The Proposal: Considerations in Starting or Acquiring a Business

Jeffrey P. Gleason, Esq., Partner, Woods Oviatt Gilman, LLP
Matthew B. Morey, Esq., Partner, Lipsitz Green Scime Cambria, LLP

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Acquiring a Business/Starting a Business – How Should Your Client Operate?

Entity Choice/Formation:

- Sole Proprietorship
- General Partnership
- Limited Partnership
- Corporation (C or S corp.)
- Limited Liability Company

- **<u>Other Entities</u>**:
  - Professional Service Limited Liability Company
  - Professional Service Corporation

Why should your client form an entity?

- Limited Liability Protection.
- Business Succession Planning Opportunities.
- Let's get "serious" (sophisticated clients form entities to acquire and operate businesses).
- "Formalize" the ownership/management rights and obligations of new business venture (the "money guys" and "service guys").

Entity Choice: Which one is right for your client?

- Who is your client? Certain businesses must operate as certain entities.
- What is your client's business/business being acquired? There may be tax reasons driving entity choice.
- Where does your client do business? If your client does business in a number of different jurisdictions, you may want to consider forming an entity in a jurisdiction other than New York (e.g., Delaware, Texas, Nevada, etc.

Sole Proprietorship:

Business conducted by an individual that is not incorporated.

- **Advantages**:
  - Simple to operate (you just start conducting business).
  - The business is legally owned by the individual – no need to file a separate tax return.
  - "Relatively" simple to close.

- **Disadvantages**:
  - Unlimited personal liability of the owner.
  - Third parties may take your client less serious (lack of sophistication in operation of business).
  - Liabilities of business impact individual, and vice-versa.
  - Business succession issues – business terminates upon death of individual.

General Partnership:

Business conducted by one or more individuals that share in the profits of the venture. Partnerships can be "de facto" (meaning no written agreement signed by the partners).

- **Advantages**:
  - Like sole proprietorships, simple to start.

- **Disadvantages**:
  - Like sole proprietorships, unlimited personal liability of the owners.
  - Tax filings more complex than sole proprietorship (Form 1065).
  - Business terminates upon death of a partner (unless affirmative election of surviving partners to continue the partnership).

Corporation:

An entity incorporated by filing a Certificate of Incorporation with the New York Department of State (for New York corporations).

Two "different" types of corporations – C or S corporation. In most cases, closely held businesses elect to be treated as an S.

- **Advantages**:
  - Limited liability of the owners (assuming adequate capitalization and no "PCV" issues).
  - Generally, cheaper than forming a limited liability company in New York.
  - Angel investors/private equity typically prefer ownership as corporation.
  - "History" of case law for corporations in many jurisdictions.
  - Certain tax advantages (e.g., potential net operating loss (NOL) carryback/carryforward in acquisitions).
  - Potential self-employment tax savings.

Corporation:

- **Disadvantages:**
  - Double-taxation (unless shareholders elect to be treated as S corporation, if permitted).
  - Statutory Considerations (New York Business Corporation Law Section 1104-a, New York Business Corporation Law Section 630).
  - Relatively "inflexible" as compared to a limited liability company (especially S corporations).
  - Inflexible corporate recordkeeping requirements as compared to limited liability companies.

S Corps.:

- Most closely held businesses elect to be treated as an S corporation if permitted to do so.
- S corporations are basically the same as a C corporation (have shareholders, board of directors, officers, etc.) except the corporation is treated differently for tax purposes. For a C corporation, income is taxed twice: (1) at the corporate level (when the corporation earns income); and (2) at the shareholder level, dividend, dissolution, or upon the sale of a shareholder's shares. For S corporations, all income generated by the corporations "flows through" to the individual shareholders- resulting in in being taxed at the individual shareholder level as opposed to corporate level.
- The default rule is that a newly formed corporation is treated as a C corporation unless it elects to be treated as a S corporation. If a client wants to be treated as a S corporation, the shareholder must make a timely election to do so.

S Corps.:

- **Is your client eligible to elect to be treated as S corp.?**
  - Entity must be a "domestic corporation."
  - Generally, only individuals, certain trusts and estates may be shareholders in a S corp. Partnerships, LLCs, corporations, and non-resident alien shareholders CANNOT be shareholders.
  - Have only one class of stock (this can be tricky and inadvertently violated).
  - Have no more than 100 shareholders.
  - Not be an "ineligible corporation" (e.g., insurance company and certain financial organizations).
- **Don't blow the deadline to elect (2 months and 15 day rule).**

Limited Liability Company:

Similar to a corporation, in that a limited liability company (LLC) is an entity that is formed by filing an organizational document with the incorporating jurisdiction (Articles of Organization in New York).

- **Advantages:**
  - Very flexible in how ownership/management can be structured (special allocations, manager or member managed, may or may not have officers).
  - Operating Agreement (required document for LLC) offers opportunities to modify default rules of the New York Limited Liability Company Law.
  - Income "flows through" to the owners (referred to as the members), like an S corp., yet without the restrictions of the S corp. rules.
  - Limited liability of the owners (assuming adequate capitalization and no "PCV" issues).
  - Single-member LLCs can be "disregarded" for tax purposes (no need for separate tax return) or elect to be treated as corporation. Multiple-member LLCs can elect to be treated as a partnership or corporation.

Limited Liability Company:

- **Disadvantages:**
  - Relatively new entities – lack of established case law.
  - Professional investors usually prefer investments with corporation as opposed to limited liability companies.
  - Costs of formation can be excessive given publication requirements (for New York LLCs).

Other Considerations:

- Should your client be incorporated in a different jurisdiction (other than New York):
  - Delaware
  - Texas
  - Nevada
- Consider qualification issues for forming in different jurisdiction, yet operating in New York.
- Potential Marketing/Trademark Issues (when acquiring business, this should be vetted in diligence phase)
- Fiduciary Duties

Acquiring A Business

Sources of Acquisition Targets

- Brokers
  - Auctions
  - Targeted Solicitations
- Finders
  - SEC No-Action Letter, January 31, 2014 (Revised February 4, 2014)
- Pre-Existing Relationships
  - Strategic Buyers vs. Financial Buyers
  - Accountants
  - Lawyers
- "Word on the Street"

Timeline of Acquisition Process

- Once the parties have come, or been brought, together, the transaction process typically takes 3-6 months
- Transaction Milestones:
  - Letter of Intent
  - Due Diligence
  - Negotiation of purchase agreement (including disclosure schedules) and ancillary documents
  - Satisfaction of Conditions
  - Closing
    - Many deals are simultaneous sign-and-close absent special circumstances (regulated industry, necessary notifications, extraordinary consents)

Hang-ups and Sources of Delay

- Consents from customers, suppliers, landlords, and regulatory agencies due to necessary assignments or changes in control of Target
- Unanticipated findings in due diligence process (environmental concerns, litigation, union matters)
- Stockholder vote/consent issues

Sidebar – Negotiations with Different Entity Types

- Corporation – Usually negotiation is conducted by executive officers with the approval of the Board of Directors (both of the Letter of Intent and the final transaction documents); approval of stockholders is a condition to closing.
- LLC – Can be difficult if not manager-managed (of Board of Managers) and negotiation is with the members (possibly with varying priorities).
- LP – Negotiation is with the General Partner; approval of limited partners is a closing condition.

Letter of Intent

- The LOI outlines the terms and conditions of the preliminary agreement of the parties with respect to the transaction.
  - Many clients will push for a very general LOI, which often creates more fights over terms later in the deal.
  - Push to be involved at the LOI stage as opposed to only after one is signed (both Seller and Buyer clients).
- Explicitly State which terms of the LOI are binding and which are non-binding.
- Even when provisions are clearly identified as non-binding, they may be enforceable as a binding agreement if the parties agree to negotiate the outstanding material terms in good faith. A plaintiff can recover expectation damages for breach of a duty to negotiate in good faith based on an expressly non-binding LOI (*SIGA Technologies, Inc. v. PharmAthene, Inc. (Del. 2012)*).

Deal Structures – Asset Purchase

- Buyer purchases specific assets and assumes certain liabilities of Seller's business
  - Can leave behind undesirable assets and liabilities, including contingent and unknown liabilities (subject to successor liability concerns)
- Buyer gets a step-up in basis in the assets (tax advantage for Buyer)
- Third party consents to assignment may be required

Deal Structures – Equity Purchase

- Requires participation of all equityholders of the Target (subject to drag-along rights that may be present)
- Buyer buy all equity interests in Target—all assets and liabilities travel with Target
- Sellers may get capital gains treatment (tax advantage for Sellers) unless deal is structured with a 338(h)(10) election
  - Buyers do not get a step-up in basis unless 338(h)(10) election is made or transaction is an F-reorganization
- Only need consents for where change of control provisions are present (including by regulation)

Deal Structures - Merger

- Forward or reverse triangular mergers
- Similar to equity purchase—assets and liabilities travel with Target
- Often used if there is a large equityholder base or if consent from all equityholders is not likely or feasible
- Dissenting equityholders may have appraisal rights
- Infrequently used in lower- and mid-market deals

Acquisition Agreement

- Regardless of deal structure, the acquisition agreement will be similar in structure:
  - Purchase Price and Adjustments
  - Representations and Warranties
  - Covenants
  - Covenants
  - Indemnity
  - Miscellaneous Provisions
- Your starting points should be the LOI, reviewing precedent at your firm, or reviewing documents on the SEC's EDGAR database
- Specialists should be brought in early—tax, environmental, real property
  - You may need to recommend to your client the use of a consultant (regulated industries, environmental concerns)
- Understand your bargaining power and position from the start
- The ABA's Deal Points Studies can be invaluable in negotiating when your counterparty claims that something is "market"

Purchase Price and Adjustments

- The purchase price may be paid at closing or deferred or adjusted in several ways:
  - Seller Note
  - Escrow
  - Earnout
  - Working capital, inventory, or other adjustments
  - Payoff of debt
  - Transaction expenses
- These items can be used to ensure the business is delivered as expected and to secure indemnity obligations.

Practice Tips

- When counseling Sellers, be sure to walk through the representations and warranties as well as the related disclosure schedules with them. Oftentimes, talking through the provisions will uncover new and necessary disclosures.
- When representing Buyers, be sure to use the Seller's disclosure schedules to confirm your findings in due diligence and identify any discrepancies between what was produced and what is disclosed.
- Remember the difference between a right to indemnity and the ability to sue for breach of contract and counsel your client on the difference.
  - Again here, know your bargaining position
  - Sandbagging vs. anti-sandbagging

Notes on Financing Your Acquisition

- Sources of financing
  - Cash
  - Debt
    - Traditional financing, Seller financing, SBA loans
  - Outside debt or equity investment
- Even if you are raising funds through debt instruments, *those instruments are securities*
  - Securities Act Section 2(a)(1): The term "security" means any note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.
- Every offer or sale of securities in the U.S. is either (1) registered, (2) exempt, or (3) illegal.

Securities Act of 1933

- Section 2(a)(3) – an "offer" of a security is "every attempt or offer to dispose of, or solicitations of offers to buy, a security or interest in a security for value"
- Section 2(a)(11) – an "underwriter" is any person who purchases a security "with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking". In this context, the "issuer" includes "any person directly or indirectly controlling or controlled by the issuer".

Exemptions from Registration

- "Keeping in mind the broad remedial purposes of federal securities regulation, imposition of the burden of proof on an issuer who would plead the exemption seems to us fair and reasonable." *SEC v. Ralston Purina Co.*, 346 U.S. 119 (1953).
- Section 4(2) of the Securities Act exempts from registration "transactions by an issuer not involving any public offering."
  - This is an independent exemption, but not a safe harbor

Safe Harbors and Other Exemptions

- Rule 504
  - Limitation of $1,000,000 in a 12 month period
- Rule 505
  - Can sell up to $5,000,000 to accredited investors and up to 35 other persons
  - Financial statement requirements
- Rule 506(b)
  - Unlimited amount of securities sold to accredited investors and up to 35 other persons
  - No general solicitation
  - Financial statement requirements still apply
- Rule 506(c)
  - General solicitation is allowed, but all investors must be accredited investors and the issuer must take reasonable steps to verify such status
- Rule 701
- Regulation S

Notes on Crowdfunding

- Title III of the JOBS Act provided a directive to the SEC to propose rules to provide an exemption from registration for crowdfunding offerings.
- Regulation CF permits offerings of up to $1,000,000 in the aggregate
  - Individual investment limitations
  - Must be conducted through registered funding portal
  - Information disclosure burden (before sale and ongoing)
  - Cost
- Requirements are often seen as too prescriptive and cumbersome to be workable in most cases

Questions?

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