

# Midstream Shareholder Liquidity Alternatives: Structuring Shareholder Take-Outs in Growth Equity Financings

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## I. Introduction

The recent increase in private financing transactions with a dividend, redemption, secondary sale, or other “take-out” component is well documented. Once the province of a relatively limited subset of sponsors and targets, the so-called “recap” financing has gone mainstream. Reliable data tracking the number of such transactions is somewhat scarce. But over the past three years, the percentage of financing transactions handled by our firm with a liquidity component has increased dramatically. With potential increases to capital gains tax rates on the horizon, we expect an even greater focus on liquidity for transactions closing through the end of 2012.

Take-out transactions take many forms. We focus here on transactions in which the target company is a corporation<sup>1</sup> and remains intact as a legal entity, the new investor acquires between 20% and 70% of the company's fully-diluted ownership, and a significant portion of the investment dollars end up in the hands of the company's existing stakeholders. This article will explain the typical structuring alternatives for these transactions, the key tax considerations for the various potential participants, and certain other important considerations.

For purposes of illustration, several examples are provided. Unless otherwise indicated, the examples assume the facts below. For brevity and ease of

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<sup>1</sup> Although the basic structuring alternatives for a non-corporate transaction are the same, the tax consequences of a transaction involving a partnership or limited liability company can differ dramatically for both existing owners and the new investor.

*Historically, recap transactions were most often a liquidity opportunity for founders. More recently, the primary objective of the take-out is often replacement of existing investor ownership with new investor ownership.*

reference, we will employ the same capitalized names and terms throughout the text.

- Company is a corporation with 40 million shares of stock outstanding:
  - 20 million shares of Common Stock owned by Founder, a U.S. individual who has owned his shares for more than 1 year; and
  - 20 million shares of Series A Preferred Stock purchased for \$1.00 per share by Original Investor, a U.S. investment fund organized as a limited partnership with various types of partners including U.S. individuals, non-U.S. persons and U.S. pension funds.
- Company has issued employee options on 10 million shares of Common Stock with a strike price of \$.50 per share.
- The Series A Preferred Stock has a per share liquidation preference of \$1.00.
- New Investor will invest \$100 million to acquire shares of Company stock.
- New Investor expects to own a majority of the fully-diluted Company stock.
- New Investor is willing to allow up to \$80 million of its investment to be paid to existing Company owners and option holders, with up to \$20 million payable to Founder and up to \$4.5 million payable to option holders.

## II. Structuring Alternatives

Numerous structuring permutations are available for financings with a liquidity component. This section describes the most typical alternatives.

### A. The Investor Transaction

New Investor's transaction may take the form of an investment in Company (or in some cases, a new entity formed to acquire Company) in exchange for newly-issued (typically) preferred stock (a "primary" issuance) or a direct purchase of outstanding stock from selling stockholders (a "secondary" purchase). Occasionally, a secondary purchase will be followed by New Investor's surrender of the acquired stock in exchange for newly-issued preferred or common stock.

In a primary issuance scenario, Company would distribute a significant portion of the new money to existing stockholders, as described in more detail below. In a secondary transaction, the existing stockholders will of course receive New Investor's money directly.

### B. Target Participants

Recipients of the take-out dollars may include Original Investor, Founder, Company option holders and other Company employees. Sometimes all groups will participate, sometimes only one. Historically, recap transactions were most often a liquidity opportunity for founders. More recently, the primary objective of the take-out is often replacement of existing investor ownership with new investor ownership.

Numerous considerations inform the decision about which Company stakeholders participate in the take-out and how to allocate take-out dollars. These include:

- New Investor's ownership requirements (e.g., majority vs minority stake)
- Current owner willingness to relinquish a controlling stake in Company
- Demands for liquidity by Founder and Original Investor
- Willingness of both New Investor and company management to allow employee participation, taking into account the motivational pros and cons of employee liquidity
- Company's operational funding requirements





### *C. The Participant Transaction*

Participation of Company stakeholders in the take-out can take any one or more of the following forms:

- Company redeems outstanding stock by paying cash to selling stakeholders
- Existing stockholders sell their outstanding Company stock to the new investor for cash (a “secondary” sale)
- A statutory cash-out merger with a “rollover” of equity by continuing stakeholders
- Company distributes cash (as a “dividend”) to some or all holders
- Compensation paid to company employees
- A loan from the company, sometimes coupled with one or more options to acquire or sell stock

The transaction may also involve a recapitalization of existing Company stock. For example, Company's Series A Preferred Stock might be reconstituted as Common Stock, or existing Common Stock might be subject to a reverse stock split.

#### *1. Redemption*

In a take-out structured as a redemption, New Investor typically will invest money directly into Company, generally in exchange for the Series B Preferred Stock, and Company will use some or all of the investment dollars to redeem existing Company shares. Existing stockholders may be given the option to elect to participate in the take-out, or the participants may be

predetermined by agreement of Company's board, management and/or New Investor.

After the redemption is complete, New Investor will own its desired percentage of Company, and the take-out participants will have achieved some measure of liquidity with respect to their ownership stakes in Company.

#### *2. Secondary Sale of Outstanding Stock to New Investor*

Although sellers often prefer the tax consequences of selling their shares directly to a new investor, recapitalization transactions are frequently structured as a purchase by New Investor of newly-issued shares from Company, followed by a redemption of Company stock. There are a few key reasons for this:

- As described above, in certain situations, the tax consequences of a redemption can be more favorable for one or more selling shareholders.
- Typically, the business deal is that the new investors will acquire a series of preferred stock that has different terms from the existing preferred stock.<sup>2</sup>

<sup>2</sup> This sometimes can be achieved by first purchasing outstanding shares directly from the sellers and then exchanging the purchased shares for the new series of preferred stock. It can also be accomplished by reconstituting the purchased shares as a new series of preferred stock. However, a primary purchase from Company followed by a redemption typically is a more direct and straightforward route from a corporate law, mechanical and tax perspective, whereas the mechanics of exchanging or reconstituting shares often involves numerous steps, more nuanced fiduciary considerations and the involvement of more stakeholders. These considerations are discussed in Part IV.

*A key issue in any redemption transaction is whether stockholders' surrender of outstanding shares in exchange for cash will be treated as a "distribution" with respect to their remaining stock of Company, or will instead be treated as a sale or exchange of the redeemed stock.*

- New Investor may prefer to deal with only one entity (the corporation), rather than numerous individual sellers.

However, a secondary sale sometimes is used – either because it is most tax-efficient for the selling stockholders, or because New Investor does not demand a new series of stock, or simply because New Investor and the sellers prefer to negotiate the terms of their transaction with minimal interference from Company.

Sometimes, a secondary purchase will be followed by an exchange. For example, if New Investor purchases Common Stock and Series A Preferred Stock, New Investor might immediately exchange that stock for newly-issued Series B Preferred Stock.

### 3. Cash-Out Merger

A statutory cash-out merger may be utilized in cases where it is not possible to easily obtain signatures from all of the participating Company stockholders (as would be required in a more straightforward sale transaction), either due to the number of existing Company stockholders or because certain stockholders may be unwilling to sign. Such a merger transaction is often structured in the following manner (or some variation thereof):

- New Investor organizes a new entity to be the acquirer ("Newco") in the merger and makes its investment into Newco in exchange for newly-issued Newco preferred stock.
- Certain Company stockholders contribute their existing Company stock to Newco in exchange for newly-issued Newco stock having (usually) the same rights as the contributed Company stock.
- Newco forms a wholly-owned "shell" subsidiary ("MergerSub").

- MergerSub merges with and into Company. Company is the surviving entity in the merger.
- Newco acquires all of Company's remaining shares in the merger in exchange for cash paid to Company's stockholders.

### 4. Dividend

Instead of using New Investor's funds to redeem Company's existing shares, Company could use those funds to declare and pay a dividend on existing shares. Depending on Company's charter or articles of organization, a dividend could be paid on Company's existing common stock, preferred stock or both.

By declaring a dividend, Company can provide a certain amount of liquidity to everyone owning the classes of share receiving the dividend. While this solution can mitigate some issues involved in picking participants for an oversubscribed take-out, it also can end up providing liquidity to investors that may not otherwise demand it.

### 5. Compensation Paid to Company Employees

Company could use New Investor's funds to pay bonuses to certain Company employees. If only employee shareholders are seeking liquidity, a bonus can put cash in their hands without going through the process of declaring and paying a dividend or redeeming stock. The bonuses would be run through Company's payroll procedures and could be made disproportionately without any effect on Company's ownership structure.

### 6. Combination

Sometimes Company might choose to use a combination of compensation and redemption to achieve all of the stakeholder's goals. With this option, Company can reorganize its capital structure through



the redemption portion of the take-out and also issue compensation to the extent it wants to reward certain employees beyond the value of those employees' redeemed shares.

### 7. Treatment of Stock Option Holders

Company may also want to provide liquidity to its option holders in a take-out. There are a few different ways to do this:

- Permit option holders to exercise all or a portion of their options (either through payment of the exercise price or through a "cashless" exercise), allowing them to participate as stockholders in the liquidity transaction; or
- Permit option holders to surrender all or a portion of their unexercised options in exchange for liquidity proceeds calculated based on the difference between the option exercise price and the fair market value of the underlying stock.

### 8. Other Liquidity Options

Of course, the alternatives for structuring cash transfers to existing Company owners are not limited to those described in this article. For Founder and key employees, in particular, numerous alternative approaches (from the simple to the very creative) have been utilized over the years. For example:

- New Investor or Company might loan money to Founder. Typically, the loan would be secured by Founder's Common Stock. The loan may be fully recourse, fully nonrecourse, or partial recourse.
- A loan coupled with a call option on Founder's company stock. In this variation, New Investor is typically the lender and holds the call option. Often, the call option cannot be exercised for some period of years, and the strike price of the option may be significantly higher than the current value of the Common Stock, reflecting the parties' expectations (or at least hopes) about the future value of that stock. Typically, the loan in this approach would be fully (or mostly) nonrecourse. In some cases, Founder may also have a put option, effectively creating a "collar" on the Common Stock.

Other variations are also possible, including a "prepaid forward" sale of the stock. Each variation (and each component choice within each variation) involves

different – and sometimes very sophisticated – tax considerations. Those considerations are beyond the scope of this article, but should be addressed with a tax advisor before any of these variations are implemented.

## III. Tax Considerations

### A. Redemption

The key tax issues that may arise as a result of a redemption transaction in connection with a recap financing are discussed below. To aid in the explanation, we will refer to the following sample facts:

#### Example 1

New Investor will pay its investment dollars to Company in exchange for newly-issued Series B Preferred Stock. Company will use \$75 million of New Investor's invested capital to redeem a portion of its outstanding equity, as follows:

- 15 million shares of Series A Preferred Stock redeemed at a \$3.37 per share price (\$50.5 million total);
- 10 million shares of Common Stock redeemed at a \$2.00 per share price (\$20 million total); and
- Options on 3 million shares, netting \$1.50 per option share after deduction of strike prices (\$4.5 million total).

#### 1. Distribution vs Sale Treatment – Why it Matters

A key issue in any redemption transaction is whether stockholders' surrender of outstanding shares in exchange for cash will be treated as a "distribution" with respect to their remaining stock of Company, or will instead be treated as a sale or exchange of the redeemed stock. The determination of sale or distribution treatment is explained below. But first, it is important to understand the stakes involved in this question. They include:

- For U.S. individuals (including U.S. individual partners of an investment fund), whether (or at least when) basis in Company's stock can be used to reduce taxable income from the transaction, as well as the tax rate applicable to the transaction.
- For non-U.S. shareholders (including non-U.S. partners of an investment fund), whether U.S. withholding tax will be imposed in connection with the transaction.
- For U.S. corporate shareholders, whether a "dividends received deduction" is available to reduce tax from the transaction.

In Example 1, Original Investor may have limited partners comprising all three of the above categories (U.S. individuals, U.S. corporations and non-U.S. persons). While U.S. corporate partners of Original Investor may have a preference for distribution treatment because of the possible dividends received deduction, non-U.S. partners often will prefer sale treatment because sale treatment generally will avoid U.S. withholding tax for their share of the redemption proceeds. If distribution treatment applies and if some or all of the “distribution” is treated as a dividend for tax purposes (as explained further below), Original Investor typically would be required to withhold U.S. withholding tax with respect to its non-U.S. partners’ share of the dividend income at rates up to 30%.<sup>3</sup>

U.S. individuals often prefer sale treatment because of the ability to use their basis in the redeemed shares to offset taxable income from the transaction. In Example 1, Founder has no basis in his shares of Common Stock, having received those shares for future services upon Company’s inception when they had no value. In addition, Founder is eligible for the 15% federal tax rate on “qualified dividends,” the same rate that would apply to long-term capital gain he would recognize on a sale of his shares. Accordingly, Founder is likely to be indifferent as between dividend and sale treatment for his redemption. On the other hand, Founder may prefer sale treatment if he lives in a state with a reduced tax rate on capital gains or if federal income tax rates on dividend income increase.

In contrast to Founder, U.S. individual partners of Original Investor likely will not be indifferent as between sale and distribution treatment. Original Investor has an aggregate basis of \$15 million in its redeemed shares. If sale treatment applies, Original Investor will recognize a tax gain on the sale of \$35.5 million – that is, its \$50.5 million of “sale” proceeds less its \$15 million basis in the redeemed shares. Because of Original Investor’s ability to utilize its \$15 million basis to reduce its gain under sale treatment, Original Investor’s U.S. individual partners may well prefer sale treatment to distribution treatment.

However, in some situations, U.S. individuals may prefer distribution treatment. If the redemption is treated as a

distribution for Original Investor, then its actual tax consequences are determined based on a three-tiered filter.

First, if Company has current or accumulated “earnings and profits” (or “E&P”)<sup>4</sup> then the distribution would result in dividend income for Original Investor up to Original Investor’s allocable share of the E&P.<sup>5</sup> Original Investor may not use its basis in the shares to offset the dividend income.

Second, if Original Investor’s redemption proceeds exceed its share of Company’s current and accumulated E&P, the next redemption dollars are treated as a tax-free return of basis up to Original Investor’s basis in its Company shares. In some cases, this may cause Original Investor and its partners to prefer distribution treatment. Under this second tier of the analysis, Original Investor may use its basis in both the redeemed shares and its retained shares. As compared to sale treatment, this potentially allows Original Investor to receive an additional \$5 million of redemption proceeds free of tax. For example, if Company has no current or accumulated E&P, Original Investor would presumably prefer distribution treatment, which would allow Original Investor to receive \$20 million of its redemption proceeds free of federal income tax. Under sale treatment, Original Investor may use only its \$15 million basis in the redeemed shares as an offset.

Third, if Original Investor’s redemption proceeds exceed both its share of Company’s E&P and its entire \$20 million tax basis in the Series A Preferred Stock, then any remaining redemption proceeds will be treated as capital gain. If Company has no current or accumulated E&P, Original Investor would have \$30.5 million of capital gain under distribution treatment, as compared to \$35.5 million under sale treatment.

## 2. Determining Distribution vs Sale Treatment

Determining whether a redemption should be classified as a distribution or a sale is equally complex, and not entirely objective in every case. However, certain

<sup>3</sup> The actual withholding tax rate for a given partner of Original Investor will depend on the partner’s home country residence and on whether that country has a tax treaty with the U.S. that reduces the regular withholding tax rate on dividends.

<sup>4</sup> There is no clear definition of E&P in the tax code. It is not synonymous with either taxable income or GAAP retained earnings. However, it is often relatively close to the corporation’s net taxable income (or loss), as reduced by previous dividends distributed by the corporation. Dividend treatment may apply if Company has *either* current-year E&P, or E&P for all prior years combined. Thus, dividend treatment may apply even if Company has no accumulated E&P (for all prior years combined), if Company has E&P for the current year viewed in isolation.

<sup>5</sup> Each shareholder of a corporation will be allocated a certain portion of the corporation’s E&P based on the relative ownership and distribution rights inherent in their stock.



objective safe harbors are available. A complete redemption of a shareholder's interest in a corporation is one safe harbor (although even this test is not as simple as it sounds, due to the potential application of certain share ownership "attribution" rules). The "substantially disproportionate" redemption is another safe harbor. Under this test, the shareholder's percentage ownership of both outstanding common stock and outstanding voting stock after the redemption must be less than 80% of its percentage ownership prior to the redemption. Various other nuances apply, including certain stock ownership attribution rules and a requirement that, immediately after the redemption, the stockholder must own less than 50% of the corporation's total voting power.

In Example 1, Original Investor's initial common-equivalent and voting percentage of the outstanding stock is 50%. To qualify for the substantially disproportionate test, Original Investor's ownership after the redemption must be less than 40% (i.e., less than 80% of 50%). In the above example, Original Investor's percentage of the outstanding common-equivalent and voting power after the redemption is approximately 14% and therefore satisfies the substantially disproportionate test, meaning Original Investor's redemption should be treated as a sale of shares for income tax purposes, rather than a distribution.

Similarly, Founder's percentage ownership of the outstanding stock decreases from 50% to approximately 29% after the redemption and should also qualify as substantially disproportionate. As noted above, Founder may be indifferent as to whether the redemption is treated as a sale or redemption for tax purposes.

If neither the "substantially disproportionate" nor the "complete redemption" safe harbors are available, a redemption may in some cases still be classified as a sale for income tax purposes if it is "not essentially equivalent to a dividend." However, this analysis is based on the facts and circumstances of each case rather than on objective criteria. The case law generally requires a "meaningful" reduction in the stockholder's interest in the corporation, but the courts and the IRS have varied interpretations of what qualifies as "meaningful." Accordingly, tax practitioners prefer not to rely on this category in advising on the tax consequences of redemptions.





*In contrast to redemptions, the tax consequences of a direct sale of stock by existing stockholders to New Investor are often straightforward.*

### 3. Possible Recharacterization

In addition to determining the general tax treatment of a redemption as either a sale or distribution, in some cases a redemption transaction may raise other tax characterization questions. In particular, if Company redeems shares held by employees, there may be a question about whether some or all of the redemption price could be characterized as compensation for tax purposes. This is usually a somewhat subjective analysis and can be a very sensitive and important issue for both the selling employees and the company.

For Company, one key question is whether a tax withholding obligation may exist with respect to some or all of the payments to employee sellers. The tax deductibility of such payments will also be a consideration for Company. A payment of compensation is deductible by Company, whereas the redemption price for stock is not. For the selling employees, compensation treatment usually will result in a significantly higher tax burden for the transaction proceeds, given that compensation is taxed at federal income tax rates up to 35% (possibly increasing in the future) and is subject to employment taxes as well.

The compensation question often arises in situations where the redemption price to be paid for – in our examples – Company Common Stock is equal to (or very close to) the price being paid by New Investor for Series B Preferred Stock. This situation highlights the question because the Series B Preferred Stock has economic features (such as a liquidation preference and dividend rights) and other rights that seemingly make it far more valuable than the Common Stock. On the other hand, in many cases, all the parties to the transaction believe that the agreed redemption price for the Common Stock does represent its true fair market value. There are several factors that tax

practitioners identify as relevant in determining whether redemption proceeds may be characterized in whole or in part as compensation. These include:

- All available information about the valuation of the Common Stock.
- The expected financial accounting treatment of the redemption price paid to employee-sellers.
- Whether the redemption price for the Common Stock is viewed as an arm's-length, negotiated price.
- Whether any portion of the Common Stock is being sold by persons who provide no services to Company (for example, if Original Investor also held Common Stock and was selling it to New Investor at the same price as Founder).
- Whether dividend treatment might be a more appropriate recharacterization than compensation.

The tax analysis should take into account all of the foregoing factors.<sup>6</sup>

In cases where some or all of the redemption price payable to employee-sellers is determined to be compensation, the redemption payment mechanics should be revised for the compensation portion of the payments. The compensation portion should be run through Company's payroll processing procedures (internal or external). Income tax withholding and employment taxes should be withheld from that portion of the payment. The resulting amount (net of withholding) can then be paid to the employee sellers. Of course, any portion of the amounts payable to employee-sellers that is determined to be equal to the true fair market value of Company's Common Stock can be paid outside those compensation procedures.

#### Example 2

Assume Company's board of directors determines (by commissioning an independent appraisal) that the fair market value of Company's Common Stock is \$1.75 per share, rather than the \$2 per share Company will pay to redeem that stock. Company's board determines based on consultations with tax counsel that the excess portion of the payment for Founder's Common Stock will be treated as compensation to Founder. Founder is being paid \$2 per share, so \$0.25 per share will be considered compensation.

<sup>6</sup> Tax practitioners may occasionally consider the relative incentive of a taxing authority to characterize the common stock redemption price as compensation. Sometimes, the overall tax revenue generated by the transaction would be lower with compensation treatment because of the resulting corporate tax deduction.



- **Redemption:** Since the fair market value of the stock is \$1.75 per share, that portion of the payment will be treated as a sale of Founder's shares (assuming Founder's satisfaction of the "substantially disproportionate" redemption test described above) and will be taxed at the 15% federal long-term capital gains tax rate, plus state and local taxes. For purposes of this example, assume a 10% state and local tax rate on both capital gains and ordinary income. Thus, in this example, Founder will pay \$4.375 million in taxes on the "purchase" portion of his proceeds. Since no withholding would occur for this tax liability, Founder would be well advised to set aside funds for payment of these taxes, either through estimated tax payments during the remainder of the year or by the due date for his tax return, at the latest.
- **Compensation:** As noted above, \$2.5 million of the total consideration payable to Founder is determined to be compensation. Company will run this amount through its payroll provider, deduct applicable income and employment taxes, and remit the balance to Founder. Assuming federal income tax is withheld at a 35% tax rate and all other taxes (Medicare, state, and local)<sup>7</sup> total an additional 12%, approximately 47% (or \$1.175 million) of the amount treated as compensation will be withheld and remitted to the applicable taxing authorities by Company. Also, Company will be entitled to a tax deduction equal to the \$2.5 million of compensation. This deduction is often a significant windfall to Company (assuming Company has net taxable income against which to use the deduction) that was not anticipated at the outset of the transaction and was created with no net cash outflow from the Company. In some cases, the parties may have originally expected that all of Founder's payment would be taxed as capital gain. In such cases, the board of Company may consider paying Founder a "gross-up" amount to cover the difference between compensation taxes and capital gains taxes.

### *B. Secondary Sale to New Investor*

In contrast to redemptions, the tax consequences of a direct sale of stock by existing stockholders to New Investor are often straightforward. In our example, if Original Investor sells 15 million shares to New Investor for \$50.5 million, Original Investor will recognize a capital gain of \$35.5 million, which is the difference between the \$50.5 million purchase price and Original Investor's \$15 million tax basis in the 15 million shares sold. As noted above, this typically will be Original Investor's preferred tax outcome (as compared to distribution treatment). Similarly, if Founder sells 10 million shares directly to New Investor for \$20 million, Founder likely will recognize a capital gain of \$20 million.

However, secondary sale transactions are not entirely free from tax uncertainty. There still can be a question about whether some of the purchase price payable to employee-sellers represents compensation. This often surprises transaction participants. Intuitively, it would seem that if no payments are made by Company to its employees, then no portion of the sale price could be treated as compensation. Moreover, participants often note that a price negotiated by unrelated buyers and sellers should be respected as fair market value. On the other hand, where the facts indicate that there is some compensatory element to the agreed price (based on the various factors described previously), most tax practitioners believe that a taxing authority would not be swayed merely by the "form" of the transaction as a secondary sale. And certain tax regulations support this belief.

In cases where it is determined that some portion of the secondary sale price does represent compensation, it is usually easiest to restructure that portion of the payment. Typically, this takes the form of a payment by New Investor to Company, followed by Company's payment to the employee-sellers after deduction of applicable withholding taxes. Often, New Investor's payment to Company is restructured as the purchase price for newly-issued preferred stock. In some cases, the parties may find it easier to restructure the entire transaction as a primary issuance of stock by Company, followed by a redemption payment to selling shareholders.

#### **Example 3**

Instead of purchasing newly-issued stock from Company, New Investor purchases already outstanding shares from Founder. Assume also that Company Common Stock has an objectively determined fair market value of \$1.75 per share and that the parties, including Company's board of directors, determine that the excess \$.25 per share payable to Founder represents compensation due to Founder's status as a key employee.

- **Treatment of the Purchase of Founder's Common Stock:** In this situation, rather than having New Investor pay the entire \$2 per share directly to Founder, a better approach is typically to bifurcate the investment as follows:
  - o \$17.5 million paid directly to Founder in exchange for 10 million shares of Founder's common stock at \$1.75 per share; and
  - o The other \$2.5 million paid to Company in exchange for a primary issuance of Company stock (most likely the Series B preferred stock described in the Base Example, rather than additional common stock).

<sup>7</sup> This assumes that Founder's other compensation exceeds the wage base limit for Social Security taxes.

Company would then process the \$2.5 million through payroll as a compensatory bonus to Founder in the same manner discussed in Example 2 above. The ultimate tax results of this approach for Founder and Company would be equivalent to those described in Example 2. However, New Investor may be unwilling to hold the common stock purchased from Founder and may require that the common stock be exchanged for new Series B Preferred Stock.

As noted in Part III.A.1 above, a secondary sale might facilitate a better (or worse) tax result for Original Investor or Founder, depending on various factors.

#### Example 4

Assume now that Original Investor agrees to sell fewer shares – only 2.5 million shares of Series A Preferred Stock – in the transaction. If the transaction is structured as a primary issuance to New Investor followed by a redemption from Original Investor, Original Investor's percentage of outstanding voting stock and common equivalents after the transaction would be approximately 44%. This reduction in Original Investor's percentage from 50% to 44% would not satisfy the "substantially disproportionate" test explained in Part III.A.2 above. Accordingly, some or all of Original Investor's redemption may be characterized as a dividend, meaning Original Investor is reducing its tax liability on that portion of its proceeds by offsetting those proceeds with a portion of its tax basis in the Series A Preferred Stock. However, if the transaction were structured as a secondary sale of Series A Preferred Stock directly to New Investor, Original Investor could use a portion of its tax basis to reduce the taxable amount. This may create tension between Original Investor's desire for a better tax outcome by selling Series A Preferred Stock to New Investors, and New Investor's preference for purchasing Series B Preferred Stock with different rights and privileges. Alternatively, New Investor may be able to exchange Series A Preferred Stock with Company for newly-issued Series B Preferred Stock; or New Investor may be indifferent to the type of stock purchased because of its expectations about Company's current value and future prospects.

### C. Cash-Out Merger

The tax issues arising in a cash-out merger transaction are particularly complex, and a full discussion of those issues is beyond the scope of this article. Depending on the precise structure used, the cash paid in a cash-out merger may be treated as "sale" proceeds for tax purposes, or as "redemption" proceeds (which in turn may result in dividend income, recovery of basis or capital gain), or as so-called "boot" in a stock rollover transaction, each with their own unique tax results.

Perhaps the most critical question in such a transaction is whether the "rollover" component will be tax-free to the rollover participants. Because this component involves the exchange of Company stock for illiquid stock of Newco, it is typically important to the participants that the rollover be nontaxable. The

tax analysis of a rollover depends in part on whether Newco is a corporation or an entity classified as a partnership for income tax purposes (typically a limited liability company, or "LLC"). If Newco is an LLC, the rollover usually can be structured as a nontaxable transaction.

If Newco is a corporation, the rollover participants and New Investor together must own at least 80% of Newco's voting power and total stock value in order for the rollover to be eligible for nontaxable treatment. However, "nontaxable" treatment for a rollover to corporate Newco is not necessarily what it seems. Depending on various factors, a rollover participant who also receives some cash in the merger may end up with approximately the same overall tax liability as if the rollover were a fully-taxable transaction, even if the rollover itself satisfies the 80% test. Again, a full explanation of this phenomenon is beyond the scope of this article.

### D. Dividend

Most of the tax considerations applicable to a dividend payment are addressed above in Part III.A. As noted above, Company's dividend of cash may represent a nontaxable return of stockholder basis in Company stock or may be taxable as dividend income. A special low federal income tax rate (15% under current law) applies to "qualified" dividend income received by individuals.<sup>8</sup>

As with redemptions and secondary sales, a dividend may raise the question of compensation treatment for employee-stockholders. However, the tax analysis is somewhat different because a dividend does not involve a sale of shares – either in form or in substance. Accordingly, the question of valuation is less relevant in this context. Rather, the tax analysis focuses on the rights of the parties to dividend under the corporate charter, relative shareholdings, arm's-length compensation and other factors. Arguably, a dividend structure renders the already subjective compensation analysis even less clear. Depending on the circumstances, there may be less inclination to recharacterize a dividend as compensation than in other contexts both on the part of tax advisors and

<sup>8</sup> In order to qualify, the stock on which the dividend is declared must be held by the stockholder for more than 60 days during the 121-day period beginning on the "ex-dividend" date (generally, the last date on which one must have owned the stock in order to become eligible for a declared dividend).



taxing authorities. On the other hand, if dividend tax treatment would result in wholly or mostly tax-free proceeds (because the company has no E&P and the dividend recipients have tax basis in excess of the dividend amount), one should take into account the increased incentive of a taxing authority to challenge dividend treatment in such circumstances.

#### Example 5

Assume now that Company will not redeem any shares of its stock, but will pay out \$40 million of New Investor's investment as a dividend to Founder and Original Investor. Assume \$30 million of this amount is distributed to Original Investor and \$10 million is distributed to Founder. Also assume that Company has \$20 million of current year E&P and no accumulated E&P.

Founder Common Stock Treatment: Even though Company may have no accumulated E&P, the \$20 million of current year E&P will render a portion of Founder's distribution taxable as dividend income for tax purposes. Assume 25% of the current year E&P is allocable to Founder (i.e., \$5 million) and therefore that \$5 million of Founder's distribution will be taxed as a dividend. If Founder had tax basis in his shares, the other \$5 million would first reduce Founder's basis before being treated as capital gain. In this case, because Founder's basis in his shares is \$0, the other \$5 million will be taxed as long-term capital gain. Because dividends and long-term capital gains are currently taxed at the same 15% federal tax rate, and assuming 10% state and local tax, Founder's dividend will be subject to aggregate tax of \$2.5 million. Again, since this tax is not withheld by the Company, Founder should consider setting aside a portion of the distribution to cover taxes when they become due. In future years, if the federal dividend rate and capital gains rate vary, Founder may find this dividend approach to be a less tax-efficient liquidity alternative.

Old Investor Series A Preferred Stock Tax Treatment: Assume Company's remaining E&P (\$15 million) is allocated to Old Investor and therefore \$15 million of Old Investor's \$30 million distribution will be treated as a dividend for income tax purposes. Old Investor's partners will be subject to the disparate tax treatment for dividends discussed in Part III.A.1. above (U.S. individuals subject to federal tax of 15%; non-U.S. persons subject to US tax withholding at rates up to 30%; and U.S. corporations may be able to benefit from a "dividends received deduction"). The other \$15 million of Old Investor's dividend will be treated as a tax-free recovery of Old Investor's basis in its Series A Preferred Stock (reducing that basis from \$20 million to \$5 million).

#### *E. Compensation paid to company employees*

The tax implications of a payment intentionally structured as compensation to Company employees are addressed elsewhere in this article. The payment generally should be run through the company's payroll procedures and applicable taxes should be withheld.

#### *F. Tax treatment of payments to stock option holders*

If Company option holders do participate in the proceeds of a take-out transaction, it is often most convenient to simply pay them in exchange for their agreement to cancel a portion of their unexercised stock options. This approach does not require the employee to write a check for the option exercise price, or the issuance of stock certificates.

Payments to employee option holders for unexercised stock options will always be characterized as compensation for tax purposes, and tax withholding will apply whether the options in question are so-called "incentive stock options" (commonly referred to as "ISOs")<sup>9</sup> or "nonstatutory stock options."

On the other hand, employees who hold ISOs should at least consider whether tax savings can be achieved by first exercising their ISOs and then participating in the liquidity transaction as a stockholder. For example, if the liquidity transaction is structured as a secondary sale directly to the new investor or as a redemption of shares qualifying as a "sale" for tax purposes, the exercise of an ISO followed shortly thereafter by a sale of the underlying shares will be treated as a so-called "disqualifying disposition." Although this approach results in the same federal income tax rate as the net "cash-out" approach described above for unexercised options, the exercise of an ISO and sale of the ISO shares allows the employee to avoid income tax withholding and employment taxes. Employees who use this approach will need to plan appropriately for payment of the income tax by the time they file their income tax returns for the year of the payment (at the latest), and in some cases may need to make interim estimated tax payments in order to avoid interest penalties.

However, in some cases, exercising an ISO may not be the optimal approach. ISOs generally must be exercised with a cash payment (rather than through a cashless exercise). And, if the liquidity transaction is structured as a distribution taxed as a dividend, the option holder may end up triggering alternative

<sup>9</sup> ISOs are employee stock options that meet certain requirements and qualify for special tax treatment under the Internal Revenue Code.

minimum tax ("AMT") by exercising the ISO<sup>10</sup> and may be taxed at the same time on the dividend income. Thus, exercising an ISO may result in 3 layers of cash cost for the employee – the exercise price, AMT and the dividend tax. The liquidity amount may or may not cover the entire cash outlay. Accordingly, the decision to exercise an ISO as part of such a transaction should be made only with the help of a tax advisor.

#### Example 6

Company will allow option holders to participate in liquidity proceeds (for options on up to 2 million shares) by either surrendering unexercised options for their net "spread" value or exercising their options and participating in the transaction as stockholders. All the options are ISOs. The ISOs have an exercise price of \$0.50 per share, so \$1.50 will be paid for each unexercised option surrendered.

Certain option holders wish to avoid employment taxes on their proceeds for 1 million option shares). Those employees pay \$500,000 to Company a few days in advance of the liquidity transaction. In the transaction, their 1 million shares are redeemed by Company for a total of \$2 million. Assume the redemption qualifies as a sale for tax purposes.

Their sale of the ISO shares is a so-called "disqualifying disposition." The employees will owe ordinary income taxes on the spread between their exercise price and the sale price. Assuming a 35% federal income tax rate and a 10% state tax rate, that would equate to approximately \$675,000 of income tax on the \$1.5 million of compensation income the options holders recognize. However, assuming the option holders' wages are already above the Social Security wage limit, the employees will avoid the Medicare tax.<sup>11</sup> No tax would be withheld from the payments to these holders. Rather, they should consider setting aside \$675,000 for payment of the tax when it becomes due.

The employees who accept \$1.5 million in exchange for cancelling unexercised options on 1 million shares will owe the same amount of income tax (assuming the same income tax rates), plus Medicare tax (and Social Security tax, if applicable), which would be withheld from the \$1.5 million.

## IV. Other Considerations

Although this article focuses primarily on structure and tax considerations, additional issues must be considered. In a "take-out" transaction structured as a redemption, Company's board of directors must consider the advisability of issuing the Series B Preferred Stock in the first instance, and then the advisability of using the proceeds to repurchase existing shares. Often, there are several legitimate reasons for approving these transactions, including the need to align Original Investor (and possibly Founder) with the strategic plan adopted by the board and management. Stockholders who are no longer interested in Company as an investment, who require very near-term liquidity, or who simply do not "buy-in" to management's strategy will often disrupt or otherwise negatively impact the management team's efforts. A prudent board will seriously consider a liquidity transaction to minimize these disruptions and negative effects.

While there are often several legitimate reasons for approving a "take-out" transaction, during the approval process a board must also be mindful of self-interested motivations and/or the appearance of impropriety. Failure to do so may raise questions (and in some cases, legal claims) from Company stockholders.

When the transaction is structured as a redemption of shares held by insiders (including investment funds affiliated with board members), courts will often scrutinize these transactions more carefully. If liquidity is available only to a select group of stockholders, Company's board should be prepared to justify the rationale for the limitation. Often, in order to avoid the appearance of impropriety, a board will require that the redemption be made available to all holders of capital stock on a pro rata basis, with a nondiscriminatory "cut-back" mechanism if participation is over-subscribed. However, by making the redemption available to a broader number of individuals or entities, the securities law rules for tender offers may be implicated – adding an additional level of complexity to the transaction.

<sup>10</sup> The alternative minimum tax may ultimately be offset against capital gains taxes in a future sale of the shares, but if the future sale is a loss for tax purposes, the AMT may never be fully recovered.

<sup>11</sup> At the current 1.45% Medicare rate, the employees would save \$21,750, and the Company would save an equal amount. The Medicare rate is scheduled to rise for some taxpayers, beginning in 2013.



*While there are often several legitimate reasons for approving a “take-out” transaction, during the approval process a board must also be mindful of self-interested motivations and/or the appearance of impropriety. Failure to do so may raise questions (and in some cases, legal claims) from Company stockholders.*

In summary, when approving a “take-out” transaction structured as a redemption, a board should carefully consider each of the following:

- What is the corporate or business rationale for the redemption/liquidity transaction?
- Who will benefit from the liquidity?
- Are there any conflicts of interest around the board table? Will any board members receive significant proceeds in the transaction?
- Is there a class or group of stockholders who are not being offered the chance to sell their shares?
- At what price should Company repurchase shares? How does this affect option pricing?
- Will Company have adequate capital to operate its business after the transaction? Does the transaction satisfy state law limitations on share repurchases and dividends?
- Are there restrictions in Company’s contracts (including investor documentation and/or debt documentation) that limit Company’s ability to repurchase shares?
- Has Company satisfied its disclosure obligations in connection with the repurchase?
- Are there any compensatory payments being made (or any deemed compensatory payments being made)? Is Company satisfying its tax withholding obligations?

The considerations applicable to a take-out transaction structured as a secondary sale are similar, but not entirely the same. In many cases, Company will not be involved in the decision to sell or set the sale price, and Company may try to avoid becoming involved in the process. The board’s actions are less likely to be scrutinized if Company is only minimally involved. Company’s involvement may be limited to approval of an exchange of Series A Preferred Stock or Common Stock purchased by New Investor for newly-issued Series B Preferred Stock, and the authorization and issuance of the Series B Preferred Stock. Company may be required to disclose more extensive information if there are several selling stockholders and/or if the tender offer rules apply. Company may determine that it is appropriate to prepare a disclosure document. However, in many cases the board’s fiduciary obligations will require a full analysis of the factors listed above.

If New Investor’s purchase of Series A Preferred Stock or Common Stock is followed by an exchange for newly-issued Series B Preferred Stock, other issues arise, such as:

- Whether the board may, in the proper exercise of its fiduciary duties, approve the exchange and/or grant New Investor additional stockholder rights.
- What the terms of the Series B Preferred Stock should be.
- What the exchange ratio should be.
- Whether there is an effect on the valuation of Company’s Common Stock and correspondingly on the pricing of Company’s stock options.
- Whether the exchange triggers any preexisting rights held by Original Investor, such as rights of co-sale, or rights of first refusal.

- The tax consequences of the exchange (both for New Investor and possibly for Original Investor and Founder).

## Conclusion

A financing transaction with a stockholder liquidity component generates opportunities to rationalize a company's capital structure; bring in new investors with fresh ideas, energy and capital to move the company forward; provide liquidity for founders and other stakeholders; take advantage of various tax benefits; and eliminate or diminish the presence of distractive stakeholders. These transactions also involve potential costs and complexities – both tax and nontax. Accordingly, such transactions must be carefully planned, and counsel should be consulted early in the process to identify and work through the potential opportunities and traps. ☺

### About the Authors

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The authors appreciate the assistance of **Jonathan Rivinus**, an associate in Cooley's Tax Group.