

STRUCTURING A BUYOUT — WHAT EVERY VC PROFESSIONAL MUST KNOW

KIRKLAND & ELLIS

by Jack S. Levin¹

THIS ARTICLE DESCRIBES THE KEY ELEMENTS ON WHICH A PRIVATE EQUITY OR VENTURE CAPITAL PROFESSIONAL (“VC”) SHOULD FOCUS IN STRUCTURING THE BUYOUT (“LBO”) OF AN EXISTING COMPANY (“TARGET”). INCLUDING:

- A. LBO of Bigco subsidiary
- B. LBO of private Target owned by individual or group
- C. LBO of publicly traded company
- D. LBO structured for recap rather than purchase accounting.²

A. Buyout of Bigco Subsidiary

In this A, Bigco, a large corporation operating many businesses wishes to sell Target — originally acquired by Bigco in the heady days of conglomerization — so that Bigco can concentrate on Bigco’s core businesses. VC — along with Target’s management (or new executives located by VC) and several lenders — is structuring Newco to acquire Target from Bigco.

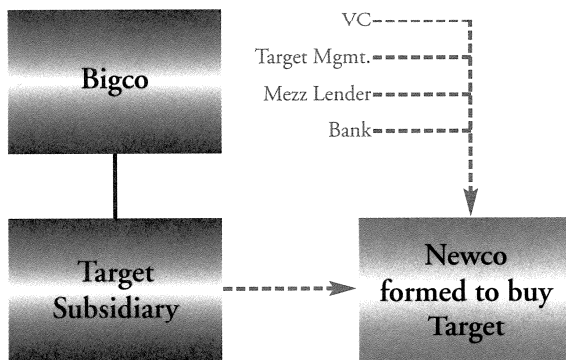


Jack S. Levin is a partner at the law firm of Kirkland & Ellis where he concentrates on mergers, acquisitions, buyouts, private equity investing, private equity fund formations, restructuring troubled companies, and other complex business transactions.

¹ ©1999 Jack S. Levin

Mr. Levin graduated summa cum laude from Harvard Law School first in his class, won the gold medal on the CPA exam, teaches part-time at Harvard Law School and the University of Chicago Law School, is author of a book “*Structuring Venture Capital, Private Equity, and Entrepreneurial Transactions*” (updated and published annually), and is co-author of a three-volume set “*Mergers, Acquisitions, and Buyouts*” (updated and republished semi-annually).

² More extensive discussion of the LBO issues discussed in this article can be found in the author’s book *Structuring Venture Capital, Private Equity, and Entrepreneurial Transactions* (cited herein as “the author’s Venture Capital book”), published by Panel/Aspen Publishers.



3 Separate Transactions

An LBO consists of *three separate transactions*, each complex and time consuming and all mutually interdependent in their consummation:

1. Newco's purchase of Target

The first transaction — Newco's purchase of Target from Bigco — presents all the issues inherent in any complex corporate acquisition:

(a) Negotiating the purchase price for the Target business, including (i) whether all of the price is payable in cash or a portion is payable in Newco subordinated notes or preferred stock (i.e., seller paper), (ii) whether the price is completely fixed or is subject to post-closing formula adjustment based (e.g.) on Target's closing date net worth or net working capital, and (iii) whether (in addition to a fixed price) there is also a formula contingent earn-out based on the Target business's future performance in Newco's hands.

(b) Negotiating Bigco's representations, warranties, and indemnification obligations regarding Target's business, which Newco seeks for three reasons:

- ❖ To obtain from Bigco information Newco can use in deciding (i) whether to buy Target, (ii) what price to pay for Target, and (iii) whether to seek specific contractual clauses dealing with specific Target issues.

- ❖ To permit Newco to call off the deal after signing the contract but before closing if Target's business fails to conform to the contractual representations and warranties.
- ❖ To allow Newco to recover money damages from Bigco after closing if the representations and warranties turn out to be incorrect.

Some of the key representations and warranties Newco may seek from Bigco include:

- ❖ No undisclosed Target liabilities, including environmental/pollution violations and clean-up obligations, employment discrimination, patent/copyright/trademark infringements, tax deficiencies, and other lawsuits, claims, and contingent liabilities.
- ❖ Target's inventory good and salable in the ordinary course of business.
- ❖ Target's receivables good and collectible in the ordinary course of business within a specified period.
- ❖ Target's tangible assets in good condition.
- ❖ Target's financial statements true and correct.
- ❖ Target has good title to its assets and Bigco has good title to Target's stock.
- ❖ Target has not violated any laws or governmental regulations.
- ❖ No governmental or third party consents necessary for completion of the LBO, except as listed on a schedule.

Bigco's representations and warranties can be unqualified or can be qualified either by Bigco's knowledge (or the knowledge of specified Bigco executives) *or* by a materiality standard *or* by both.

Only if Bigco's representations and warranties survive the closing can Newco make a contractual claim against Bigco for damages, in which case three important contract negotiation issues are (i) the time period during which Newco can make claims, (ii) the stated deductible amount which must be reached before Newco can claim the excess or the threshold amount which must be reached before Newco can claim the entire amount, and (iii) any cap or ceiling on Newco's claims.

Security for any Newco claim against Bigco (e.g., escrow, holdback, setoff against seller paper, lien on Bigco assets) is important where Bigco is in questionable financial health and may not be able to satisfy Newco's claims.

(c) Negotiating Newco's closing conditions.

Newco generally seeks expansive closing conditions allowing it to bow out of the transaction (after signing the acquisition agreement but before closing) if things do not go as Newco anticipated (i.e., Newco seeks a contract which is in effect an option to acquire Target), including:

- ❶ Successful completion of Newco's financing (i.e., a financing out).
- ❷ Satisfactory completion of Newco's due diligence examination of Target (i.e., a due diligence out).
- ❸ Compliance with all applicable laws and regulations, including Hart-Scott-Rodino ("HSR") antitrust clearance from FTC.
- ❹ Necessary third-party consents.
- ❺ No material adverse change ("MAC") to Target's business.

Bigco generally resists both a financing out and a due diligence out or at least attempts to limit the time during which Newco can exercise such outs.

(d) Structuring the Newco-Target acquisition as a purchase of assets, a purchase of stock, a forward cash merger, a reverse cash merger, or a reverse subsidiary cash merger, which involves many complex issues, including:

- ❶ Whether the structure selected affords Newco asset stepped up basis ("SUB") or asset carryover basis ("COB") for tax purposes.
- ❷ Whether the structure selected results in single or double tax to the seller.
- ❸ Whether the structure selected requires the consent of other contracting parties, e.g., a sale of assets where seller holds non-transferable technology licenses or leaseholds.

(e) Negotiating Bigco transition services agreement. Newco often seeks a contract obligation for Bigco to supply transition services to Newco for a reasonable period at reasonable prices, including MIS, purchasing, employee benefit administration, insurance administration, space rental, accounting services, receivables collection and/or payables management.

(f) Negotiating Bigco's covenant not to compete with the Newco-Target business.

(g) Organizing Newco's due diligence on the Target business.

2. Newco's debt financing.

The second of the three transactions comprising an LBO—Newco's debt financing—includes negotiating the terms of Newco's substantial senior bank and subordinated mezzanine ("mezz") debt layers (which make Newco's buyout of Target a *leveraged* buyout) and structuring the debt terms so that Newco satisfies all seven IRS hurdles necessary so that interest and original issue discount ("OID") on the acquisition debt is deductible.³

³ Newco's hurdles to interest and OID deductibility are extensively discussed in chapter 6 of the author's Venture Capital book and in the author's and William R. Welke's article "Five New Tax Developments Private Equity Investors Must Know" in *The Venture Capital Review*, Spring 1999.

3. Newco's equity financing.

Newco's equity financing is the third of the three transactions comprising an LBO, including such issues as:

- ❶ The common stock split among VC, management, and the mezz lender.
- ❷ Whether management buys cheap common stock to obtain LTCG tax treatment or receives options (ISOs or NQOs).
- ❸ Vesting arrangements on management's stock or options, including Code §83(b) tax issues and APB 25-FASB 123 accounting issues presented by such vesting.⁴
- ❹ Whether Newco's securities are structured so that VC is entitled first to receive back its investment plus a fixed yield (through straight debentures and/or preferred stock) before splitting the residual (common stock) profits with management and the mezz lender.
- ❺ Board control of Newco and veto powers for certain equity owners and creditors.
- ❻ Right of certain Newco equity owners to mandate or veto a Newco sale or IPO.
- ❼ Whether Newco is formed (i) as a regular C corp subject to double tax *or* (ii) as a flow-through entity (i.e., an LLC, partnership, or S corp)

subject only to single tax, in which case ultimate sale of Newco to BuyerCo can be structured to deliver asset SUB to BuyerCo with single (not double) tax to Newco and its equity owners.⁵

Federal income tax aspects

Newco would prefer to structure the acquisition so that, for tax purposes, Newco obtains asset SUB for Target's business, equal to the sum of (i) the purchase price Newco pays Bigco, *plus* (ii) the Target liabilities assumed by Newco, *plus* (iii) Newco's acquisition expenses.⁶ Bigco, on the other hand, may prefer to structure for asset COB, for tax purposes, for reasons discussed below.

Where the transaction is structured to achieve asset SUB for tax purposes, Bigco pays tax as if it had sold Target's *assets*. However, where the transaction is structured for asset COB, Bigco pays tax as if it had sold Target's *stock*.

Where Target is a Bigco subsidiary (filing or eligible to file a consolidated tax return with Bigco under the 80-80 test⁷), it is generally feasible to structure the transaction so that Newco takes asset SUB while Bigco pays only one tax, i.e., tax on a sale of Target's assets.⁸ This can be achieved either (i) by an asset sale, *or* (ii) by a forward cash merger of Target into Newco or its subsidiary NewSub, *or* (iii) by a stock sale with Code §338(h)(10) election (under which all parties to the transaction are treated as if there were an asset sale rather than a stock sale).⁹

4 Various methods of incenting Newco-Target's key executives, including stock options (ISOs and NQOs), sales of cheap Newco stock structured to obtain LTCG treatment, vesting, Code §83(b) elections, and APB 25-FASB 123 accounting issues are extensively reviewed in ¶¶202, 203, and 407 of the author's Venture Capital book.

5 Choice of entity for Newco is extensively discussed in chapter 3 of the author's Venture Capital book.

6 This article focuses on the typical situation where the FV of Target's assets exceeds their tax basis. The tax structuring would be different if Target's assets were worth less than their pre-acquisition tax basis.

7 The 80-80 test is met where Bigco owns 80% of Target's stock *both* by vote and by value (ignoring certain types of non-voting fixed and limited preferred stock).

8 Bigco as a C corp pays federal income tax at rates ranging up to 35% on both ordinary income ("OI") and capital gain ("CG").

9 A Code §338(h)(10) election is permitted only where Newco is a corporation (not a partnership or LLC), both Newco and all of Target's old shareholders elect, and certain other technical requirements are met. A Code §338(h)(10) election should not be confused with a regular Code §338 election, which has significantly different tax ramifications.

- ❖ In the SUB transaction discussed in this A, Target is a Bigco subsidiary before the transaction. By contrast, where Target (before the transaction) is not a Bigco subsidiary (see B and C below), structuring Newco's purchase of Target for asset SUB results in double tax on the transaction (unless Target is a seasoned S corporation, a partnership, or an LLC).
- ❖ The SUB transaction described in this A results in only single tax — on Target's asset-sale gain — because Code §332 exempts Bigco from paying a second level of tax when Bigco receives a liquidating distribution (consisting of Target's asset-sale proceeds) from its 80-80 subsidiary, Target. However, where Target is a C corp owned by a group of shareholders (as discussed in B and C below) Code §332 does not apply to exempt the shareholders from paying a second tax on their liquidating distribution from Target.
- ❖ However, were Bigco (in this A) to redistribute the sale proceeds to its shareholders, there would be a second tax at the Bigco shareholder level, regardless of whether Bigco's sale of Target was structured for SUB or COB.

One situation where Bigco would resist an asset SUB structure is where Bigco's outside tax basis in Target stock substantially exceeds Target's net inside tax basis in its assets, generally because Bigco (i) acquired Target some time in the past in a stock purchase structured for asset COB and (ii) paid a substantial premium over Target's inside net asset tax basis at the time of the stock purchase. In this case, Bigco's taxable gain on sale of Target's stock to Newco (with no Code §338(h)(10) election) is calculated on Bigco's higher tax basis in Target's stock, whereas Bigco's taxable gain on a sale of Target's assets to Newco

(or Bigco's sale of Target's stock to Newco with a Code §338(h)(10) election) would be calculated on the lower tax basis in Target's assets.¹⁰

Whether it is worthwhile for Newco to raise its purchase price for Target in order to induce Bigco to structure for asset SUB (where Bigco's outside tax basis in Target's stock exceeds its net inside asset tax basis) depends on the discounted present value ("PV") of Newco's expected tax savings from the additional tax deductions for cost of goods sold, depreciation, and amortization resulting from asset SUB, which in turn depend upon:

- ❖ The amount of step-up allocable respectively to inventory, depreciable assets, and amortizable intangibles.
- ❖ The useful life of the depreciable/amortizable assets.
- ❖ Whether Newco elects FIFO or LIFO for stepped-up inventory.
- ❖ The degree of risk that IRS successfully challenges (on audit) Newco's SUB allocation among the assets.
- ❖ The amount and timing of future taxable income Newco expects to generate which can be sheltered by the additional deductions.
- ❖ The applicable corporate tax rates in the future years when the additional deductions are allowable.
- ❖ The appropriate discount rate for computing the PV of the future tax savings.

¹⁰ However, where Bigco or Target has a substantial NOL which could shelter Bigco's asset-sale gain, Bigco may be willing to structure for asset SUB even where Bigco's outside tax basis in Target's stock substantially exceeds Target's inside net asset tax basis. Where Bigco and Target do not have a substantial NOL, Bigco may be willing to structure for asset SUB if (and only if) Newco increases the purchase price for Target so as to compensate Bigco adequately for Bigco's larger tax on an asset SUB transaction.

The result achieved by applying these tax considerations to specific transactions changed radically with the 1993 enactment of Code §197, under which virtually all purchased intangibles (acquired in an SUB transaction) are now amortizable for tax purposes over a 15-year period. Code §197's pro-taxpayer aspect is tax amortization (over 15 years) for goodwill, going concern value, and other similar intangibles which previously were not amortizable at all for tax purposes. Code §197's anti-taxpayer aspect is the automatic 15-year life for virtually all purchased intangibles, including those which generally had much shorter tax lives before §197's enactment.¹¹

In an asset SUB acquisition, §197's 15 year amortization period applies to virtually all purchased intangibles. Even in a COB acquisition, §197 applies to a covenant not to compete purchased from Target's shareholders.

Where Newco and Target are more than 20% related by vote or by value, calculated by comparing Target's pre-acquisition ownership to Newco's pre- or post-acquisition ownership, Code §197's illogical and arbitrary anti-churning rules may prevent 15-year amortization of intangibles held by old Target before 9/93 that would have been non-amortizable before §197's enactment (goodwill and going concern value or any other intangible with no reasonably ascertainable useful life).¹² In a buyout of a Bigco subsidiary, there may be such more-than-20% overlapping ownership between Target and Newco where Bigco buys a portion of Newco's stock.

Additional LBO issues

HSR filing and waiting period. If the transaction meets both the size of person test and the size of transaction test and does not qualify for an exemption, there is generally a 30-day waiting period after making the required HSR filing (accompanied by a \$45,000 payment), which period is extended if FTC or Department of Justice issues a second request for information.

The *size of person test* is generally met if either Target (along with its affiliates as described below) or Newco (along with its affiliates as described below) has annual net sales or total assets of at least \$100 million and the other has annual net sales or total assets of at least \$10 million. Net sales and total assets are generally measured at the level of ultimate parent, including any controlled entities (i.e., affiliates).

In determining affiliation, a *corporation* is treated as controlled by a person who either holds voting securities with 50% or more of the corporation's voting power for directors or has the contractual right to designate 50% or more of the corporation's directors, whereas a *partnership or LLC* is treated as controlled by a person who has the right to receive 50% or more of the partnership/LLC profits or assets upon dissolution.

Where Target is controlled by Bigco, Target sales and assets are measured by looking at Bigco and all of Bigco's controlled entities (including Target). Where VC controls Newco, Newco's sales and assets are measured by looking at Newco, VC, and all of VC's other controlled portfolio companies.

11 Prior to 1993, many taxpayers enjoyed a degree of success allocating a portion of the purchase price (in an asset SUB transaction) to intangibles such as covenants not to compete, patents, custom computer software, customer lists, order backlog, advantageous customer and supplier contracts, know-how, and the like (as opposed to goodwill and going concern value which were clearly non-amortizable) and amortizing such amount over a reasonably short estimated useful life, although the result in litigation was often quite fact-specific (where IRS challenged the deduction).

12 Where Target and/or Newco is a partnership or LLC, the anti-churning rules are slightly different. In addition, although there are strong arguments under the statute and certain prior precedents that the corporate anti-churning rules should not apply unless Target and Newco are 50% or more related by vote or value, IRS proposed regulations (to be effective on finalization) take the position that the anti-churning rules generally apply where Target and Newco are more than 20% related.

The *size of transaction test* is met if Newco will (after the transaction) hold Target voting securities or assets, whether acquired in one or a series of transactions, (i) with a value exceeding \$15 million *or* (ii) constituting 50% or more of Target's voting securities where Target and its controlled subsidiaries has annual net sales or total assets of at least \$25 million.

The parties are nevertheless exempt from HSR filing where (i) the acquiring company (Newco) is newly formed, *and* (ii) substantially all of Newco's capital is devoted to acquiring Target, *and* (iii) no one person controls Newco (generally using the control test described above), *and* (iv) no one person holds \$15 million of Newco voting securities.

Protecting Newco from Target liabilities

generally. Where Newco (or Newco's subsidiary NewSub) *purchases Target's stock*, Target (which becomes a Newco subsidiary) remains liable for all of its fixed and contingent liabilities. If the parties intend Bigco to retain some of Target's liabilities (including contingent liabilities) in the context of such a stock acquisition, Bigco can agree to indemnify and hold harmless Newco and its new subsidiary Target against such liabilities. However, should Bigco fall upon financial hard times, its indemnification may be worthless and Newco's new subsidiary Target may hence bear such liabilities.

Where *Target merges into Newco (or NewSub)*, state merger law generally causes the surviving corporation (Newco or NewSub) automatically to become liable for all of Target's liabilities. If the parties intend Bigco to retain some of Target's liabilities in the context of a merger, Bigco can agree to indemnify and hold harmless Newco (or NewSub) against such liabilities, in which case Newco is protected, subject to the risk Bigco is unable to fulfill its indemnification obligation.

Where Newco (or NewSub) *purchases Target's assets*, the parties can tailor the asset purchase agreement so that Newco (or NewSub) expressly assumes only specified liabilities and leaves all other liabilities behind in Target, which remains a Bigco subsidiary. However, even in such an asset purchase, several legal doctrines (discussed below) may cause buyer involuntarily to inherit a Target liability if Target (which remains a Bigco subsidiary) is unable to pay its retained liabilities. Hence, it is desirable for Bigco to agree in the asset purchase agreement to indemnify buyer against Target liabilities not assumed by buyer, in which case *buyer is protected, subject to the risk both Target and Bigco are unable to pay the retained liabilities.*

The most prevalent involuntary-liability-inheritance doctrines applicable to an asset purchase include (i) *the bulk sales act* under which in approximately 13 states the buyer of Target's assets (including inventory) in bulk is generally liable for Target's liabilities—up to the fair value (“FV”) of the inventory and equipment purchased—unless notice is given to Target's creditors at least a specified period before the sale and (ii) *the de facto merger and successor liability doctrines* under which some courts have held a bulk asset buyer responsible for some Target liabilities—especially tort liabilities for defective products, underfunded pension liabilities, and environmental liabilities—under vague common law doctrines where Target's business is transferred to buyer as a going concern and Target goes out of existence, especially, but not exclusively, where Target's old stockholder(s) receives a substantial equity interest in buyer.

Because of bulk sales act, de facto merger, and successor liability risks, it is often desirable, where Newco is making or intends to make several acquisitions (or where Newco already has other assets), for NewSub to acquire Target's assets, so that if buyer is unexpectedly held liable for Target liabilities not expressly assumed, such exposure is limited to NewSub while Newco's other assets are insulated.

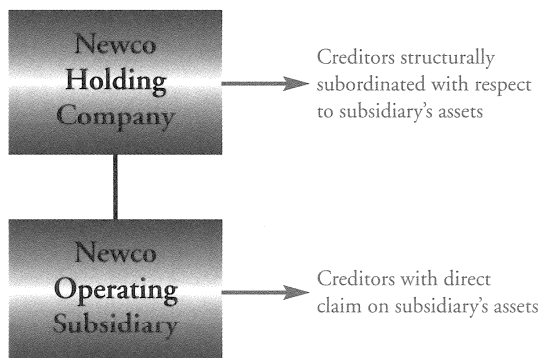
Bigco's unpaid consolidated federal income

taxes. Where Bigco files a consolidated federal income tax return with Target before the acquisition, federal tax law (Reg. §1.1502-6) creates a surprising risk for Newco: each entity (including Target) that was a member of Bigco's consolidated tax group for any part of a year is liable for all of Bigco group's federal income tax for such year (even on income generated by other members of the group) if Bigco ultimately does not pay IRS. Hence, where Newco buys Target's stock, Target remains liable for the entire Bigco group's federal tax deficiencies for each year in which Target was a Bigco subsidiary for any part of the year, if Bigco and does not ultimately pay IRS.

Relative Rights of Newco's Financing Parties.

The essence of an LBO is that no entity above Newco is liable on Newco's acquisition debt, i.e., that neither VC nor any other Newco shareholder guarantees or is otherwise contractually liable for acquisition debt incurred by Newco in acquiring Target.

Should Newco default on its acquisition debt (e.g., bank debt, mezz debt), issues would arise as to the relative priority of various creditor groups inter se with respect to the Newco-Target assets. These relative priority issues can be significantly affected by structuring (as part of the LBO) some creditors into a Newco operating subsidiary (so they have first claim on such subsidiary's assets) and some creditors into Newco holding company (so they are structurally subordinated by operation of law to the subsidiary's creditors with respect to the subsidiary's assets), in which case lenders at the subsidiary level can foreclose on and sell subsidiary assets free of Newco holding company debt.



There are several methods to create or avoid such structural subordination with respect to the new acquisition debt:

◆ *Stock purchase.* Newco can purchase Target's stock with money borrowed at the Newco holding company level, so Target becomes a Newco subsidiary. As long as Target does not liquidate or merge into Newco and Target does not guarantee Newco's acquisition debt, Newco is the only entity liable for the new acquisition debt. Hence, Target's trade and other creditors are not affected by the acquisition and the acquisition debt is structurally subordinated to Target's trade and other debt.

◆ *Asset purchase.* Newco can purchase Target's assets with money borrowed by Newco and assume Target's liabilities. In this structure (as well as each of the structures discussed below), the new acquisition financing ends up a liability of the same entity that is liable to Target's old trade and other creditors. Hence, Newco's acquisition debt is not structurally subordinated to Target's pre-acquisition creditors, and the old Target creditors are disadvantaged by the acquisition since the post-acquisition entity (Newco) which is liable to them has also become liable for the new acquisition debt. In other words, the new acquisition debt becomes a pari passu claim against the purchased Target assets — and may even effectively become a senior claim if the acquisition lenders receive liens on such assets — thereby diluting the assets available to service Target's pre-acquisition debt.

◆ *Stock purchase plus liquidation.* Newco can purchase Target's stock with money borrowed at the Newco level and immediately thereafter (i) liquidate Target by distributing its assets (subject to its liabilities) upstream into Newco *or* (ii) merge Target upstream into Newco. Target's pre-acquisition creditors are disadvantaged by the acquisition because Newco ends up liable for both Target's pre-acquisition debts and the new acquisition debt.

- ❖ *Reverse subsidiary merger.* Newco can merge a transitory Newco subsidiary into Target (a reverse subsidiary merger or RSM), with money borrowed at either the Newco level or the transitory subsidiary level, so that (i) Target survives the merger, (ii) Target's old shareholder(s) receives the stated merger consideration in cancellation of all Target's old stock, (iii) Newco receives new Target shares in exchange for its transitory subsidiary shares, and (iv) after the transaction Newco owns 100% of Target's stock. Target's pre-acquisition creditors are disadvantaged to the extent the new acquisition debt is at the transitory subsidiary level, so that Target inherits the acquisition debt in the merger. However, Target's pre-acquisition creditors are not disadvantaged to the extent the new acquisition debt is at the Newco level.
- ❖ *Reverse merger.* Newco can merge directly into Target (a two-party reverse merger), with (i) Target surviving the merger, (ii) Target's old shareholder(s) receiving the stated merger consideration in cancellation of all Target's old stock, and (iii) Newco's shareholders receiving new Target shares in exchange for their Newco shares, so that after the transaction Newco's shareholders own directly 100% of Target's stock. Target's pre-acquisition creditors are thus disadvantaged because Target inherits the new acquisition debt.
- ❖ *Part stock purchase, part redemption.* Newco can purchase a portion of Target's stock from Target's old shareholder(s) (with money borrowed at the Newco level) and Target can simultaneously redeem the remainder of its stock from Target's old shareholder(s) (with money borrowed at the Target level), so that after the transaction Newco owns 100% of Target's stock. Target's pre-acquisition creditors are disadvantaged to the extent the new acquisition debt is borrowed at the Target level to finance the redemption, but are not disadvantaged to the extent the new acquisition debt is borrowed at the Newco level to finance the stock purchase.

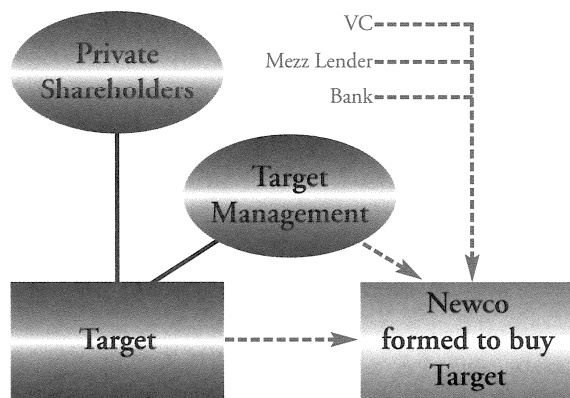
Fraudulent Conveyance Issues. Where the acquisition is structured so that the same entity is liable both for the new acquisition debt and for Target's pre-acquisition liabilities, so that Target's trade and other creditors are worse off after the transaction than before (because the new acquisition lenders have become *pari passu* with, or senior to, Target's old creditors), the entity which ends up liable to Target's old creditors must meet three financial tests immediately after the acquisition — solvency, adequate capital, and ability to pay debts in the ordinary course of business as they mature — in order to avoid a fraudulent conveyance risk.

Where any of these three tests is not met, so that the transaction constitutes a fraudulent conveyance, and where the acquisition entity fails to pay its debts, there is risk that the new acquisition lenders constitute aiders and abettors (hence both losing their liens and being involuntarily subordinated to other creditors) and that Target's selling shareholders (at least insider shareholders who knew that the transaction added substantial debt to the acquiring entity's balance sheet) must give back sales proceeds. There is even some risk a fraudulent conveyance may cause Newco's new shareholders to be liable as aiders and abettors. The fraudulent conveyance rules, if found to apply, often help not only Target's pre-acquisition creditors, but also subsequent creditors.

Where the acquisition is structured so that it prejudices Target's pre-acquisition creditors, Newco generally supplies the acquisition lenders with carefully prepared asset appraisals, contingent liability estimates, cash flow projections, solvency opinions, and other data designed to make the lenders comfortable that all three of these financial tests are satisfied.

B. Buyout of Private Company

In this B, Target is a private company owned by an individual or a group (but is not a Bigco subsidiary), Target's principal shareholders (unable to locate the fountain of youth) are focusing on estate planning, and hence would like to liquefy their estates. In other respects, the facts are the same as in A.



Federal income tax aspects

Just as in A, Newco would prefer to structure the acquisition to obtain, for tax purposes, asset SUB for the Target business. However, depending upon whether Target is a C corp, an S corp, a partnership, or an LLC, Target and its owners may prefer to structure for asset COB, for tax purposes, as discussed below.

Target is C corp. If Target is a C corp and the transaction is structured for asset SUB—e.g., Target's sale of assets to Newco followed by Target's liquidation—the sellers owe double tax, i.e., Target owes corporate-level tax on its asset-sale gain and Target's shareholders owe shareholder-level tax on their liquidation proceeds less their stock tax basis. Generally, Target's old shareholders bear the economic impact of both taxes.

The same double tax result obtains where the transaction is structured for asset SUB as a taxable forward two-party merger or a taxable forward subsidiary merger. However, in these cases the incidence of Target's corporate-level tax falls on Newco because in the merger Newco (or NewSub) inherits Target's corporate-level tax liability.¹³

- By contrast, in A above (where Target is a Bigco 80-80 subsidiary and Bigco retains the sale proceeds), structuring the acquisition for asset SUB (either as an asset sale or as a stock sale treated as an asset sale by virtue of a Code §338(h)(10) election) does not result in double tax because the liquidation (or the §338(h)(10) deemed liquidation) of Target into Bigco is a tax-free Code §332 liquidation. Where, however, Target is a C corp but not a Bigco 80-80 subsidiary, structuring for asset SUB results in double tax, i.e., Target-level tax on the asset gain and shareholder-level tax on Target's liquidation.

Where Target is a C corp and does not have a substantial NOL to shelter its asset-sale gain, it is generally not advantageous to structure for asset SUB because the PV of the seller's second tax—payable immediately—exceeds the PV of Newco's tax saving on account of asset SUB—which occurs over a number of years (15 years in the case of Code §197 amortizable intangibles), as described in A above.¹⁴

Where the parties structure for asset COB, it is generally tax efficient from Newco's standpoint to pay as much of the purchase price as possible directly to Target's shareholders as (i) compensation for future executive or consulting services and/or (ii) covenant-not-to-compete payments. Such payments are:

¹³ Similarly, where the asset SUB structure is Newco's purchase of Target's stock (or Newco's acquisition of Target's stock in a taxable reverse subsidiary merger) plus a regular §338 election, there is also double tax on the transaction with Newco bearing the corporate-level tax.

¹⁴ One exception: Target might be willing to structure for asset SUB by an asset sale where Target's shareholders are elderly and imminently anticipating death SUB for their stock. In this case double tax on the sellers can be avoided where Target sells assets to Newco and Target postpones its liquidation by remaining in existence as an investment company until its shareholders obtain SUB for their Target stock by reason of death.

- a. taxable to the recipients as OI,
- b. not taxable at the Target level, and
- c. as long as reasonable in amount, deductible by Newco over the life of the consulting arrangement (in the case of consulting payments) or deductible over 15 years under Code §197 (in the case of covenant payments).¹⁵

However, because Target's individual shareholders are taxed at substantially higher rates on OI (including a consulting or covenant payment) than on LTCG—a 39.6% top federal income tax rate for OI compared to a 20% top federal income tax rate for LTCG—Target's shareholders will desire to minimize allocation to consulting or covenant payments and/or may seek a gross-up payment from Newco to compensate them for the higher tax rate.

Target is S corp. Where Target is a seasoned S corp (rather than a C corp), Newco can structure for asset SUB—either a sale of Target's assets followed by Target's liquidation or a sale of Target's stock with §338(h)(10) election—without imposing the burden of double tax on the sellers.¹⁶

However, in the case of an S corp which was formerly a C corp, Code §1374 imposes a corporate-level tax on any sale of the corporation's assets occurring during its first 10 years as an S corp, based on the lesser of (a) the built-in gain in an asset at the time the corporation became an S corp or (b) the actual gain recognized on the sale of such asset. This Code §1374 tax also applies to assets previously acquired from a C corp by the S corp (even though never itself a C corp) in an asset COB transaction (e.g., a tax-free merger of a C corp into an S corp), based on the lesser of (a) the built-in gain in a COB asset at the time acquired by the S corp or (b) the actual gain recognized on the sale of such asset. Where Code §1374 applies,

there is double federal income taxation on the portion of S corp's gain covered by Code §1374 (the built-in gain).

Target is partnership or LLC. Where Target is a partnership or LLC, Newco can structure for asset SUB without double tax to the sellers. In this case, there is no need for a Code §338(h)(10) election to achieve asset SUB and there is no Code §1374-like penalty tax.

§197 amortization. In an asset SUB transaction, Code §197's anti-churning rules (as discussed in A) may prevent 15-year amortization of certain intangibles where persons who owned more than 20% of Target's stock before the buyout own more than 20% of Newco's stock after the buyout. There may be such more-than-20% overlap where, for example, Newco sells stock to Target's executives who were Target shareholders before the buyout.

Target management tax-free rollover

A Target executive who owns appreciated Target stock and plans to invest in Newco could escape LTCG recognition on a disposition of his/her Target stock by engaging in a tax-free rollover of appreciated Target stock in exchange for Newco stock pursuant to Code §351 (which deals with the tax-free formation of a new corporation). In other words, the executive could contribute appreciated Target stock to Newco (tax free) in exchange for Newco stock with an FV equal to the FV of the Target stock contributed, at approximately the same time as Newco's other shareholders (including VC) form Newco.

This approach is feasible only where the acquisition is structured for asset COB, i.e., Newco purchases Target's stock *or* Newco acquires Target's stock by a reverse subsidiary merger *or* Newco's shareholders acquire Target's stock by a reverse two-party merger.

¹⁵ Prior to the 1995 enactment of §197, a covenant not to compete could have been amortized over the life of the covenant, which was generally far shorter than 15 years.

¹⁶ A Code §338(h)(10) election is permitted in only two circumstances: where Target is an 80-80 Bigco subsidiary as discussed in A or where Target is an S corp as discussed here.

An executive swapping low basis Target stock tax free (in a Code §351 transaction) for high FV Newco stock takes COB for the Newco stock (equal to his or her low basis in the Target stock) and hence defers LTCG until disposition of the Newco stock, but permanently avoids LTCG recognition if he or she dies while owning the low basis Newco stock.¹⁷

Shareholder vote and dissenters' rights

In a *merger or asset sale*, a vote of Target's shareholders by a requisite majority¹⁸ binds all of Target's shareholders (subject to a dissenting shareholder's right to claim appraisal rights, i.e., a cash payment equal to the court-determined FV of the dissenter's Target stock). However, where the transaction is structured as a *sale of Target's stock*, any recalcitrant old Target shareholder has the right to retain his or her Target stock, so that Newco may end up owning less than 100% of Target.

This recalcitrant-minority-shareholder problem is generally solved—where an acquisition is meant to be taxed as a stock purchase but one or more old Target stockholders refuse to sell—by structuring the transaction as a reverse subsidiary merger (an “RSM”) of Newco's newly-formed transitory subsidiary (NewSub) into Target, with Target's old shareholders receiving cash in exchange for their Target stock and Newco receiving Target stock in exchange for its NewSub stock. Such an RSM requires the affirmative vote of a requisite majority of Target's old shareholders and generally allows dissenting Target shareholders to claim appraisal rights. However, after the RSM Newco owns 100% of Target's stock and, for tax purposes, such an RSM is generally taxed as if Newco had purchased Target's stock, because IRS (i) disregards Newco's transitory subsidiary and hence disregards the RSM and (ii) views the transaction as if Newco had purchased Target's stock from Target's old stockholders.

An alternative method for squeezing out 100% of Target's old shareholders is a reverse two-party cash merger of newly-formed Newco into Target in which Target's old shareholders receive cash while Newco's shareholders receive Target stock in exchange for their Newco stock and Newco disappears. This transaction (like an RSM) requires the affirmative vote of a requisite majority of Target's shareholders and generally allows dissenting Target shareholders to claim appraisal rights. However, after the transaction Newco's shareholders own 100% of Target's stock and for tax purposes, this transaction is generally taxed as if Newco's shareholders had purchased Target's stock from Target's old shareholders, because IRS (i) disregards Newco as transitory and hence disregards the merger and (ii) views the transaction as if Newco's shareholders had purchased Target's stock from Target's old shareholders.¹⁹

LTCG tax on sale of Newco

When Newco is ultimately sold, its shareholders who are individuals generally pay tax on their shareholder-level gain at a 20% LTCG rate. However, where the transaction meets certain requirements, an individual who owns Newco stock directly (or through a partnership, LLC, or S corp, including a venture capital fund formed as a flow-through entity) is entitled to a reduced 14% LTCG rate under Code §1202. Some of the many arbitrary requirements for this §1202 LTCG rate reduction are (i) the individual (or flow-through entity) must have purchased the Newco stock directly from Newco and held it for more than 5 years and (ii) Newco must have held \$50 million or less of assets immediately after the individual's investment in Newco.

Where Newco meets the requirements necessary for a Code §1202 rate reduction, Code §1045 allows an individual who holds Newco stock directly (or through a flow-through entity) to pay no tax (i.e., to defer the gain)

17 An executive receiving any Newco “Non-Qualified Preferred”—generally debt-like redeemable preferred stock—in such an otherwise tax-free rollover would recognize gain up to the Non-Qualified Preferred's FV unless one of the exceptions discussed in ¶403.1 (9) through (15) of the author's *Venture Capital* book is satisfied.

18 Most states require only a majority shareholder vote, although a few require a higher vote, and Target's charter may require a higher vote than normally required by state law.

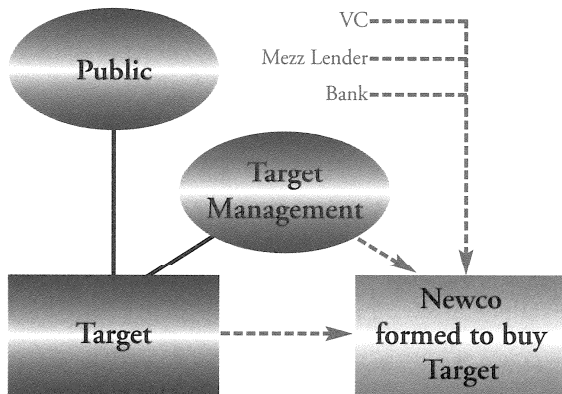
19 In this case no §338(h)(10) election is permitted (even where Target is an S corp) because a single corporate entity did not purchase at least an 80-80 amount of Target's stock (unless Newco is itself an 80-80 subsidiary of another corporation).

on a sale of Newco stock where the shareholder has held the Newco stock more than 6 months and reinvests an amount equal to the proceeds in other §1202 qualified stock within 60 days after the Newco stock sale. Such deferred gain is then recognized when the individual sells the replacement stock, unless the individual dies holding the replacement stock and thus qualified for death SUB.²⁰

The LBO of private Target owned by a group, as discussed in this B, also presents all the issues discussed in A above where Target was a Bigco subsidiary.

C. Buyout of Public Company

In this C, Target is a publicly traded C corp.²¹ Target’s board of directors has concluded that (i) although Target’s business is sound, the stock market does not properly value a company of Target’s size in Target’s industry and (ii) Target’s shareholder value can be maximized by selling Target. In other respects, the facts are the same as in A above.



One-step vs. two-step LBO

There are two principal methods for structuring Newco’s LBO of public Target: In a *one-step merger structure*, Newco (or Newco’s subsidiary NewSub) merges into Target with Target’s shareholders receiving cash for their Target stock in a two-party cash reverse merger (or an RSM). With such a one-step approach, Newco does not

gain control of Target until the merger is completed, which can take as long as four months, principally because of SEC’s proxy rules which apply because public Target’s shareholders must vote on the merger.

In a *two-step approach*, Newco first makes a cash tender offer for Target’s stock followed by a squeeze out reverse cash merger of Newco (or NewSub) into Target, with Target’s remaining shareholders (who did not sell in the cash tender offer) receiving cash for their Target stock in the clean-up merger. With such a two-step approach, SEC’s tender offer rules allow Newco to complete the first step tender offer quickly (approximately one month) and hence gain control over Target.

Federal income tax aspects

The federal income tax issues in acquiring publicly traded Target are generally the same as those discussed in B above regarding the LBO of a free-standing private C corp (i.e., a company which is neither a Bigco subsidiary nor an S corp, partnership, or LLC). Whether Newco acquires Target in one step or in two steps, the transaction is generally structured for asset COB so that only one tax is imposed on the sellers, i.e., a LTCG tax on Target’s shareholders.

By contrast, if the transaction were structured for asset SUB—with Newco purchasing Target’s assets or Newco acquiring Target in a forward cash merger—double tax would be imposed (i.e., corporate-level tax on Target’s inherent asset appreciation and shareholder-level tax on the Target shareholders’ stock gain). In an actual asset sale, the double tax would be wholly borne by sellers, while in a forward cash merger the corporate-level tax would be borne by Newco. As discussed in B, it is generally not tax advantageous to structure the acquisition of a C corp for asset SUB (because the PV of the second seller tax exceeds the PV of Newco’s tax saving), unless public Target has a substantial NOL to shelter its corporate-level asset-sale gain.

²⁰ Code §1202’s reduced LTCG rate and Code §1045’s tax-free rollovers are extensively discussed in §906 of the author’s Venture Capital book.

²¹ Under Code §7704, every *publicly traded* company—even if formed as a partnership or LLC—is treated as a C corp for tax purposes (with very minor exceptions).

Practical scenario

VC may prefer to approach public Target's CEO with a firm offer at a stated premium price, fully backed by financing commitments, in order to induce Target to accept the VC-Newco offer as quickly as possible.

However, to delay Target's public disclosure obligation, VC may instead decide to approach Target's CEO with merely an expression of interest.

If VC's approach to Target management is not productive, VC may decide to approach Target's board members, either directly through general contacts or by delivering a "bear hug" letter proposing a friendly combination on terms to be negotiated.

During this process, VC may begin accumulating Target stock in the open market. However, VC must file with SEC a schedule 13D once VC acquires more than 5% of a class of Target's voting stock registered under 1934 Act §12 and must generally make an HSR filing with FTC *once VC acquires \$15 million of Target voting securities*. In addition, VC must file a schedule 13D even before acquiring more than 5% of a class of Target's voting stock when (i) VC is acting in concert with other Target shareholders who, in the aggregate together with VC, own sufficient Target shares to exceed the 5% reporting threshold or (ii) VC obtains an option to acquire Target stock, whether from Target or from Target shareholders, which causes VC to be treated as owning sufficient Target shares to exceed the 5% reporting threshold.

When Target's management is investing in Newco there is a conflict between (i) Target management's duty to obtain the highest possible price for Target's public shareholders and (ii) Target management's natural desire for Newco (which will be partly owned by Target's management) to purchase Target at the lowest possible price. Thus, Target's board may utilize some or all of the following protective devices to avoid liability to Target's public shareholders for breach of fiduciary duty: (i) appoint an independent Target board committee (which in turn selects independent legal counsel and an independent investment banker

for the committee), (ii) obtain an investment banker fairness opinion, (iii) seek a majority vote of Target's disinterested directors, and (iv) seek a majority vote of Target's disinterested shareholders.

Once Newco and Target have reached at least a tentative deal and during the tender offer one-month delay or the merger four-month delay, Newco may desire some or all of the following protective devices to discourage competing bidders and/or to compensate Newco should another bidder ultimately triumph: (i) a no-shop clause, (ii) an exclusivity clause, (iii) a break-up fee, (iv) a topping fee payment to Newco if Target is sold to another buyer at a higher price, (v) an option to buy unissued Target shares at a fixed price, (vi) an option to buy outstanding Target shares at a fixed price from one or more large Target shareholders, and (vii) a crown-jewel option to buy a Target division or other key Target asset at a fixed price.²²

D. Buyout Structured For Recap Accounting

Several years after VC has acquired Target in a buyout, VC often turns to the public equity markets to sell its Target stock. Because the price of Target's shares in a public offering is often based on a multiple of Target's book earnings calculated in accordance with generally accepted accounting principles ("GAAP"), VC may want to structure its initial buyout of Target in order to obtain the benefits of recapitalization or "recap" accounting, increasing Target's post-acquisition GAAP earnings and, hopefully, its ultimate IPO value.

Where VC simply forms Newco to acquire Target in a buyout (as described in A through C), GAAP *purchase accounting rules* generally require Target's assets to take a new aggregate book value equal to the amount paid by Newco to acquire Target, *plus* Target liabilities assumed, *plus* expenses of the acquisition. This new aggregate book value is then allocated first to Target's current assets at FV, second to Target's fixed assets and identified intangibles at FV, and the residue to Target's goodwill. GAAP purchase

22 Other public LBO issues, including federal margin regulations, SEC's going private rules, SEC tender offer and proxy rules are discussed in §503 of the author's *Venture Capital* book.

accounting rules require such goodwill to be amortized—thus reducing Newco/Target's post-LBO GAAP earnings—over not more than 40 years (depending on the industry, often much less than 40 years) and FASB has proposed reducing this amortization period to a maximum of 20 years.

These GAAP purchase accounting rules apply regardless of whether the LBO is structured as an asset purchase, stock purchase, or merger. Hence, even where the acquisition has been structured to achieve asset COB for tax purposes (e.g., a stock purchase with no Code §338(h)(10) election), so that Newco has no tax saving from asset SUB, the GAAP purchase accounting rules require increased book depreciation/amortization. If Newco/Target were subsequently to go public (or be acquired by a public company focused on Target's GAAP earnings), purchase accounting would decrease Newco/Target's valuation.

Pooling accounting—under which Target's old asset book value simply carries over with no increase in post-acquisition GAAP depreciation/amortization—applies only if 90% or more of the consideration for the acquisition of Target common stock and common stock equivalents consists of Newco voting common stock and numerous other arbitrary pooling requirements are satisfied. Because the predominant consideration paid to Target's shareholders in a buyout is almost invariably cash, the 90%-Newco-voting-common-stock requirement cannot be met. Moreover, FASB has proposed that pooling accounting be repealed.

However, where VC's buyout of Target is structured for *recap accounting*, a pooling-like result is obtained—i.e., there is no change in Target's asset book value, no additional goodwill is created, and hence Target's post-acquisition book earnings are not reduced for goodwill amortization.

Even where a buyout results in a change of Target's control, recap accounting—and not purchase accounting—generally applies to Target so long as (i) Target survives, (ii) Target's old shareholders as a group continue to own a “significant” (generally somewhat more than 5%) stake in recapitalized Target's common equity, and (iii) a number of other arbitrary recap requirements are met.

Recap accounting may also apply in two circumstances where T's old shareholders do not retain a significant (or indeed any) continuing interest in recapitalized T's common equity. *First*, recap accounting generally applies where T has publicly held debt or publicly held preferred stock outstanding prior to and independent of the recapitalization and such public debt or preferred stock remains outstanding after the recapitalization. *Second*, SEC has approved recap accounting where at least one of the new investors purchasing a significant stake in T's recapitalized common equity as part of the LBO is independent of the investors sponsoring the recapitalization transaction.

Where the transaction satisfies one of these routes to recap accounting, recap accounting generally applies (i) whether pre-recap Target is privately owned (as in B), publicly traded (as in C), or a Bigco subsidiary (as in A) and (ii) whether Target is a C corp, S corp, LLC, or partnership. Even where Target is a Bigco division (not a separate entity owned by Bigco), recap accounting can generally be achieved.²³

23 Purchase and recap accounting are extensively discussed in the author's and William R. Welke's article “Structuring Buyouts for Recap Accounting” in *The Venture Capital Review*, Spring 1999, and in ¶504 of the author's *Venture Capital* book.