CLIENT ADVISORY:

LIQUIDITY OPTIONS FOR OWNERS OF PRIVATE COMPANIES

One of the frustrations of being a shareholder of a private company is that, while their ownership stake in the company may have significant value, historically it has not been readily convertible into cash. Since the shares are not registered with the Securities and Exchange Commission they cannot be traded in the public markets, and transfers of shares of private companies are subject to federal and state securities laws and often to contractual prohibitions on transfer under shareholder agreements. In many cases, shareholders had only two alternatives: wait until the company goes public or, more commonly, is acquired by another company.

However, in recent years, a third alternative seems to be emerging in the form of so-called liquidity rounds or secondary sales of private company stock. In general, these typically fall into one of two categories: company sponsored transactions (usually in the form of a company redemption) and shareholder sales to third parties. Both raise a variety of issues, but in many cases they are different issues from the perspective of the company and the shareholder.

Redemption by the Company

From the company's perspective, there are distinct advantages to the redemption approach because the company retains greater control. However, the devil is in the details. Under the laws of many states, a redemption offer by a closely held company must be made to all shareholders, although there is no requirement that all or any particular percentage of shareholders elect to participate. Secondly, the laws of the state where the company is organized often limit the source of funds that may be used by the company to redeem outstanding shares. Finally, Section 302 of the Internal Revenue Code can produce some surprising and unpleasant tax results if the redemption is not properly structured.

These include treating the payment received by the redeeming shareholder(s) as a dividend, subject to ordinary income rather than long term capital gain treatment, and loss of the selling shareholder's tax basis in the shares redeemed.

Sales by Existing Stockholders to a Third Party

Most often, these transactions take place in connection with an angel or other private equity financing, where most of the stock acquired is newly issued by the Company but the investor is willing to purchase a limited amount of stock from existing shareholders. They may also arise when an existing shareholder wants to buy more equity in the company but the company is not interested in issuing new shares.

In that situation, minority shareholders are often willing to sell some or all of their equity.

Since the buyer is a third party and not the company itself, many of the rules that apply to a redemption by the company, do not apply to a third party sale. However, since shares of most closely held companies are subject to transfer restrictions, a third party sale will usually require the company and sometimes other shareholders to waive the transfer restrictions.

Either of the approaches summarized above can provide liquidity to company shareholders in advance of a sale of the company or an IPO. However, both require careful planning and sound professional advice. If we can provide any additional information, please contact your regular PLDW attorney or William F. Miller.

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William F. Miller is a Partner with Pannone Lopes Devereaux & West LLC and a member of the Corporate & Business Law Team. He is a highly skilled attorney with more than 30 years of experience who focuses his practice on corporate and business law matters, including mergers and acquisitions, angel, venture capital and private equity financing, commercial contract matters, intellectual property protection and licensing, and entity and investment fund formation. Mr. Miller frequently advises early stage technology companies, manufacturers, service and distribution companies as well as investors in such companies.

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