LEGAL UPDATES

Rollover Equity in a Sale to a Private Equity Firm: Seller's Concerns

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When a private equity (PE) firm acquires a closely held business, it is quite common for the seller to roll over some of its equity into equity in the entity (the "Company") that is acquiring the business. If the seller has sufficient other assets, the rollover equity can be a very attractive high risk/high reward investment. Moreover, PE firms often want a seller to roll some equity. This can show that the seller believes in the business being sold. It also can help assure cooperation and commitment from the seller after the closing of the sale.

COVID-19 has led to a reduction of the amounts that lenders are willing to lend in M&A transactions. This may increase the amount of rollover equity that PE firms seek from sellers, to replace amounts that would have been borrowed in the pre-COVID market.

This article discusses a seller's considerations and objectives when rolling over equity as part of the sale of their business to a PE firm. The focus is pro-seller provisions that should be pursued in the negotiations.

Pre-COVID-19, a seller who owned a well-performing business had a great deal of leverage in negotiations with PE firms. Commonly, multiple buyers were competing for the right to purchase the business, and thus sellers maintained substantial leverage to dictate the terms of the sale. However, while overall M&A activity has rebounded nicely in Q3 2020, M&A activity is still down compared to this time last year. As such, demand has decreased, so some leverage likely has shifted back to buyers. The shift in leverage may affect a seller's ability to obtain all the desirable terms described below.

Summary of Key Points:

- If, after sale of the business, a high risk/high reward investment is appropriate for the seller, rolling over equity with a qualified PE firm in a business the seller knows typically is much more attractive than other investment choices.
- The seller should receive the same class of equity that the PE Fund owns (normally not an issue).

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- The seller should have the right to hold the equity until an exit event occurs. For a successful Company this normally is when the best pricing is achieved.

- There should be reasonable limitations on amounts that can be distributed to the PE firm from the Company.

- Come along rights — which give the seller the right to participate on a pro rata basis in any sales for value by the PE firm — are always included, and will apply to an exit event. Sellers should push for these rights also to apply to other, smaller transactions where the PE firm is realizing value.

- The seller should have strong protections against dilution.

Investment Considerations

When the deal goes well, a PE investment in a Company can have an excellent return, with a 20% or more rate of return often being achieved. However, PE owned Companies also sometimes fail, with little or no money being returned to investors. Even a PE Fund that is quite successful in terms of the overall return that its investors receive often will have several companies within the Fund fail.

This means that a seller rolling over into the acquiring Company should be able to afford to lose its entire investment. The seller should have sufficient secure assets to meet its needs, so that making a high risk/high reward investment is acceptable.

For a seller who has the financial strength and appetite for such an investment, rolling over equity as part of a sale of their business almost always is the best choice as compared to alternative investments. Unlike an investment from the open market, the seller knows the Company's business very well and understands its prospects and risks. Moreover, the seller should believe in the PE firm who will be directing the Company, and be confident in its track record and abilities

We recently have represented sellers who went to market only to PE firms — no strategic acquirors — with an express requirement that the seller be able to rollover equity as part of the deal. This reflects the attractiveness that a rollover investment can have for the right seller.

Typical Structure

Normally the PE firm will set up a new entity (the Company, as defined above) to carry out the acquisition. (If the acquisition is an add-on by an existing platform company owned by the PE firm, the purchase will be made by an already existing entity. In such an add-on acquisition, an equity rollover may not be possible, or at a minimum will be more complex to work out.) Most commonly, the Company will be a limited liability company (LLC). The PE firm will invest in the Company from the fund (the "Fund") then being operated by the PE firm. There may be other investors alongside the Fund, with likely candidates including companies providing funding to the transaction and principals at the PE firm.

Assuming the Company is an LLC, the document that will govern the seller's rights and obligations with respect to its equity investment is the LLC Agreement or Operating Agreement (hereinafter referred to as the "LLC Agreement"). This usually is a complex document since it governs all the different investors in the Company. Besides the Fund and the Seller, these can include persons or entities who are investing alongside the Fund. There also are often provisions for equity incentives — such as profits interests — to be provided to management of the Company.

As the majority owner, the PE firm will control the Company. The seller may have a seat or seats on the board or other governing body, but these will not convey control. The seller has to rely on provisions in the LLC Agreement to protect its interests.

The Rollover; Tax Treatment; Leverage and Percentages

In the classic rollover transaction the seller will sell most of its equity for cash, and exchange the rollover portion of its equity for equity in the Company. In many cases, it is possible for the seller to avoid paying current tax on the portion of the equity that is rolled over, especially where the Company is an LLC. Tax specialists should be involved in the transaction to determine if current tax can be avoided and to assist in structuring to achieve this result.

When the transaction is leveraged, so that the Company borrows some of the purchase price for the acquisition (which is nearly always the case with a PE-backed buyer), the effect of the borrowing is to reduce the percentage of the sale proceeds that the seller has to roll over to acquire any specified percentage in the Company. Consider a transaction where the business is sold for $100 million, $50 million of which is borrowed. This means that the seller will be paid $100 million, but the equity in the Company will have a total value of $50 million. If the seller wanted to obtain 20% of the Company, the seller would have to pay (in the form of rollover equity) $10 million, or only 10% of the proceeds received by the seller. So the seller would end up retaining 90% of the purchase price — $90 million — and still would own 20% of the Company.

Key Points for the Seller

Some of the most important points to negotiate on behalf of the rollover seller are:

Same Class of Equity. The seller should receive the same class of equity — e.g., A Units in an LLC — that the Fund acquires. This aligns the interest of the seller with the interest of the PE firm. While in years past this could be an issue, this now is pretty much the norm.

Right to Hold Equity Until There is an Exit Event. The PE firm's first draft of the LLC agreement typically will include certain call options (a "Call") to buy out the seller before an exit event. For example, if an individual seller was going to continue to be employed by the Company, there might be a Call to buy out the seller if employment is terminated. The Call normally will be at a value determined by appraisal or some other method intended to approximate fair market value. The Call might also include a provision requiring the seller to accept a note for a portion of the purchase price.

These provisions should be strongly resisted. Where the Company is successful, the best value — in the sense of the highest multiple — will almost always be achieved when the Company exits by going to market through an effective sale process. Under a Call — where "fair market value" is determined by an appraisal — the multiple typically will be lower because the appraisal will be tied to normal pricing in the market. By contrast, where an effective sales process is conducted to sell the Company, the process should result in getting the buyer who is willing to pay the highest multiple. In addition, the PE firm will always try to take the Company to market when it can get the best return. A Call, on the other hand, could be triggered when the Company is not yet prime for sale, such as when the Company is still making investments which have not yet resulted in increased earnings. These factors mean that a seller who gets bought out before the exit event likely will get a lower rate of return than if it stayed in until the exit.

If part of the Call purchase price is paid by a note, the seller's position is even worse. If the Company performs poorly and goes under, the note — which is at risk of being put behind secured creditors such as institutional lenders — likely will not be paid in whole or in part. On the other hand, if the Company performs well the seller will not participate in the increase in value, and will only receive the amount of the note. In other words, the seller continues to have much of the downside that it would have if it retained its equity, but none of the upside.

For all these reasons, we feel that the events which trigger a Call should be extremely limited. One acceptable event might be the seller breaching a noncompete agreement. Another might be the seller transferring or attempting to transfer the equity in a prohibited manner. The Company also will argue for a Call if a seller who has been employed by the Company is terminated for cause. This point can come out either way. Whatever the trigger events which are ultimately negotiated, protections for the seller such as materiality standards and notice and a right to cure should be included.

What About a Put? We have represented sellers who said that if they left the Company, and were no longer involved in its operations, they would want to have an option to require the Company to buy back their equity (a "Put"). We generally advise our client that it is better to forgo the Put and insist on the right to retain their equity until there is an exit event. The valuation for the Put will be at a lower rate of return, just like a Call. And, if the seller requires a Put, it will certainly have to give Calls to the Company. Moreover, the rights evidenced by a Put are somewhat illusory, because they will always be subject to the Company's financial condition and to lender consent. Lender consent in particular can be subject to manipulation by the Company.

Come-Along Rights. Where the Fund is selling equity in the Company, come-along rights permit the seller to sell its equity, on a pro rata basis, at the same price, terms and conditions as of the Fund is selling. Some form of come-along right is standard in the LLC Agreement, and generally will always be triggered when there is a full exit. (Indeed, in a full exit the Fund will be requiring the seller to sell pursuant to bring-along rights.) A focus for rollover sellers should be extending the come-along rights to other situations where, before a full exit, the Fund, the PE firm or affiliates are transferring a portion of their equity for value. This can be highly negotiated, but the seller's basic position should be that it gets to cash out, on a pro rata basis, whenever the Fund gets to cash out.

Limit on Payments from the Company to PE Firm. The LLC Agreement frequently will provide for some kind of payment to be made annually to the PE firm. Where the payments are not fair market value payments for products or services provided by the PE firm, they really are a type of preferred return, one in which the seller's rollover equity does not share. Some form of these payments is very common. However, the seller should insist on limits to the amounts that can be paid, so the drag on return does not become excessive, and require that any other payments made by the Company to the PE firm or affiliates be on fair market price and terms.

Protection Against Dilution. The seller should focus on strong protection against its equity being diluted. Preemptive rights are the basic mechanism used for this purpose. Where applicable, preemptive rights give the seller the right to buy a proportionate amount of any new equity being issued at the same price and terms offered to others, thus preserving the seller's percentage interest in the equity of the company. However, exceptions to the preemptive rights provisions are almost always proposed, and have to be carefully negotiated. Moreover, in some cases, even though preemptive rights are available, as a practical matter they might be difficult for the seller to exercise. For example, the seller might not be able or willing to expend the funds required to exercise the preemptive rights and buy additional equity. The seller should attempt to limit the rights to do these types of transactions without their consent. Also, any transactions proposed with entities affiliated with the PE firm should be a special focus for restriction.

Permitted Transfers for Estate Planning Purposes. The LLC Agreement will include broad restrictions on the transferability of the rollover units that are acquired by the seller. The seller should negotiate reasonable exceptions to these restrictions for legitimate purposes such as estate planning.

Protection Against Amendments. Having negotiated provisions such as those described above, the seller then must carefully review the provisions permitting amendment of the LLC Agreement to be certain the provisions are not subject to being amended without the seller's consent.

General Deal Considerations

Where a seller is doing an equity rollover, the seller should carefully evaluate the quality and track record of the PE firm that it is dealing with, because the PE firm's skill in managing the Company will contribute to a successful investment. Besides reviewing the PE firm's success with previous investments and its expertise in the business of the Company, seller should also review the PE firm's reputation for dealing with its minority investors. Where the PE firm has been successful, the seller should be sure that the individuals who were key to that success are still active in the firm.

The seller has the most leverage before it goes exclusive with the buyer, which typically happens when a letter of intent is agreed upon. Therefore, the seller also should consider addressing the points about the rollover, which are most critical to it (see above) at the time a letter of intent or term sheet is negotiated, rather than leaving the points to be addressed at a later time. Even though the terms negotiated in the letter of intent will not be legally binding, they will carry weight as the parties negotiate the definitive agreements.

The LLC Agreement usually is a long and complex document. There are legitimate reasons for this. However, the complexity, and in particular the definitions, sometimes can conceal provisions which do not benefit the seller. The seller's counsel has to be prepared to review the draft very carefully to be sure it fairly reflects the seller's interests.

Conclusion

An equity rollover provides a seller with a high-risk proposition, but where the seller possesses the resources, an equity rollover provides the seller with the opportunity for a high return. Where the seller possess the ability to rollover equity, the terms of the deal will determine the seller's ability to maximize their return, and the seller should work with its legal counsel to ensure that rolling over equity is the best course of action, and that its rollover rights are adequately protected.

For more information, please contact Business Transactions Practice Group Leader Mark Williamson or your regular Lathrop GPM contact.