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Focus on Private Equity

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Private Equity Firms Face Potential Liability Under Plant Closing Laws

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The federal Worker Adjustment and Retraining Notification Act (WARN) requires an employer with 100 or more employees to provide 60 days' advance notice of a "mass layoff" or "plant closing," as defined in the statute, unless an exception is applicable. Several states have comparable laws that typically are triggered at a lower threshold of employment losses. Failure to provide the 60-day notice often results in class action litigation and potential liability for the pay and benefits that the affected employees would have received if the employer had given proper notice. Private equity firms and their holding companies and advisory firms often are drawn into the litigation based on allegations that, whether as a parent entity or a lender, they are liable along with the (frequently bankrupt) portfolio company. Avoiding such litigation and exiting quickly from litigation that could not be avoided will depend on the degree to which the private equity participants proactively manage their activities in light of the criteria the courts use to assess their potential liability.

For example, in December 2013, the U.S. Court of Appeals for the Second Circuit (with jurisdiction over New York, Connecticut and Vermont) ruled in *Guippone v. BH S&B Holdings LLC* that a private equity firm or its holding company may be liable to a class of employees for the failure of its portfolio company to comply with the WARN law. Essentially, Steve & Barry's was a chain of retail apparel stores owned and operated by Steve & Barry's Industries, Inc. (S&B Industries), the assets of which were purchased by BH S&B Holdings LLC (Holdings), which was wholly owned by BHY S&B Holdco, LLC (HoldCo), a holding company, which in turn was owned by various private equity investment firms. Holdings, the operating company that employed the employees, lacked a board of directors of its own, and the officers of Holdings included representatives from the private equity firms. After Holdings' lender exercised its rights under its loan agreement and "swept" roughly $30 million from Holdings' account, the Holdco board passed a resolution authorizing Holdings to file for bankruptcy protection. It did, quickly followed by store closings and employee terminations. The trial court dismissed the private equity firms at the pleading stage, but denied HoldCo's motion to dismiss. After discovery, the trial court granted HoldCo's motion for summary judgment on the basis that there were not sufficient facts to permit a jury to conclude that HoldCo was a single employer with Holdings.

However, while the appellate court affirmed the dismissal of the private equity defendants at the pleading stage because of insufficient factual allegations, the appellate court reversed the ruling in favor of Holdco and remanded the case for a trial to determine whether HoldCo was a single employer with Holdings. On the latter issue, the court declined to apply the test for determining whether a lender or creditor is responsible for its debtors WARN violation (*i.e.*, whether the creditor was responsible for operating the business as a going concern rather than acting only to protect its security interest and preserve the business asset for liquidation or sale). Instead, the court joined a growing consensus that the proper test for whether a related or parent entity (or, as in this case, an equity investor) can be considered an employer under WARN is the "five non-exclusive factors set forth in Department of Labor regulations" (*i.e.*, 20 C.F.R. §639.3(a)(2)):

> Under existing legal rules, independent contractors and subsidiaries which are wholly or partially owned by a parent company are treated as separate employers or as a part of the parent or contracting company depending upon the degree of their independence from the parent. Some of the factors to be considered in making this determination are (i) common ownership, (ii) common directors and/or officers, (iii) *de facto* exercise of control, (iv) unity of personnel policies emanating from a common source, and (v) the dependency of operations.

No single factor controls, and all factors need not be present—the courts balance these and any other particularly relevant factors in deciding whether the nominally separate entities actually functioned as a single entity with regard to the policy of whether to terminate the employees. The presence of the first two factors (common ownership and common directors and/or officers) is not controlling. The second factor (whether the two entities have the same people occupying director, offer positions at both entities, repeatedly transfer management personnel between the entities, or have officers or directors occupying formal management positions regarding the second entity) is of minimal importance because courts generally presume that they are wearing the appropriate subsidiary hat when acting for the subsidiary.

The third factor (*de facto* control) is the most critical factor and focuses beyond the issue of whether the parent merely exercised control pursuant to the ordinary incidents of stock ownership and, instead, on whether the affiliated company or private equity firm was the decision maker responsible for the employment practice giving rise to the litigation—the plant closing or mass layoff. The fourth factor focuses on whether the parties have centralized control of labor relations, such as centralized hiring and firing, payment of wages, maintenance of personnel records, benefits, and participation in collective bargaining. Finally, the fifth factor examines whether the entities share administrative or purchasing services or interchange employees, equipment or commingled finances, beyond mere reporting by the subsidiary's officers to the parent, pursuant to a chain of command.

In *Guippone*, the appellate court sent the case back for a jury trial because the plaintiff had shown that a fact question on single-employer status existed. Holdings lacked a board, and one of HoldCo's directors admitted that he did not know the distinction between Holdings and HoldCo. HoldCo's board chose Holdings' management and negotiated its financing. The record could permit a jury to conclude that Holdings lacked the ability to make any decision independently and that the HoldCo board resolution authorizing Holdings to effectuate the reductions in force was, in fact, the direction from HoldCo to Holdings to undertake the layoffs.

This and similar cases demonstrate the importance of observing corporate formalities, establishing and filling the director and officer positions of all entities, permitting the operating company management to make the decisions regarding employment terminations and plant closings, and clearly communicating and documenting these activities.

Incentivising Management Across the Pond

By James Ross, Partner, U.S. & International Tax Practice Group, and Eleanor West, Associate, Corporate Advisory Practice Group

Large U.S.-headquartered, international private equity (PE) players have long been investors in UK and wider European assets. More recently, however, as stability and growth returns to European economies and more European PE funds are considering exit opportunities, more mid-market U.S. PE funds that typically invest domestically are considering deploying dry powder across the pond in the United Kingdom. While similar in many regards, there are a number of key differences in U.S. and UK buy-out transactions. In this article, we look at one of these areas, incentivizing UK resident management teams in a tax-efficient manner. We'll explore U.S.-style "unapproved" stock options, restricted stock, enterprise management incentive (EMI) stock options and Entrepreneurs' Relief. The proper structuring of these alternatives needs to be carefully addressed in the early stages of any transaction.

To provide context, the top income tax rate in the United Kingdom is currently 45 percent, and capital gains are taxed at a top rate of 28 percent. By point of comparison, the top income tax rate in the United States is currently 39.6 percent, and the long-term capital gains rate is 20 percent. Given the differential in rates between ordinary income and capital gains in each jurisdiction, both U.S. and UK resident management teams are keen for PE sponsors to structure incentive equity packages to achieve capital gains treatment. In the United Kingdom, however, with an overall higher tax burden and where mandatory national insurance contributions (NICs) may sometimes be chargeable on realized gains in addition to income tax, the stakes are that much higher to properly structure management incentive equity in a tax-efficient manner.

U.S.-Style Unapproved Stock Options

Oftentimes in U.S. transactions, when stock options are issued to management of PE-backed companies, the options are exercisable immediately before a sale of the company at a predetermined strike price. In the United Kingdom, "unapproved" stock options of this nature are unattractive for UK management teams because they create tremendous tax burdens for the optionholders.

In the United States (in the case of non-qualified stock options), no income tax arises on the grant of unapproved stock options, but the exercise of the option triggers an income tax charge on the fair market value of the shares at the time of exercise, less the strike price paid by management. In the United Kingdom, however, when such options are exercised in connection with a sale, the resulting shares will be regarded by the tax authority, Her Majesty's Revenue and Customs (HMRC), as readily convertible assets. As such, any gain arising on exercise will be subject to NIC payments at a rate of 2 percent for the optionholder and 13.8 percent for the issuing company. Furthermore, where unapproved stock options are granted, the issuing company may require management to pay both the employee and employer portion of the NIC amounts. Though any portion of the employer NIC amount that is actually paid by the optionholder is tax deductible, this additional cost puts management's effective tax rate in the region of 55 percent. At these rates, issuing U.S.-style stock options is clearly an unattractive form of remuneration for UK-resident management teams.

Any sophisticated adviser will warn management against accepting U.S.-style stock options, and the UK market has developed a number of more tax-efficient incentives in response, which we explore in the following paragraphs.

Restricted Stock

If structured appropriately, a much more tax favorable form of equity incentive for UK management teams is outright stock ownership. This many time takes the form of a "flowering" class of stock, which participates in proceeds from a liquidity event in circumstances in which the PE investor has achieved a target rate of return. The stock is likely restricted in nature, as it will be subject to compulsory transfer provisions that result in forfeiture or mandatory sale for less than fair market value, depending on whether, and perhaps how and when, a recipient's employment ends. Proper structuring can ensure that no charge to income tax arises as a result of the actual acquisition of the restricted stock and that gains delivered upon a liquidity event are subject to capital rather than income tax treatment.

On the front end, it is important that the stock is acquired by management at no less than its unrestricted market value. This is because a subscription for stock at less than the unrestricted market value will trigger an immediate "dry" charge to income tax arising on the difference between the subscription price and the unrestricted fair market value of the stock. A financial buyer's use of leverage in a buy-out, however, naturally supresses the value of the stock. As a result, while management may have to pay some consideration for the acquisition of its restricted stock, in many cases it may not be an unmanageable amount. A common issue to avoid is delaying the issuance of management equity until after the closing of an acquisition. As the acquisition financing is repaid and the portfolio group deleverages, the equity value of the company increases, making any subscription more expensive for management and, therefore, a less attractive and less practical incentive.

Once acquired, income tax on restricted stock will be triggered by the lifting of the shares restrictions. For example, as performance or time-vesting requirements are satisfied, there will be a deemed gain on the appreciation of the stock since its acquisition that will be subject to income tax rather than capital gains tax rates. Also, because management will have a current tax obligation but not necessarily a corresponding cash inflow (given that the shares are likely subject to restrictions on transfer and, therefore, not freely saleable by management), the tax treatment of its restricted stock also results in an additional financial burden for management. Furthermore, the issuing company will be liable for NIC payments in respect of any gain at a rate of 13.8 percent. To achieve more favorable tax treatment, a PE sponsor should require management to enter into a voluntary election to "opt out" of the restricted securities regime. The effect of the opt-out election in the United Kingdom is that income tax will be charged on any deemed benefit received by management on the issue of the stock on the day it is acquired, but gain realized on a subsequent disposal of the stock will be taxed at the capital gains rate of 28 percent and not subject to NIC payments.

EMI Stock Options

While restricted stock is clearly more employee favorable to UK-resident management teams than U.S.-style unapproved stock options, in some circumstances, granting stock options to management may still be relatively tax efficient. EMI stock options are tax-advantaged options intended to help smaller, higher-risk companies recruit and retain talent. These options have significant tax benefits for both management and the employer company. No tax arises upon the grant of an EMI option and, more importantly, no income tax charge or employee or employer NIC payments are triggered on exercise of the option. Instead, any gains made on the sale of the option shares will be subject to capital gains tax, and the employer company receives a tax deduction (equal to the difference between the fair market value of the shares at the time at which the option is exercised and the strike price of the shares).

While EMI options are very tax advantageous for both management and the employer company, the rules around whether an employer company qualifies for EMI status are relatively restrictive. In broad terms, the employer company must first be a "qualifying company," meaning that it forms part of a group which has fewer than 250 employees and gross assets of less than £30 million. There are also restrictions around the type of trade that can be carried on by a qualifying company, and EMI options cannot be granted, for example by a company involved in banking, securities trading or insurance activities. EMI options may be utilized, however, within certain other industries, including technology and manufacturing.

Additional restrictions on the issuance of EMI options relate to the aggregate sterling value that may be granted, the relative concentrations in which they may be held by employees and the identity of the issuer. A qualifying company can issue EMI options with a market value at the date of grant of up to £3 million in total, and no individual may hold unexercised EMI options with a market value of more than £250,000. Furthermore, EMI options have to be granted over shares in the parent company in a group structure, which can cause difficulty depending on the structure of the initial investment and any add-on acquisitions.

Entrepreneurs' Relief

Perhaps most attractive to UK management is structuring incentive equity to obtain Entrepreneurs' Relief. Entrepreneurs' Relief allows qualifying capital gains to be taxed at a rate of only 10 percent (up to a lifetime limit of £10 million).

There are, however, a number of conditions that must be met in order for Entrepreneurs' Relief to be available to management, the most important being that it only applies in the context of "personal trading companies." A company is considered a management member's personal trading company if such management member holds at least 5 percent of the company's ordinary share capital for a period of at least one year prior to the date of the sale of the shares. This requirement does not mean, however, that a manager need be entitled to 5 percent of the economics of ordinary share capital, but only that they own 5 percent of the voting share capital of the company. At first blush, giving management voting rights that are disproportionate to its economic rights may seem unattractive to a PE sponsor. There are ways, however, in which this control can be effectively fettered, such as implementing enhanced contractual veto rights on important matters and obtaining stricter step-in rights, in the case of management non-performance. Where shares are acquired pursuant to EMI options, however, the 5-percent requirement does not apply, and Entrepreneurs' Relief can be claimed, provided at least one year has lapsed between the grant of the option and the sale of the shares. This reinforces the benefit of using EMI options, where practicable.

Conclusion

Seasoned management teams are more sophisticated than ever before and demand ever more complex incentivization structures to combat onerous tax burdens. As the buy-out market in the United Kingdom heats up, having a good understanding of the nuances of the tax regime and keeping on top of developments in market practice are key to ensuring U.S. PE investors appear attractive in competitive processes.

McDERMOTT PRIVATE EQUITY HIGHLIGHTS

Boot Camp for Private Equity Investment Professionals

Please join us at City Winery in Chicago on May 1 for a complimentary Boot Camp, presented in partnership with the Illinois Venture Capital Association and West Monroe Partners, designed to provide private equity professionals with a thorough overview of the critical aspects of a typical buyout transaction. Participants are sure to gain practical knowledge and a deeper understanding of the fundamentals of deal-making. The event will encourage substantive interaction among private equity professionals, as well as informal networking immediately following. For more information, visit: http://www.mwe.com/PE_Boot_Camp_May2014/

McDermott Advises Union Park Capital in its First Platform Investment, Testing Machines Inc.

McDermott represented Union Park Capital, a private equity firm focused on lower middle-market industrial technology companies, in its first acquisition of Testing Machines Inc. (TMI). TMI is a global testing instrumentation manufacturer for the paper, pulp, film, foil, ink, coatings, nonwoven and corrugated industries. Union Park acquired the TMI, Lako Seal Testers, Fibro, Messmer Buchel, TMI Trading (Shanghai) Co., Ltd., and Adamel L'Homargy divisions of The TMI Group of Companies. The acquisition serves as a launching pad for Union Park's first platform, which it hopes will drive organic and inorganic growth. This platform focuses on materials and physical testing and is the first phase of a larger, deliberate strategy to build a concentrated portfolio.

Questions concerning the information contained in this newsletter may be directed to your regular McDermott Will & Emery lawyer or the editors listed below:

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