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Key Legal and Tax Implications of Up-C Public Company Acquisitions

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Introduction

With the increase over the past 10+ years in the number of companies that pursue an initial public offering ("IPO") through a so-called "Up-C" structure ("Up-C Pubcos"), we have witnessed an increase in the number of M&A transactions that involve the acquisition (by both private and public acquirers) of Up-C Pubcos. This article describes some of the legal and tax considerations unique to acquisitions of Up-C Pubcos.[1] Many of these considerations relate to a number of the issues addressed in our prior articles relating to so-called tax receivable agreements ("TRAs").[2]

Background

In a basic Up-C IPO structure, a business historically conducted through an entity classified as a partnership for U.S. tax purposes goes public through the formation of a new public company that serves as its general partner or managing member and acquires equity interests in the partnership. Certain pre-IPO owners will continue to own an interest directly in the partnership, in addition to "vote only" shares in the public company that do not have any economic rights.

Pre-IPO owners that retain partnership equity typically will be entitled to "tax distributions" from the partnership to satisfy their tax obligations resulting from their allocable share of the partnership's taxable income. Pre-IPO partnership owners obtain liquidity from time to time by transferring their partnership interests to the public company in exchange for public company stock, which they then sell. These transfers typically result in the public company receiving a partial basis "step-up" with respect to the assets of the partnership, which is frequently amortizable over a fixed number of years (typically 15 years to the extent such step-up is attributed to the business's goodwill). These amortization deductions may reduce the net taxable income and resulting cash tax obligations of the public company. A TRA in an Up-C structure typically will provide, among other things, that the TRA payees (consisting of most pre-IPO owners and their assignees) are entitled to 85% of the actual cash tax savings the public company realizes as a result of these amortization deductions. TRAs also typically include assignment provisions that enable pre-IPO owners to transfer their future entitlements to TRA payments to others.

A post-IPO change-of-control transaction (a "CoC") typically also will result in a forced exchange by pre-IPO owners of their partnership interests in exchange for shares of Up-C Pubco stock, which are then transferred to the buyer in the CoC. An increasingly common term of a TRA is a prepayment provision, which provides that the CoC will require the public company to make a TRA termination payment based on the present value of the tax attributes subject to the TRA (a "CoC TRA payment"). This calculation often utilizes various assumptions favorable to the TRA payees, including that the public company always has sufficient income to utilize the relevant tax attributes and that the public company is always subject to the maximum tax rates in effect on the date of the CoC, all of which can contribute to a significant payment upon a CoC. Other TRAs may provide for no acceleration upon a CoC, but rather that the TRA continues to be paid over time with future calculations made utilizing similar TRA payee favorable assumptions regarding the income and applicable tax rates of the company. TRAs are also subject to amendment by specified groups of holders, such that the default outcome in a CoC can change if the requisite TRA holders agree to accept an alternative.

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Key Considerations

Terminating or Amending the TRA

- In some cases, a buyer will bid for an Up-C Pubco with the assumption that there will be no CoC TRA payment and that the relevant TRA payees (or their assignees) will agree to amend the TRA to eliminate in whole the entitlement to a CoC TRA payment. Upon receipt of an offer that assumes an elimination of a CoC TRA payment obligation, the board of the Up-C Pubco may have a threshold decision to make with respect to how to organize itself in response to the overture. Specifically, if the TRA payees (1) wish to receive all or a portion of the CoC TRA payment and (2) have designated directors to serve on the Up-C Pubco board, those directors should consider the fiduciary duty implications associated with involvement in board discussions regarding the potential CoC. If the TRA payees are also controlling shareholders of the Up-C Pubco, the Up-C Pubco board and the controlling shareholders may consider treating the transaction as one involving a controlling shareholder and implementing the "MFW" process under Delaware law, although countervailing considerations exist as well. Ideally this decision would be made early in the process to satisfy the MFW process condition that the MFW protections be established at the outset of the process; however, with appropriate process management, and some risk tolerance, the decision can be delayed to the point where the potential TRA payees decide to negotiate for what amounts to differential consideration in the transaction. Ultimately, shareholders and board members are well advised to take advice from experienced counsel at the outset of any such transaction.

- Deciding whether to eliminate a CoC TRA payment obligation requires careful consideration, and it can be particularly complicated for a potential payee that also holds a significant equity position in the business. The elimination of the CoC TRA payment entitlement should increase the amount the buyer is willing to pay for Up-C Pubco equity by eliminating an upfront liability that the buyer would indirectly inherit through its acquisition of Up-C Pubco and because the buyer will benefit from the tax basis step-up that the transaction will create. As such, in agreeing to eliminate the CoC TRA payment, a (typically small) group of TRA payees may be able to push the buyer to increase the price per share it is willing to pay on account of the tax basis step-up, which benefits all holders of equity. As TRA payees whose consent is needed to eliminate the CoC TRA payment can hold a substantial portion of the target's equity, the net impact of an agreement to eliminate the TRA CoC payment can have a relatively modest impact on overall consideration paid to many of the TRA payees in the proposed CoC. (Parties also may seek to amend the TRA to eliminate or reduce TRA payments expected to be made in the sign-to-close period, particularly where such payments are expected to be material.) Unsurprisingly, TRA payees that have a blocking right over TRA amendments may demand an inducement payment if these payees do not hold a meaningful stake in the business at the time of a CoC.

- Buyers and shareholders that wish to have the TRA amended to eliminate or reduce a CoC TRA payment obligation will need to analyze the amendment provisions of the TRA carefully. Principally, they will need to confirm which holders have the ability to effect the amendment and consider the risks associated with interpretation of the provision, including possible litigation by parties to the TRA adversely affected by the amendment. In many cases, unlike with customary credit agreements, it is possible to alter the terms of a TRA, including the right to payment, without the consent of all TRA payees. A substantial misalignment of economic interests may exist between potential TRA payees that no longer hold a substantial equity stake in the business and those that do. After the CoC, the litigation and other risks associated with a TRA amendment are the buyer's risks to the extent the dispute regards whether the amending parties had the authority to effect the amendment, given that the buyer inherits any exposure relating to an invalid TRA amendment. Further, consideration will need to be given to confidentiality, Regulation FD and deal leak considerations to the extent approval to amend the TRA is required from parties not "under the tent" with respect to the proposed transaction.

Tax Distributions

- For businesses that generate taxable income, it may be important to the pre-IPO partnership owners that, during the interim period between the signing and closing of the CoC, the partnership continues to make tax distributions. As a buyer, it will be essential to understand taxable income projections, the expected cash required to fund such obligations, and the expected time to elapse between signing and closing (which can be uncertain in a transaction that carries antitrust risk) as this sign-to-close cash leakage could impact buyer's pricing of the CoC. Buyers are well-advised to assume some cash leakage for tax distributions between signing and closing and, if the amount is material, to call out their assumption in their initial bid letter to place a stake in the ground for negotiation purposes.

- If parties seek to limit tax distributions that are otherwise payable prior to the CoC pursuant to the partnership agreement, it will be important to obtain the requisite consents from the relevant pre-IPO partnership owners to amend the partnership agreement accordingly.

- Assuming that tax distributions do occur during the interim period, the partnership will need to be thoughtful in how it calculates the distributable amounts, particularly given that (x) there are typically no "true-up" tax distributions after the closing of the CoC if the business underestimated its taxable income for purposes of making tax distributions during the course of a year and (y) the partnership may realize a substantial amount of transaction tax deductions from the CoC that reduce its pre-closing taxable income and therefore the income allocations to the pre-IPO owners holding partnership interests. Particularly challenging is that anticipated deductions, like those available at the closing of the proposed CoC, are typically not taken into account when allocating income prior to the closing. Parties may, for example, ultimately choose to agree to a cap on tax distributions or a fixed amount of tax distributions during the sign-to-close period.

Equity Rollovers

- Certain pre-IPO partnership owners and certain shareholders of the Up-C Pubco may wish to roll their existing equity interests into the buyer structure in a tax-deferred transaction. The ability to complete such rollover on a tax-deferred basis will be highly dependent on the facts and can be particularly challenging for pre-IPO owners holding partnership interests, particularly if the buyer is another public company.

Payors and Payees: Termination Fees and Engagement Letters

- All termination fees under the CoC documentation should be payable to or by, as applicable, the partnership or its wholly owned subsidiaries. Having such fees be payable solely to the Up-C Pubco can result in non-economic outcomes given that pre-IPO owners may have substantial economic interests in the partnership and no economic interests in the Up-C Pubco.

- To support the position that all fees payable by the target business to investment bankers and advisors result in available tax deductions at the partnership level (among other issues, including maintaining appropriate economic symmetry as described above), it is a best practice that the partnership be party to engagement letters with bankers and advisors and that the bankers and advisors directly invoice the partnership.

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Impact on Transaction Structure; Exchange Mechanics

- CoCs of Up-C Pubcos have been most frequently effected using the one-step merger structure and not the two-step structure involving a tender offer followed by a squeeze-out merger. The one-step structure is generally adopted in public target CoC transactions where regulatory approval timelines or a "go-shop" process are likely to push the expected closing day beyond the anticipated timing for shareholder approval. However, the exchange mechanics included in up-C structure documentation can also nudge transaction participants toward a one-step merger structure as most up-C transaction documentation does not contain exchange provisions conducive to participation in a tender offer.

- Practitioners managing the closing process will also need to pay special attention to the exchange mechanics to ensure a smooth closing by, for example, preventing exchanges of partnership equity for Pubco shares as the closing date draws near.

Withholding Tax Considerations on the CoC Exchange

- Typically, the exchange of partnership interests for shares of Up-C Pubco stock in connection with the closing of the CoC will be a taxable event. Up-C Pubco will need to collect taxpayer residency forms (e.g., IRS Forms W-9 for U.S. persons) to avoid having to pay federal withholding taxes arising from the exchange. This has become a more prevalent issue since the enactment of new "Tax Code Section 1446(f)" withholding tax rules enacted under the legislation commonly known as the Tax Cuts and Job Act of 2017. Complex withholding calculations and adjustments to the exchange mechanics may be necessary in the event a pre-IPO owner is a non-U.S. person.

Gain Calculations for Pre-IPO Owners

- The calculation of gain realized by a pre-IPO owner holding partnership interests in connection with a CoC is highly complex and will depend on its allocable share of the liabilities of the partnership and whether such member's basis is effectively "negative" (e.g., as a result of loss allocations or debt-financed distributions). In such a case, a pre-IPO owner may have more gain than it expects in a taxable transaction (or, if the transaction is tax-deferred, a pre-IPO owner may not be able to achieve complete tax deferral).

- A portion of the gain realized by pre-IPO owners also may be re-characterized as ordinary income under the Tax Code's so-called "hot asset" rules. This commonly arises, for example, where the owner has previously been allocated material amortization or depreciation deductions or where the partnership has material long-term contracts under which it is required to perform services. Accordingly, pre-IPO owners may want to agree to purchase price allocation principles with buyer to ensure greater certainty on the quantum of ordinary income being recognized.

Support Agreements and Pre-Closing Tax Covenants

- Where the buyer seeks a pre-IPO owner to sign a shareholder support agreement, it is often advisable for the pre-IPO owner to negotiate protections with respect to various tax matters consistent with what may often arise in private M&A transactions involving partnerships. Such covenants would typically cover: (i) participation and consent rights with respect to tax audits, (ii) review rights over tax returns with respect to pre-CoC tax periods and methodologies for allocating pre-closing tax items of the partnership (including transaction tax deductions), and (iii) termination of any tax indemnification obligations such member may have pursuant to the pre-CoC partnership agreement. The parties will also need to consider whether a so-called Tax Code Section 6226 "push out" election is appropriate with respect to relevant pre-Closing tax periods (which would "push out" pre-Closing

tax liabilities to pre-IPO owners in the event of a U.S. federal income tax audit). All of these terms are typically included in a separate tax matters agreement negotiated by such holders and executed at the time of execution of the merger agreement and the shareholder support agreement. Note also that such an agreement could also be demanded by pre-IPO partnership owners in connection with an agreement to amend the TRA to eliminate the potential CoC TRA payment entitlement or an agreement to amend the operating agreement of the subsidiary LLC to adjust pre-closing tax distributions.

Partnership-Level Tax Obligations

- Buyer will want to be mindful of any post-closing tax obligations of the operating partnership arising from pre-closing activities. This can commonly arise from nonresident state withholding tax regimes as well as from elections a number of partnerships have made recently at the state level (subsequent to the enactment of the deduction limitations under the Federal Tax Code on state and local taxes) to have the partnerships be subject to a "pass-through entity tax" that can yield a federal tax credit for partners. Buyers and pre-IPO owners holding partnership interests will want to understand if any expected refunds that arise at the partnership level are required by law to be remitted to the applicable partners or if the partnership may retain such refunds.

For further information regarding Up-C Structures and TRAs, please contact one of the members of the Ropes & Gray team listed above.

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