Structuring and Negotiating Rollover Equity Interests in Private Equity Transactions

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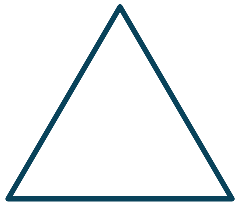
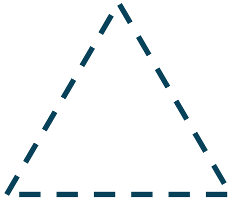
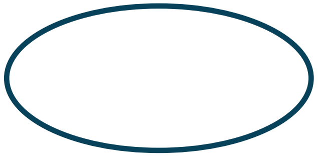
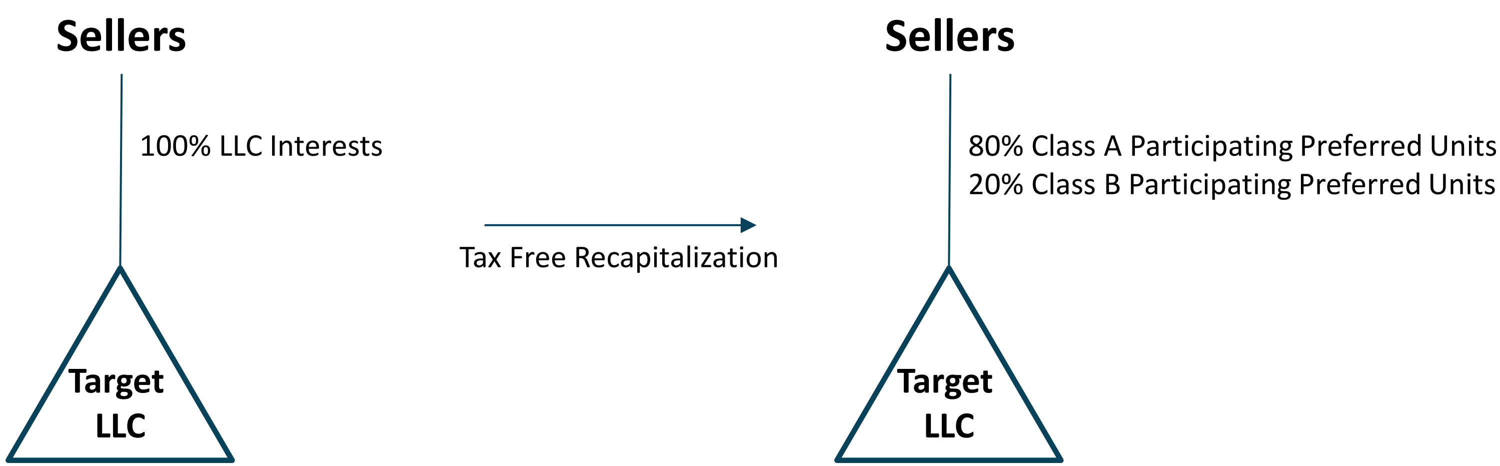
KEY:

Symbol	Federal Tax Treatment of Entity
	Partnership
	Disregarded Entity
	C Corporation
	S Corporation

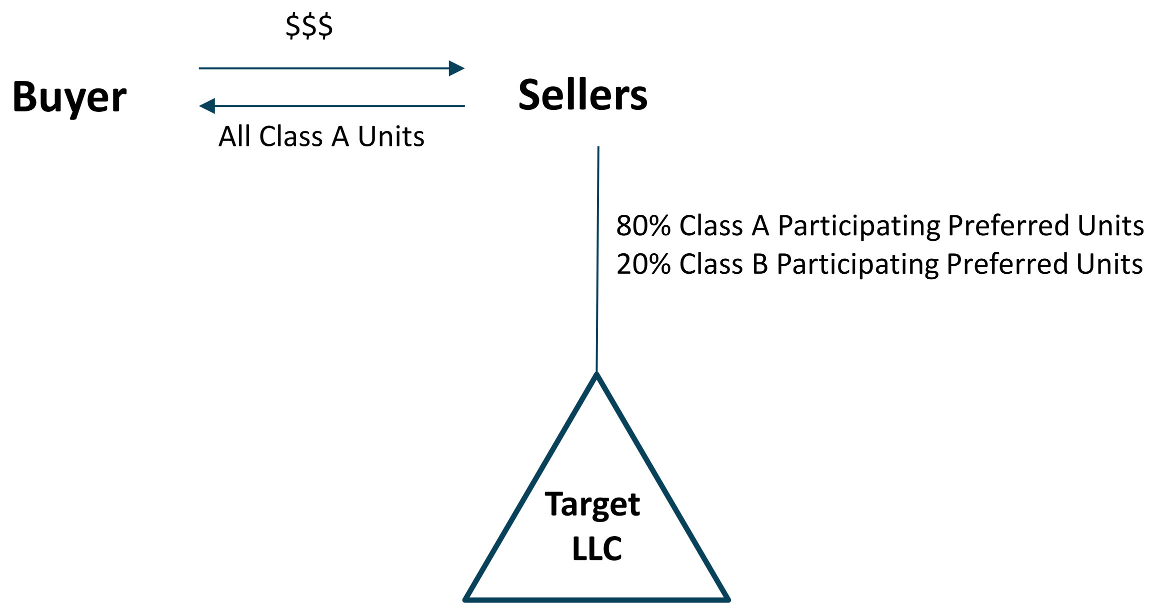
LLC Structure – Step 1

The Target LLC recapitalizes its outstanding equity interests to 80% Class A Participating Preferred Units with a senior liquidation preference and Class B Participating Preferred Units, which may stand behind the Class A Units on liquidation and perhaps other distributions. Participating Preferred Units generally have a liquidation preference and a preferred return preference at about 8% over management's profits interests.

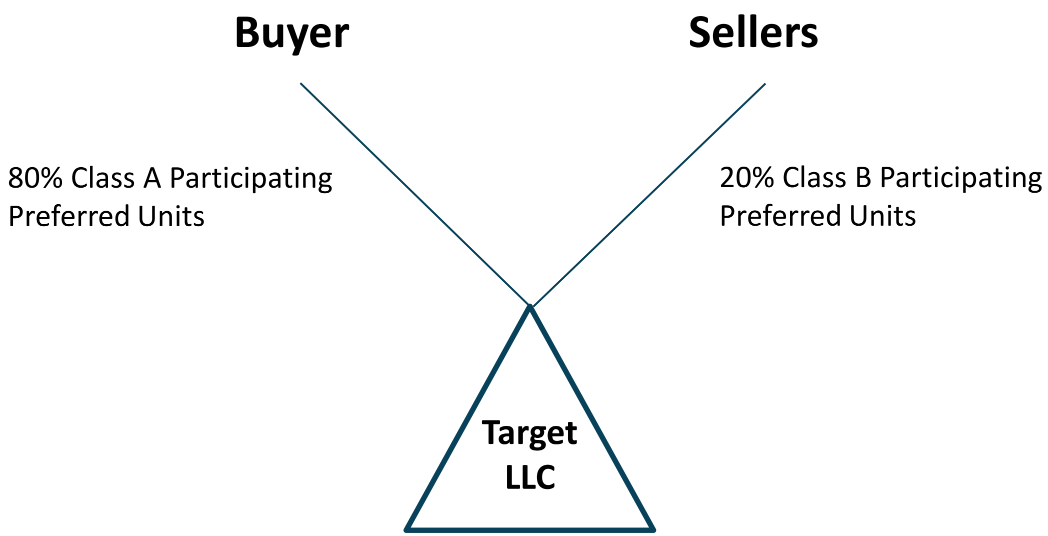


LLC Structure – Step 2

The Buyer purchases all of the issued and outstanding Class A Units from the Sellers.



LLC Structure – Final Structure

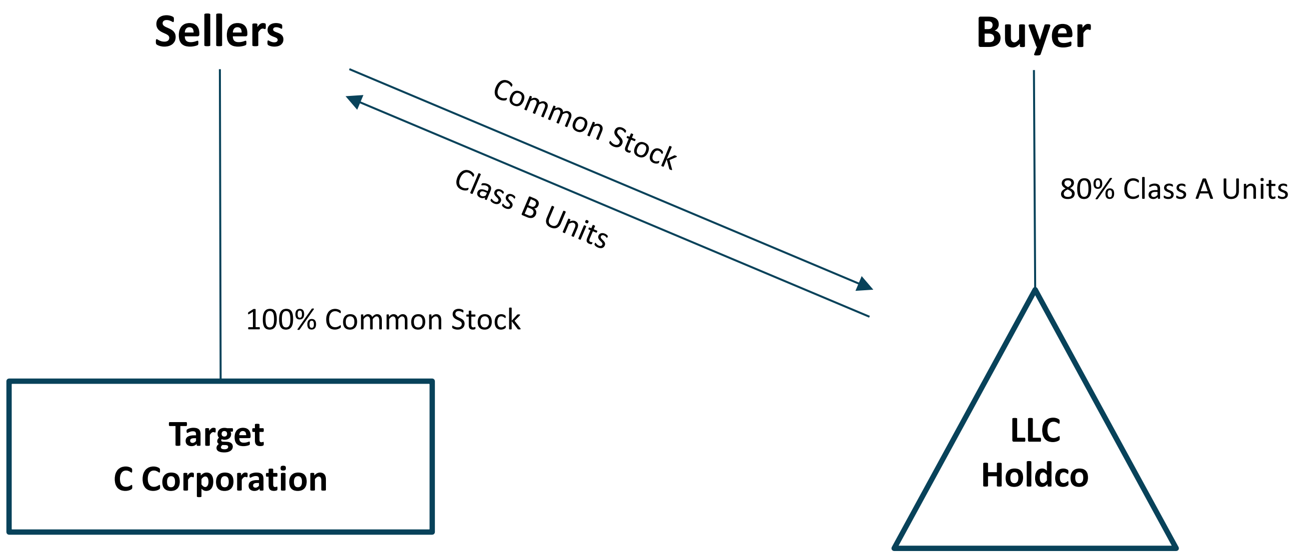


Notes:

- Depending on the assets of the Target LLC, the Sellers may recognize both capital gains and ordinary income (i.e., depreciation or amortization recapture).
- The Buyer will want the Target LLC to make a Code §754 election if there is appreciation in the Target LLC's assets (and may increase the purchase price as a result of such election).
- The Sellers will likely be subject to state income tax on sale of LLC interests, based on their residence.
- Even if the Target LLC was formed before 1993, there should not be anti-churning issues.
- Debt financing at the LLC level may cause part of the acquisition to be taxed as a redemption or other distribution, which would generate a tax basis adjustment inside the partnership which would likely be shared by the partners (rather than the tax basis adjustment generated by an equity purchase, which belongs to the purchaser).
- A buyer PE firm may use a blocker corporation or an AIV to hold the Target LLC interests.
- Retention of the LLC structure provides a single level of tax for rollover and some AIV investors (i.e., increase in tax basis of equity for share of after-tax earnings and potential increased purchase price on future sale of the business).

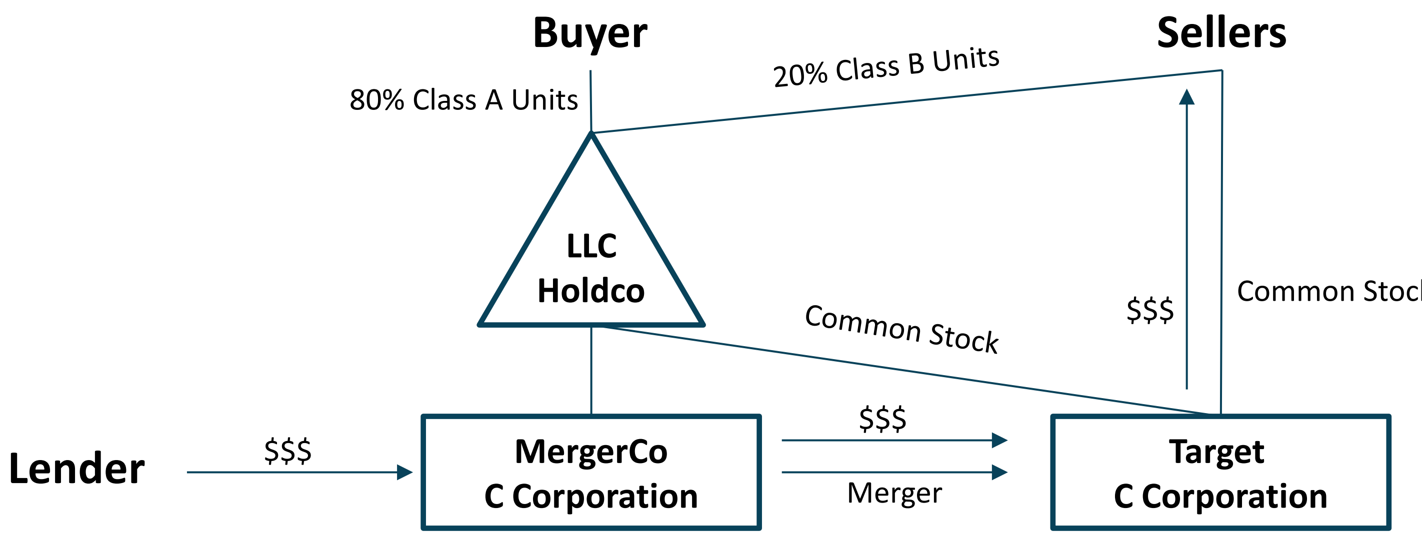
C Corporation with LLC Holdco Structure – Step 1

The Buyer will form an LLC holding company ("LLC Holdco") and contribute cash for 80% Class A Participating Preferred Units. The Sellers will contribute a portion of their Target Stock to LLC Holdco in exchange for the Class B Participating Preferred Units. The Class A Units will have a liquidation preference over the Class B Units.



C Corporation with LLC Holdco Structure – Step 2

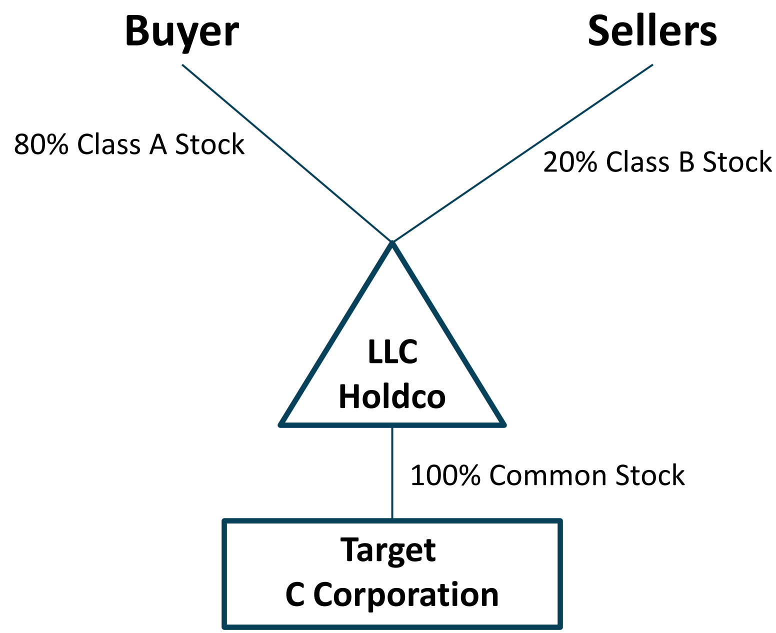
The LLC Holdco forms a transitory merger subsidiary ("MergerCo"), which is capitalized with some equity and borrows part of the purchase price from a third party lender. MergerCo merges with and into Target, with Sellers receiving cash in exchange for their remaining Target Common Stock and LLC Holdco receiving Common Stock in Target in exchange for its MergerCo stock.



<u>Notes</u>:

- The receipt of cash from Target by the Sellers that is funded by third party debt should be treated as a redemption of the Sellers' Common Stock. If the Sellers being redeemed are the rollover shareholders, then the distribution received by such Sellers may be treated as a dividend to the extent of earnings and profits in the Target if the redemption is not a substantial reduction of such Sellers' interests in the Target.
- The cash received by Sellers from MergerCo which was contributed to MergerCo by Buyer should be treated as an acquisition of shares by Buyer.

C Corporation with LLC Holdco Structure – Final Structure

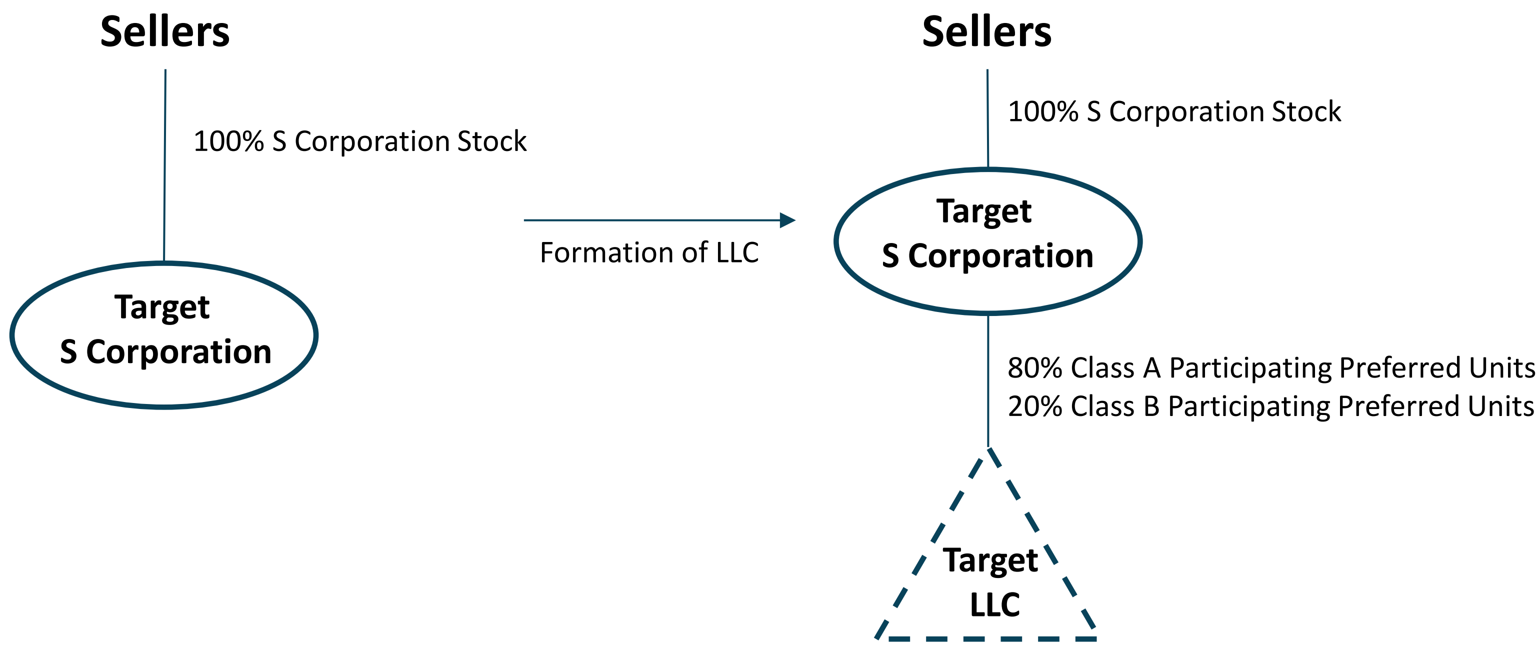


Notes:

- The LLC Holdco allows for the issuance of profits interests to management and other key employees.
- The operating agreement of an LLC will contain the substantive provisions otherwise contained in a shareholder's agreement, articles of incorporation, and bylaws of a corporation in a single document.
- The LLC Holdco will allow the parties to more easily split proceeds on a sale and account for escrows and shareholder representative amounts.
- The LLC Holdco provides an additional liability shield for the owners.
- The LLC Holdco allows for add-ons to be held in a brother-sister corporate subsidiary which can be sold separately without corporate tax.
- The Sellers should recognize capital gains on the stock sale or redemption, with the previously discussed caveat that a portion of the redemption may be taxed as a dividend.
- Many states will tax the Sellers on their gain if they are residents there, but some, such as Florida or Nevada, will not.
- There are no anti-churning concerns because any intangible assets would be held inside the corporation, and the transaction is a stock sale.

S Corporation Structure – Step 1, Alternative A

The Target S Corporation forms a wholly owned LLC subsidiary, contributing operating assets of the S corporation to the LLC in exchange for 80% Class A Participating Preferred Units and 20% Class B Participating Preferred Units in the LLC.

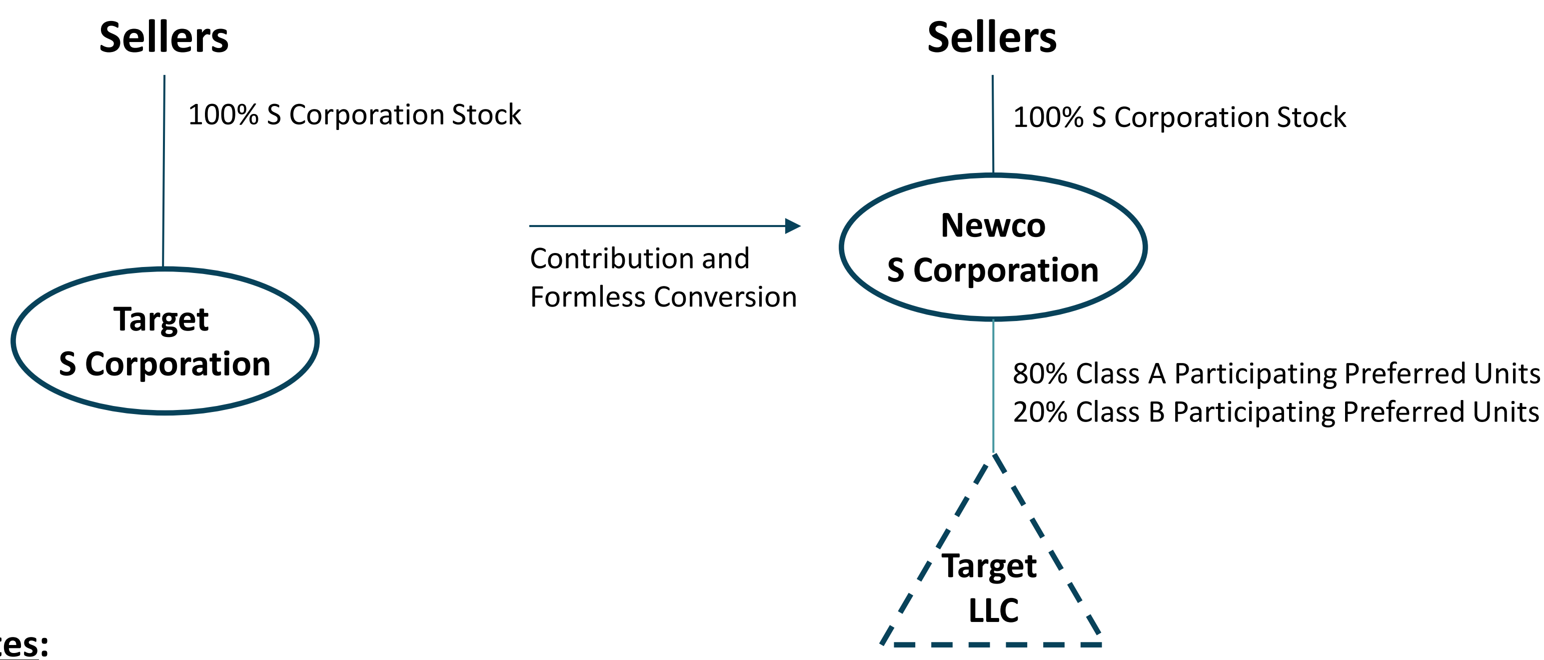


Notes:

- If the transaction is structured as the acquisition of 80% or more of the S corporation stock, the Buyer may want to make a Code §338(h)(10) election, but a tax-free rollover is not possible with such an election.
- With a deemed sale of assets, whether due to a Code §338(h)(10) election or a sale of interests in a disregarded entity, success-based fees may need to be capitalized and treated as a reduction of the amount realized on the sale (as opposed to an ordinary deduction).

S Corporation Structure – Step 1, Alternative B

The Sellers form a new S corporation ("Newco") and contribute all of the issued and outstanding Target S Corporation stock to Newco. Effective as of the contribution, the Sellers convert the Target S Corporation to a limited liability company under a state conversion statute; the contribution and conversion is intended to qualify as a Code §368(a)(1)(F) reorganization and should have no tax effect. After the conversion, the outstanding equity of old Target S Corporation, now Target LLC, will be 80% Class A Participating Preferred Units and 20% Class B Participating Preferred Units.

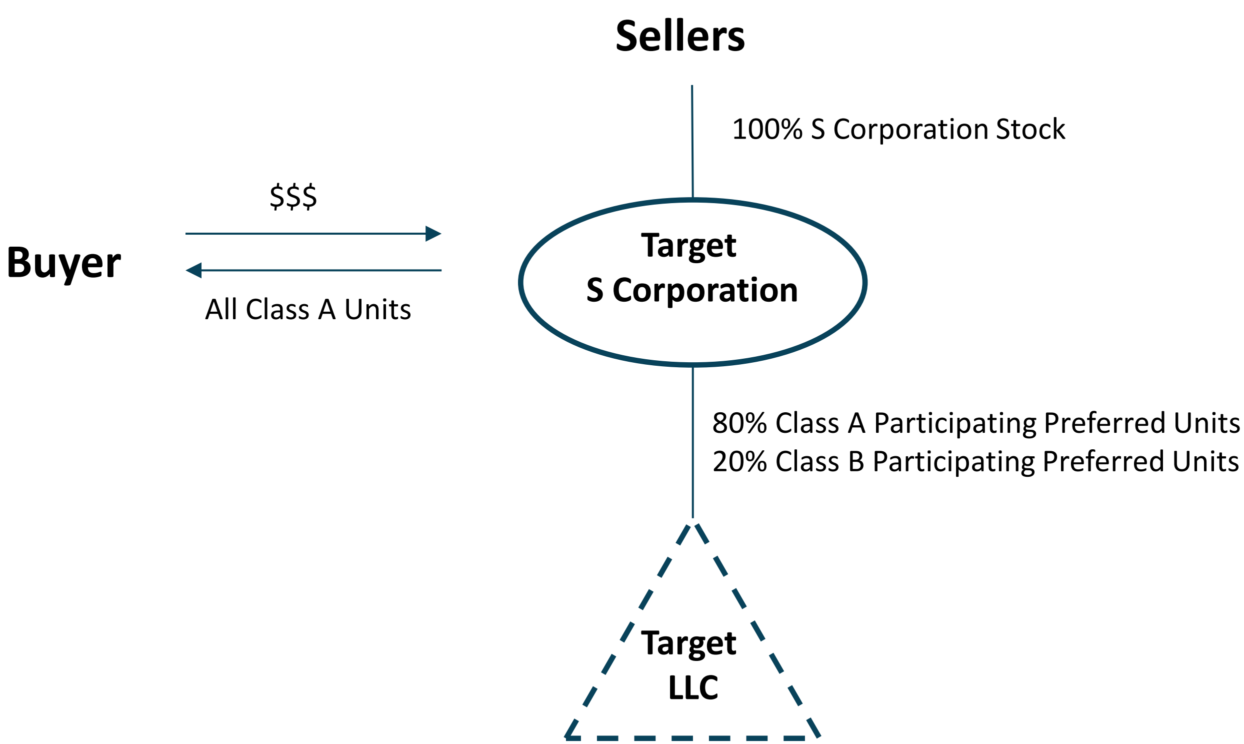


Notes:

- The use of an F reorganization allows the Target LLC to retain its employer identification number it obtained as an S corporation, helping to prevent headaches related to the transaction, such as payroll difficulties or reporting to regulators such as Medicaid or Medicare.

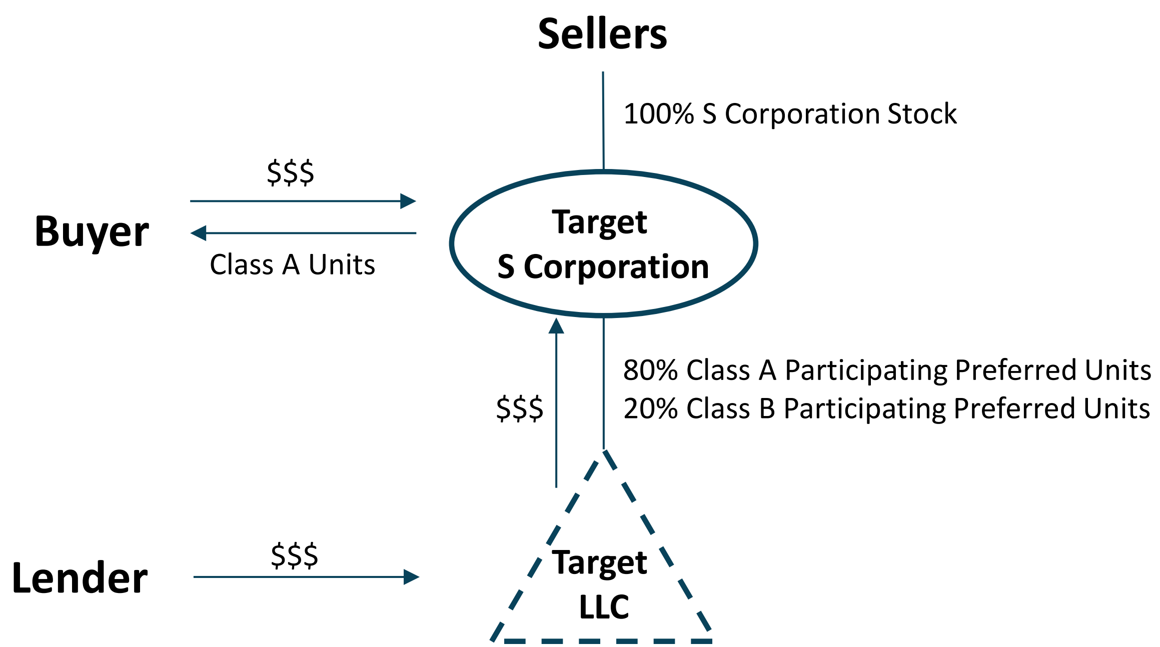
S Corporation Structure – Step 2 (Alternative A)

The Buyer purchases all of the issued and outstanding Class A Units from the Seller S Corp.



S Corporation Structure – Step 2 (Alternative B)

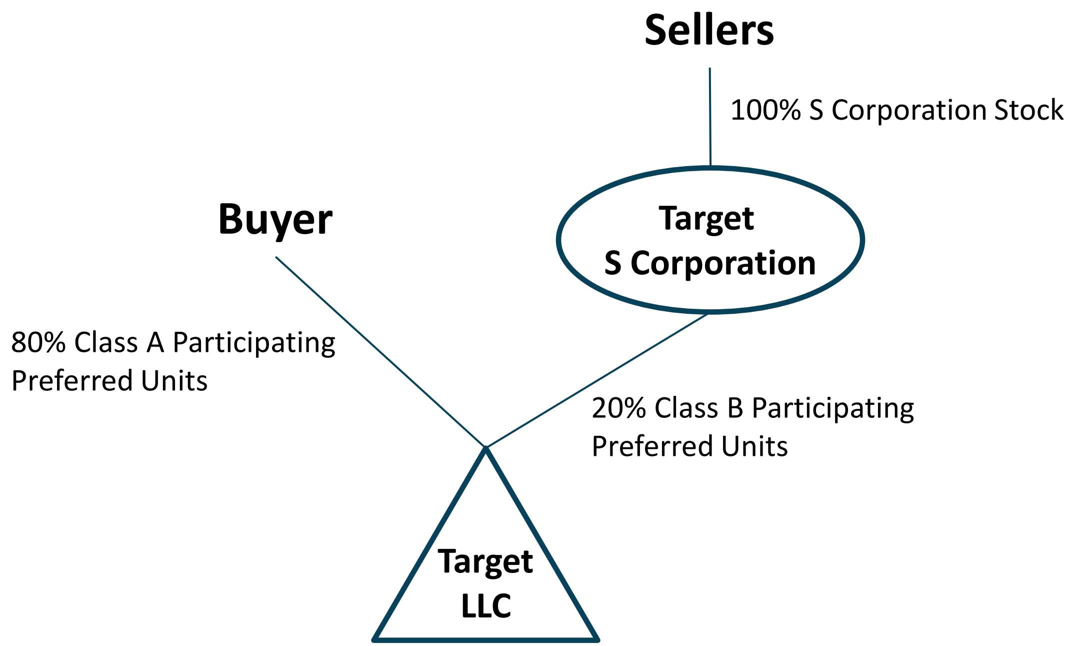
The Buyer purchases a portion of the issued and outstanding Class A Units from the Target S Corporation for cash, and causes the Target LLC to incur debt, which is used to redeem the remaining equity held by the Target S Corporation other than the rollover equity.



Notes:

- For federal tax purposes, the equity purchase should generally be treated as if the Buyer purchased a pro rata portion of each of Target LLC's assets, and the Target S Corporation and the Buyer should be treated as jointly contributing the assets of Target LLC to a new tax partnership.
- The debt-financed portion, because it's a distribution from the LLC to the Target S Corporation, should be treated as a disguised sale by the Target S Corporation of a pro rata share of the partnership assets represented by the redeemed Units to the Target LLC.

S Corporation Structure – Final Structure



Notes:

- Depending on the assets contributed to the Target LLC, the Sellers may recognize both capital gains and ordinary income. The Buyer may provide a gross-up to account for the extra taxes compared to a stock sale (including additional state income taxes).
- The Buyer will be treated as purchasing a pro rata share of the assets of the Target and contributing such assets to the Target LLC in exchange for its Class A Units.
- The Sellers will likely be subject to state income tax on their flow-through share of the gain from the S corporation's sale of LLC interests/deemed asset sale, based on their residence and perhaps based on where the S corporation conducts business.
- If the business began before 1993, there may be anti-churning concerns if the Buyer purchases less than 80% of the outstanding equity. Any LLC interests redeemed in Step 2, Alternative B, should likely not be counted in determining if Buyer has purchased at least 80% of the outstanding equity, which means that if the redemption represents a significant portion of the overall acquisition, the Buyer may end up "purchasing" less than 80% of the outstanding equity.
- If the LLC is established as a partnership at least one day before the transaction, query whether the anti-churning issue can be avoided as in the LLC structure previously discussed.

Provisions to Consider for the Operating Agreement or Shareholders' Agreement

1. Percent of Target equity or assets rolled over?
2. Percent of "New" Entity owned by Rollover Members?
3. Mandatory capital contributions for growth or add-ons?
4. Pre-emptive rights for additional security issuances? If so, include a pay-to-play provision?
5. Liquidation preference for Buyer? Senior or secondary liquidation preference for Rollover Members?
6. Incentive equity for Rollover Members?
7. Tax Distributions? The Buyer has extra amortization deductions.
8. Board membership for Rollover Members (until diluted)?
9. Consent rights for Rollover Members?
10. Investment opportunities?
11. Tag-along rights?
12. Redemption of Rollover Units for competition, retirement, or otherwise?
13. Rights to financial and other information?
14. Rollover member rights to consent to amendments to the agreement?