction. A drop-down transaction usually involves the pre-transaction formation of an LLC to hold the target company’s assets, liabilities and contracts. In exchange for a contribution of the target company’s business and assets, the target company is issued a 100% equity interest in the newly-formed LLC. At this point in the transaction, the newly-formed LLC is a disregarded entity for federal tax purposes. The next step is the acquisition by the financial buyer of a controlling interest in the LLC for cash, with the rollover participants retaining their rollover equity and the cash being distributed either proportionally or disproportionately among the selling owners.

The purchase of the newly-formed LLC’s equity by the buyer will be treated as a formation of a partnership under IRC § 721, with the cash consideration treated as being paid to acquire target company assets. Usually this deemed asset acquisition qualifies the gain for long-term capital gains treatment (subject to the application of the IRC § 751 “hot assets” exception for appreciated inventory, receivables and gain on depreciated assets). To the extent of the cash portion of the purchase consideration, the new LLC and its owners will be able to take advantage of a tax basis step-up in the new LLC’s assets on a going-forward basis. The new LLC will have a carryover basis and holding period in the portion of assets deemed to be purchased in the transaction. Here again, it is possible to structure the transaction as an installment sale under

IRC § 453 if the payments are spread over at least two years, subject to certain limitations, but the contributing target company will be taxed on all of the gain associated with the IRC § 751 hot assets at the time of contribution, regardless of whether the actual payments for those assets are deferred into subsequent years.

A drop-down transaction is particularly useful where the target company is an S corporation and the buyer would be an ineligible shareholder (typical for a financial buyer operated as a partnership or corporation). In a drop-down transaction, the target S corporation will be a continuing owner of the new LLC post-transaction and tax status will be unaffected by the transaction.

There are a number of other possible benefits to using a drop-down transaction. The target company can retain unwanted assets and contractual obligations and known or unknown liabilities. Post-closing, the parties will take advantage of favorable pass-through tax treatment by operating the business through an LLC taxed as a partnership.

In a fashion similar to a pre-sale recapitalization employed in a partial equity acquisition, the parties may capitalize the new LLC with preferred units (these preferred units may have senior liquidation preferences, preferred returns and participation rights) and common units (often profits interests under Revenue Procedure 93-27). The financial buyer would then acquire the senior preferred equity and rollover participants would “rollover” (retain) either a subordinated class of preferred units or common units.

If the parties expect rollover participants to own an interest in the buyer’s historic business, those business assets can be contributed into the new LLC. In some cases, that won’t work for business or regulatory reasons and one possible solution where the buyer is an LLC is for its owners to contribute the buyer’s membership interests to the newly-formed LLC. Another possible solution that is a variation of the drop-down transaction is for the target company to contribute the assets to be acquired in the transaction directly into the historic buyer in exchange for membership interests and cash.

If some of the target company's owners are not continuing on post-acquisition as indirect owners, their equity in the target company can be redeemed by the remaining members of the seller group as a part of the transaction. Where the acquisition vehicle is a pass-through LLC/joint venture, financial buyers routinely use a "blocker" corporation between their investors and the new LLC 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).

The "F" reorganization variation on the drop-down transaction.

If the target company is an S corporation, a useful variation of the typical drop-down transaction is to add a new first step involving the formation of a holding company for the target S corporation. The target company's shareholders would contribute their S corporation stock to the new holding company. The target company would then be a subsidiary of the new holding company and can convert into an LLC under state law. The holding company formation transaction qualifies as an "F" reorganization (IRC § 368(a)(1)(F)), with the holding company being treated as the continuation of the target company for S corporation tax purposes. The converted LLC subsidiary can then recapitalize with preferred and common units and the preferred units can be sold to the financial buyer. The balance of the transaction would fall within the standard drop-down transaction, with the target owners retaining indirectly through their S corporation holding company a class of preferred or common units in the target company (now converted into the joint venture LLC).

The benefits of the "F" reorganization drop-down include the fact that the target company (the corporation converted into the LLC) can retain its old EIN and there is no asset transfer for state law purposes. The down-side of this structure is that the financial buyer is acquiring equity in a pre-existing company which may harbor unknown liabilities and have legal issues based on its past operating history.

The LLC holding company formation equity rollover transaction (an IRC § 721 exchange). An IRC § 721 exchange involves the contribution of target company assets or equity to either an

existing or newly-formed tax partnership (usually an LLC).

If the target is a C corporation, management rolling equity over into the buyer will often contribute their rollover stock to an LLC holding company in exchange for LLC units. The contribution of stock to the LLC holding company would be nontaxable to the extent that the stock is exchanged for LLC units. The holding company LLC would then drop down a transitory merger subsidiary (either corporation or LLC) and the remaining target shareholders would be cashed out in a reverse taxable merger. The second step cash-out merger is often used to avoid the need to have all target shareholders agree to a stock sale. Post transaction, the LLC holding company might facilitate the undertaking of additional acquisitions and allow for the issuance of profits interests.

The same two step structure outlined above is often used if the target is a partnership for tax purposes. Here the contribution might involve the target's assets rather than its equity if the buyer is concerned with the target's operating history and unknown liabilities.

The corporate holding company formation equity rollover transaction (an IRC § 351 exchange). The IRC § 351 exchange is a common rollover transaction structure employed to take advantage of an IRC § 351 tax-free exchange as the vehicle for obtaining tax-free treatment for the target's rollover equity. This technique involves the formation of a corporate holding company. The financial buyer exchanges the stock of any operating entities that it already owns plus cash to the holding company in exchange for equity in the holding company. The target company's owners exchange their target company equity for holding company stock and cash, or for only cash if there are target company owners who are not rollover participants. If properly structured, the rollover participants' exchange of target company stock for holding company stock is tax-free under IRC § 351, except for any cash (boot) received in the transaction. Target company owners who receive all cash are treated as selling their stock. A variation of the IRC § 351 exchange involves a partial sale and partial exchange of target company stock by rollover participants. This variation allows the rollover participants to recover their target company stock

basis against the cash payment, which won't occur in the straight IRC § 351 exchange described above (IRC § 351 requires that gain realized be recognized to the extent of boot). Another variation of the IRC § 351 exchange, which is particularly useful where the target company is an S corporation, is for the target company to contribute assets to the holding company in exchange for holding company stock and cash.

There are several potential tax problems associated with the IRC § 351 exchange. If the plan calls for the rollover participants to own 50% or more of the holding company's (including constructive ownership under IRC § 318) stock as part of the holding company formation transaction, the IRC § 304 rules should be carefully reviewed because falling within the scope of that provision would result in the cash boot being taxed at ordinary dividend income rates. There is also a possibility of additional taxable income being triggered under IRC § 357, which governs the assumption of liabilities by the newly-formed holding company.

While an IRC § 351 exchange may be effective for achieving a nontaxable exchange the rollover equity, the buyer may be unwilling to create a new holding company, particularly if the buyer is substantially larger than the target or has a complicated financial or ownership structure.

The tax-free reorganization equity rollover transaction. If an unusually high percentage of the purchase consideration is paid in the form of buyer stock, a rollover transaction could be structured as a tax-free reorganization. A properly structured tax-free reorganization allows the selling shareholders of a corporation to defer taxes on the portion of proceeds received in the form of buyer equity. Cash included as purchase consideration will generally be treated as taxable "boot". IRC § 368 provides for several forms of tax-free reorganizations. A merger (type A reorganization) involves the exchange of target stock for buyer stock in a statutory merger. The amount of taxable "boot" (cash, notes, other non-qualifying stock property) possible in a type A reorganization doesn't generally exceed 50% of the overall merger consideration. Other forms of tax-free reorganizations include the exchange of target company assets for buyer stock (a type C reorganization), the

exchange of target company stock for buyer stock (a type B reorganization) and the use of buyer subsidiaries to facilitate triangular mergers. Each of these other types of reorganizations require a higher percentage of buyer equity than a type A reorganization. Seller's counsel should be familiar with the details of each potential tax-free rollover structure to identify situations where use of the reorganization structure would be possible. In a typical rollover transaction, the percentage of equity to be retained by the management is insufficient to satisfy the continuity of interest requirements applicable to the different types of tax-free reorganizations.

Buyers considering using tax-free 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 use of a C reorganization (assets for stock) addresses a buyer's desire to avoid unwanted target company liabilities, but B reorganizations (stock for stock) and C reorganizations are seldom utilized in a typical equity rollover transaction. Where 100% of the consideration is buyer equity (more often the case with strategic buyers), tax-free reorganizations are the default choice.

In most cases, a reorganization transaction won't be available because the percentage of stock consideration will be too low and/or the buyer won't want to merge the target company with the buyer (the percentage of stock required for reorganizations other than an "A" reorganization will always be too high for a rollover transaction).

Avoiding tax traps associated with equity rollover transactions.

Advisors structuring rollover transactions must be familiar with all of the technical tax rules for achieving tax-free treatment under IRC §§ 351, 368, 721 and 751, along with other applicable federal, state and local tax provisions. Not surprisingly, there are a number of potential tax traps to be avoided in structuring a rollover transaction.

One trap to avoid is where rollover equity is subject to "vesting" tied into post-closing employment. In those situations, the retained equity may be characterized as compensatory equity and fall within

the IRC § 83 equity compensation tax regime. If rollover equity is treated as being subject to IRC § 83, an IRC § 83(b) election would be necessary to avoid having all of the sales proceeds from future sales of the rollover equity being treated as compensation. The problem with the IRC § 83(b) election is that the issuance of the rollover equity could result in substantial taxable compensation or trigger a deemed sale of the equity rolled over in the transaction. A possible alternative to placing a vesting requirement on the rollover equity would be a purchase price adjustment (which might include equity forfeitures or buy-backs) if certain triggering events occur. If favorable tax treatment is desired, a forfeiture provision tied to termination of employment should be avoided.

Another tax trap is the possible application of the anti-churning rules. If the target business existed on or before August 10, 1993, and the management team will own more than 20% of buyer's equity post-rollover, the "anti-churning rules will block the acquired target company goodwill and going concern value from being amortized under IRC § 197. If the buyer is using an LLC as the purchasing vehicle, the anti-churning rules can under some circumstances create an issue even where the management team ends up holding less than 20% of the buyer's equity.

Another issue that we see frequently are transactions where the parties intend to convert a partnership into a corporation with the intent of participating in an IRC § 368 tax-free reorganization. The possible result of converting to corporate status for the purpose of participating in a tax-free reorganization might be the IRS ignoring the conversion and treating a purported tax-free reorganization transaction as a fully taxable sale. The IRS' position for doing so would be the step transaction doctrine.

There are additional potential tax traps associated with rollover transactions relating to the tax identity of target company, the rollover participants or the buyer. Both buyers and sellers should rely on competent tax advisors, which might include both attorneys and accountants.

The form of the transaction documents is important to preserve favorable tax treatment. If the parties expect include a nontaxable equity rollover in a transaction, best practices suggest the use of a

“contribution” or “exchange” agreement rather than a “purchase agreement.” If the rollover technique selected includes an exchange of target equity for buyer equity, the use of the appropriate contribution agreement format should help avoiding any confusion regarding the intended tax results. Mischaracterizing the entire transaction as a purchase suggests to the IRS that the participants should be bound by the form of their transaction documents. A definitive agreement should always include operative deal provisions tracking the correct nontaxable rollover technique selected. Where the rollover transaction involves an IRC § 351 exchange involving the formation of a holding company, it is important that the parties include an acknowledgement that the target company’s and buyer’s contributions are part of the same overall IRC § 351 exchange. If the exchange is intended to fall within IRC § 721, the agreement should reflect the parties’ intention to rely on that provision.

The tax provisions in the buyer’s LLC’s operating agreement affect rollover participants. In several of the equity rollover structures outlined above, the rollover participants’ equity will hold LLC interests post-transaction. Internal governance, buy-sell provisions and the economic terms of the relationship will be set out in the LLC’s operating agreement. Both the tax and business terms of the LLC’s operating agreement should be of interest to rollover participants. Rollover participants should pay careful attention to the LLC agreement’s tax allocation provisions. There are “seller-friendly” (the traditional method) and “buyer-friendly” (remedial method) allocation methods permitted under the IRC § 704 Treasury Regulations. Under the remedial method, the target company’s owners could recognize the built-in gain on their rollover equity prior to a secondary sale of the business. Rollover participants should always look for an annual tax distribution provision in the LLC operating agreement and confirm that there is no obligation to make additional capital contributions or loans to the LLC, or to guarantee the LLC’s debt or other obligations.

What happens if target management holds options or other equity rights? Structuring nontaxable rollovers is usually relatively easy if the participants hold vested equity in the target entity. But a nontaxable rollover won’t be possible with respect to options,

restricted stock units (RSUs), stock appreciation rights (SARs), phantom equity or transaction bonus arrangements. Conversion of these equity rights into buyer equity triggers taxable compensation for the target management participants equity to the fair market value of the buyer's equity issued in the rollover. An alternative to a taxable conversion of these equity rights is to substitute buyer equity rights for the target equity rights, but the subsequent cashing out of these rights will trigger compensation rather than capital gains treatment. In some cases, the best rollover arrangement would be a combination of an exchange of comparable equity rights coupled with an equity grant by the buyer. If the buyer's equity has vesting requirements, an IRC § 83(b) election is usually recommended. In connection with the sale of a target company, management team members with transaction bonuses arrangements should go ahead and take their bonus payment and suffer the compensation treatment associated with it, as it seldom makes sense to "rollover" a transaction bonus arrangement that is being triggered by the initial sale to the financial buyer.

The future unfavorable tax treatment accorded target equity rights in a rollover transaction should be considered by the target's founders at the time they adopt their equity plans. The short answer is to adopt equity grant arrangements, but there are business and governance issues that often lead to companies adopting equity rights plans instead of equity grant arrangements.

Financial buyers often include incentive equity pools in their deals

Many financial buyers introduce incentive equity pools in connection with their acquisitions. In a large study of PE investors, the authors found that 61% of PE investor expect to create value by improving incentives.^[2] Participants often include both key members of the target company's management team and executives brought in after completion of the rollover transaction. Like rollover equity, incentive equity pools are seen to incentivize employees by giving them tangible "skin in the game", which aligns their interests with those of their owners, in addition to serving as a tool to attract and retain employees. In some industries, making

these benefits available to key employees is not only customary but required to remain competitive in a tight market for skilled workers.

One study found that incentive equity pools average about 17% of company equity for small and medium size portfolio companies and 15% for larger companies^[3], but can range from 5% to 20% of company equity. The CEO's incentive compensation averages 8% of company equity for small and medium size companies and 6% for larger companies.^[4] Incentive equity includes grants of restricted equity, options, profits interests (used with LLCs), restricted stock units (RSUs), stock appreciation rights (SARs) or phantom equity. A typical plan provides for equity that vests based on a combination of time vesting and performance-based vesting (typically return on investment capital or IRR). Participants leaving employment before the company is sold 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 usually subordinated to preferred equity held by the buyer's investors and the management team's rollover equity. Holders of incentive equity expect their payday to occur when the company is sold (or there is an IPO), and often don't participate in a meaningful way in profit distributions generated through day-to-day operations.

Considering the equity incentive plan's tax consequences is a critical part of the planning process. Deferral of compensation income is always a primary goal of participants, but this desire must be balanced with the attractiveness of capital gains rates. Although the detailed business and tax consequences of incentive equity pools are beyond of the scope of this article, the management team should ensure that experienced counsel reviews the terms of the plan and advises them regarding its key business and tax issues.

Some financial buyers will give rollover participants the opportunity to co-invest

Some PE sponsors give rollover participants and possibly other members of the target company's management team the opportunity to co-invest in the target company and/or other PE sponsor portfolio company investments. In most cases, these direct investment opportunities are looked upon favorably by investors as

the investor's economic return is not reduced by the carried interest paid to the PE sponsor by its fund. A co-investment opportunity should be viewed like any other potential equity investment in a business.

A potential investor should become familiar with the business, including its products and services and financial condition. The potential investor should also examine the capitalization of the entity through which the investment will be made, sometimes co-investments are directly into the entity holding the portfolio company business and sometimes are in an entity that in turn acts as investor in the portfolio company. The potential investor should make sure that there will be a tax distribution and no obligation to make additional capital contributions. Other key terms include pre-emptive rights to participate in additional equity raises and the absence of restrictive covenants that would unduly restrict the right of the investor to engage in activities that might compete with those of the portfolio company or the PE sponsor's other portfolio companies. Focusing on restrictive covenants is important for target company's management team and other founders who might want to continue working in the industry if the relationship with the financial buyer ends down the road. Finally, a co-investment opportunity often represents an undiversified investment for rollover participants who already have a lot a stake in the success of the continuing business. In many cases, the financial buyer owns interests in multiple companies and can spread risk over those investments while the rollover participants' investment is concentrated more heavily in the target company. All of this said, the opportunity to co-invest often represents a valuable opportunity for the management team.

Rollover participants should view their rollover equity as an investment in the continuing business

Owners who agree to roll over some of their target equity are in many respects making the equivalent of a minority equity investment in the buyer. Unlike the typical cash investor in a closely-held business, rollover equity "investors" often undertake

little or no investigation of the business, legal or financial condition of the acquirer or the features associated with their minority equity “investment” in the acquirer. This happens for a number of reasons. In some cases, the cash portion of the deal is enough to relegate the rollover piece to something of the tail on the dog. In other deals, the mindset of being a “seller” rather than an “investor,” not to mention dealing with the dynamics of a buyer who doesn’t view the rollover equity piece of the deal to be an investment, results in rollover participants not carefully vetting the buyer, or the buyer’s business, financial condition or equity. Finally, in some deals, rollover participants simply aren’t in a good position to make demands.

There are a number of risks associated with “purchasing” rollover equity that shouldn’t be ignored by rollover participants or their representatives. One real risk is that the enterprise value of the buyer’s business has been inflated for purposes of the exchange of target equity for buyer equity. Owners are often so focused on obtaining a strong valuation for their target company that they ignore the value placed on the buyer’s business for rollover equity purposes. Rollover participants should carefully consider the buyer’s financial information and assumptions supporting the buyer’s valuation of its business.

Rollover participants may receive equity in an entity whose sole business is the target business or an entity through which the financial buyer holds interests in other business assets (a common result where the target company is an add-on acquisition or part of a larger roll-up transaction). While the potential rollover participants’ “due diligence” of a buyer’s capitalization and financial structure is necessary regardless of the history and status of the buyer, due diligence and the buyer’s representations and warranties are particularly important where target company owners are receiving equity in a diversified business.

Accepting that the deal dynamics may present constraints on viewing rollover equity as an investment, rollover participants and advisors should do their best to undertake meaningful due diligence of the buyer’s business and financial condition, the buyer’s capitalization and debt structure, the economic and tax features of the rollover equity, the buyer’s strategy, philosophy and track

record with respect to owning, operating and selling portfolio companies, and the buyer's plans for the target company.

Ideally, rollover participants should undertake the same due diligence of the buyer that they would if they were approached to make a cash investment in the acquirer. This due diligence would normally include at the very least a review of the buyer's financials statements and governance documents (e.g., articles, bylaws, shareholders agreement or operating agreement).

An LLC's capital structure often includes several classes of preferred LLC units, along with common units that are "profits interests" for tax purposes. In addition to common stock, corporate buyers may have one or more of classes of preferred stock, convertible debt, warrants, options, stock appreciation rights and phantom equity. If the rollover equity is subordinated to the buyer's debt and preferred equity, rollover participants should study the closing pro forma balance sheet and make sure they have a good understanding of how and when they will be able to monetize their rollover equity interest. Do the buyers have any expectation that the company will distribute operating profits or is the play strictly to achieve the sale of the business after five years? In a future sale, how much must the company appreciate before the rollover participants will see a return? What management (and other) fees will be paid by the company on an annual basis, and in connection with a sale or refinancing? Does the financial buyer have a carried interest that pays out prior to, or participates pro rata with the rollover participants' equity? If a rollover participant stops working for the company, what are the equity repurchase rights? Is there any put right favoring the rollover participant under these circumstances? In a future sale, are the terms of any drag-along rights fair to the rollover participants? Are there go-along rights?

If the buyer intends to combine the target business with the buyer's larger business, the management team's due diligence efforts should extend to that existing business. Rollover participants should ask for representations, warranties and covenants from the buyer similar to those customarily given to investors in a company's preferred stock, but the reality is that in many equity rollover transaction this investor protection is lacking.

From an economic perspective, rolling over equity is similar to including an earn-out in the deal. In both cases, the eventual value to the seller depends on the post-transaction success of the target business. It is uncommon, but not entirely unheard of, to tie puts and calls into an equity rollover arrangement. Including separate exits for the management team conflicts with the financial buyer's usual goal of making sure that cashing out the management team's "skin in the game" is tied to a successful exit by the financial buyer. One practical distinction between an earn-out and a rollover is that monetizing rollover equity requires not only the successful post-sale operation of target business but also a second sale before there is a liquidity event. The importance of a successful second sale suggests that target owners should include as a part of their seller "due diligence" a look at the buyer's track record as both an operator and as a successful reseller of portfolio companies.

Viewing rollover equity from the vantage point of being a minority partner

Not only are rollover participants investing in buyer equity, but they are also being asked to shift from being in control to holding a minority ownership position. Rollover participants should look beyond the dollars and carefully consider what life will be like after closing with their financial buyer. There are many financial buyers competing for deals and each one of them has a different approach for handling the management of their portfolio companies. Some financial buyers adopt a more or less hands-off approach, relying on the target's management team to operate the business on a day-to-day basis unless the wheels begin to fall off. So long as the portfolio company is meeting its financial performance goals, the financial buyer's representatives may show up at the company only for monthly or quarterly board meetings. In contrast, other financial buyers seek out targets where they believe a heavy role in operations is warranted. These buyers routinely maintain a substantial presence their portfolio companies and their representatives often participate on almost a day-to-day basis in the operation of the company. No matter what the financial buyer's level of involvement, the target's management team must accept

that they have traded absolute (or close to absolute) control for a minority owner role. After the sale, the financial owner will expect to make major decisions and rollover participants will usually have little say in capital transactions. The upshot is that rollover participants should select their future boss wisely. The first step in selecting the right buyer is for the target company's owners to know themselves in terms of what post-closing ownership arrangement they can comfortably live with, and what type of financial buyer they want as a partner.

The target's owners should consider interviewing the management teams of the financial buyer's other portfolio companies. The target's owners should ask themselves whether they feel comfortable with the "style" and personalities of the potential buyer's partners, managers and portfolio executives. Questions to ask include:

- The role the buyer sees for its personnel in the target company's operations post-closing?
- What degree of oversight will the buyer have in the day-to-day operations of the target company?
- How often will the portfolio company executives meet with its new owner?
- What is the buyer's business plan for the target business?
- What is the buyer's exit strategy for the target business?
- Does the buyer plan on doing any add-on acquisitions?
- Does the buyer see a need for injecting additional capital into the target company and how will that be achieved?
- What are the buyer's plans for leveraging the target company?
- Does the buyer have the resources and experience necessary to assist the management team in achieving the business plan and second exit?
- What is the buyer's track record for successfully selling portfolio companies?

- Do the objectives of the buyer fit with the management team's long-term objectives?

In advance of inking a deal, potential rollover participants should carefully review the buyer's management fees, other compensation arrangements and any affiliate relationships that might siphon off the target company's profits to the immediate and future detriment of rollover participants. In order to negotiate from a position of strength, the management team should try to negotiate the terms of their post-closing employment arrangements with the target business in advance of the signing of the definitive agreement. A positive aspect of being acquired by a financial buyer is that the target's management team may be permitted to participate in the buyer's incentive option plan post-closing. These incentive plans are put in place to further incentivize the management team and usually include a mixture of options that vest over time and options that vest upon achieving certain performance goals.

Typical minority equity owner issues confronting rollover participants

Rollover equity will almost always represent a minority equity position in the post-closing business. All of the usual concerns voiced about holding a minority equity position apply, although rollover participants may have more leverage than most minority investors due to their significant role in working towards a future successful exit for the financial owner. Negotiating for reasonable minority owner protections for rollover participants may be difficult where their main goal is to bank the closing consideration.

Rollover participants should have a clear understanding of the buyer's debt and equity structure and whether additional equity or debt can be issued which might dilute their position. If the rollover participants' equity stake is meaningful, they should consider negotiating for supermajority voting rights (i.e., a percentage where the vote of the rollover participants is required to take an action) on key issues. It is unusual, however, for a buyer to give rollover participants a meaningful vote on any matters other than possibly requiring their consent to conflict of interest transactions, and even that right isn't often seen.

Rollover participants will want to make sure that there is a mandatory tax distribution and that there is no requirement to make additional capital contributions, guarantee debt or make loans to the business. Fortunately, these “red flags” are not typical in equity rollover deals with financial buyers.

Financial buyers will often include fiduciary duty waiver clauses in their LLC operating agreements and limit their obligation to bring business opportunities to the company. Rollover participants should make an effort to keep the financial buyer’s representative subject to fiduciary duties and an obligation to act in good faith. If the rollover transaction involves a substantial percentage of the participants’ equity, they should consider negotiating for board representation, board observer rights, or the right to fill slots reserved for the buyer’s senior executives. Meaningful representation is often the exception to the general rule that rollover participants usually have little or no say in major decisions (although they often are left to run the company on a day-to-day basis).

Most equity issued in a rollover transaction will be subject to typical buy-sell provisions, including a right of first refusal or first offer clause favoring the financial buyer, a drag-along (forced sale) clause favoring the financial buyer, and in some instances a tag-along (co-sale) clause benefiting the rollover participants. Rollover participants should take a careful look at what rights the financial buyer’s board representatives will have to cause the company to issue additional equity (are there broad pre-emptive rights?), admit additional members, leverage the company with debt or encumber the company’s assets. Does the financial buyer have other powers that could reduce the economic value of the rollover participants’ equity interests? Will the company’s debt be cross-collateralized against the debt of the financial buyer’s holding company or other portfolio companies? Rollover participants should consider negotiating for restrictions on rights which might “dilute” their equity interests (difficult to successfully negotiate for), or at least securing pre-emptive rights to participate in additional equity offerings.

Another issue that should be addressed in a rollover transaction is the restrictive covenants often found in LLC operating agreements or shareholder agreements. Participants are routinely asked as part of owning rollover equity to join in these agreements with covenants restricting compensation and the pursuit of business opportunities. The restrictive covenants found in equity agreement often are different in scope (e.g., time period, geographic scope, the business restricted) from those included in the sale documents or employment agreements. Rollover participants may need to negotiate carve-outs from these covenants and try to conform the terms to those in the participants' other agreements with the buyer. Rollover participants should avoid falling into the trap of backing into agreeing to these covenants due to their failure to pay close attention to the terms of an LLC agreement. The same issue can arise when the management team is issued incentive equity and asked to enter into restrictive covenants with a broader scope than their employment agreements.

Securities Law Compliance Issues

The details of federal and state securities laws are beyond the scope of this article, but those involved in structuring equity rollover transactions should have a working understanding of registration and disclosure requirements.

Companies issuing securities in equity rollover transactions must look for exemptions from registration and make the necessary disclosures to avoid fraud allegations. The primary remedy for failing to satisfy these requirements (along with potential civil or criminal regulatory penalties) will be rescission, meaning the company must repay any invested capital, which in the case of an equity rollover transaction might mean the value of the rollover equity.

Exemptions from Registration. Every transaction in securities must either be registered with the SEC or be exempt from registration. Most states also have registration requirements for securities transactions (Blue Sky Laws). Typically, equity rollover transactions are structured to qualify for an exemption from both federal and state registration requirements under Rule 506 of Regulation D, issued under the Securities Act of 1933 (the "Securities Act"). Equity

incentive plans put in place by the buyer are usually structured to qualify for the Securities Act's Rule 701 exemption and similar state exemptions.

The Rule 506 Exemption. The vast majority of private securities offerings, including equity rollovers, are structured to qualify for the federal "safe harbor" exemption provided by Rule 506. One good thing about Rule 506 is that there is a federal preemption of state securities registration laws. Under Rule 506, issuers can raise an indefinite amount of money from an unlimited number of "accredited investors", or up to 35 non-accredited investors. Strong consideration should be given to limiting rollover participants to accredited investors. The term "accredited investor" is defined at Rule 501 of Regulation D and includes:

- executive officers of the issuer (i.e., its president and other officers who perform policy making functions);
- any natural person whose individual net worth, or joint net worth with spouse, exceeds \$1 million (excluding the value of their primary residence); or
- any natural person whose individual income is in excess of \$200,000 in each of the two most recent years (or joint income with spouse in excess of \$300,000) and who has a reasonable expectation of reaching that same income level in the then-current year.

Most participants in an equity rollover transaction will fit within one of these accredited investor definitions. While Rule 506 allows for grants to up to 35 non-accredited investors, there are additional significant and burdensome disclosure requirements. These disclosure requirements, similar in scope and form to the information required in registered offerings with the SEC, are likely to meaningfully increase the expenses of the offering, and in many cases, the information may not even be available (e.g., historical audited financial information). Subject to addressing the anti-fraud requirements (see the discussion below), the SEC does not require disclosure of any specific information in an all-accredited offering because accredited investors are presumed to be able to "take care of themselves."

The Rule 701 Exemption. Most buyer adopting compensation plans providing for issuance of incentive equity rely on Rule 701's exemption from the federal securities registration requirements. Rule 701 was designed specifically for stock option and other compensatory employee benefit plans. In order to qualify for Rule 701 treatment, securities must be issued pursuant to a written compensatory benefit plan, which can include a written contract relating to compensation. Eligible participants include employees, officers, directors and general partners. The amount of securities that may be sold during any consecutive 12-month period in reliance on Rule 701 cannot exceed the greater of \$1 million, 15% of the issuer's total assets or 15% of the outstanding class of securities being offered.

Unlike Rule 506, the Rule 701 federal exemption does not enjoy preemption at the state level, meaning Rule 701 offerings must either be registered at the state level or there must be an applicable state exemption. Most states have a registration exemption for securities transactions in connection with employee benefit plans, many of which mirror the requirements of Rule 701. However, California and some other states do not mirror Rule 701. Issuers should be aware that if eligible employees are located in multiple states, there must be an applicable securities law exemption in each state where an employee is located, not just in the company's state of domicile.

Dealing with the Anti-Fraud Provisions. Buyers issuing equity need to be aware that satisfying an exemption from registration does not prevent them from tripping over the anti-fraud provisions of the Securities Act. These rules essentially provide that issuers may not mislead investors (including equity rollover participants), whether through a misstatement of a material fact or, under certain circumstances, by omitting a material fact or facts. Generally speaking, buyers should provide rollover participants with any information about the company or the offering that a reasonable investor would deem important in making an investment decision. Although there is no bright line here, in a rollover transaction involving target company management, it may be reasonable to believe that the management know any material information about the target company, so the focus should be on the buyer's business

and financial performance. As previously mentioned, there are no specific disclosure requirements in an all-accredited offering under Rule 506. But if there is a plan to merge the target company with another operating entity (or other strategic transaction) following the closing, details about that plan and the companies and properties involved may be material to management's decision to participate in the rollover transaction.

When using Rule 701 in conjunction with an employee equity compensation plan, issuers should provide participants copies of the written plan, the relevant entity governance documents (e.g., articles, bylaws, LLC agreement, stockholders agreement) along with any other information about the company that might be important for investors to know.

Legal representation, disclosure and conflict of interest issues seen in sale transactions involving the use of rollover equity

In many transactions, the target company's counsel handles both the review and negotiation of the definitive transaction documents and the management team's rollover, employment and incentive equity documents. The theory behind this is that the successful negotiation of ancillary documents is necessary to move the transaction forward. This argument is often true but there should be disclosure to the management team that they are encouraged to consult with their own legal and tax advisors. There may be circumstances where it would make more sense for the management team to have separate legal counsel review their employment and incentive compensation agreements.

If the target company has minority investors, best practices for dealing with possible conflict of interest issues includes disclosure of all of the material terms of deal, including the management team's employment and incentive equity arrangement with the buyer and the terms of any equity rollover transaction. Two possible ways of handling a conflict of interest transaction are full disclosure of the deal terms coupled with approval by at least majority of the minority investors or structuring the transaction to make available

statutory appraisal rights available for the minority owners.

Founders should engage in business succession planning years before a sale transaction looms

If reading this article convinces you that selling your business to a financial buyer, rolling over a portion of your equity and becoming a minority equity owner may not be for you, then you should begin serious succession planning early in the lifecycle of your business. Consider building a strong management team that will allow you to retire when your business is sold. Focus on implementing a succession plan involving the sale of your business to family members, employees or a strategic buyer. Consider an employee stock ownership plan (ESOP).

As discussed above, it is often necessary for rollover participants and their counsel to take a proactive role in structuring and negotiating the terms of an equity rollover to ensure that the participants end up with favorable tax treatment and fair treatment with respect to their new minority equity owner role. Frost Brown Todd LLC attorneys have extensive experience representing target companies and rollover participants in sales to financial buyers. If you need additional information or assistance in structuring and negotiating your sale transaction, please contact [Scott Dolson](#) or any other Frost Brown Todd LLC transaction attorney, or a Frost Brown Todd tax attorney for *Tax Law Defined™* with respect to the tax aspects of the equity rollover.

[1] Gompers, Kaplan and Mukharlyamov, "What Do Private Equity Firms Say They Do?", Harvard Business School Working Paper 15-081 (April 27, 2015) at § 5

[2] Gompers at § 6.3.1.

[3] Gompers at § 4.3.

[4] Gompers at § 4.3.

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