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Transfer restrictions in joint acquisition vehicles: How to overcome some lurking issues

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Tag-along rights, drag-along rights, rights of first offer (ROFOs), and rights of first refusal (ROFRs) are commonly negotiated provisions in joint acquisition arrangements.

These provisions are complex and raise a number of substantive and procedural issues that require careful and precise drafting to avoid surprises or disputes in the event of a sale. This Client Alert addresses some of these issues and offers possible ways to resolve them.

COMMON TRANSFER RESTRICTIONS IN JOINT ACQUISITION VEHICLES

Many acquisitions are made by a group of investors, often including a strategic investor and one or more private equity firms or other financial buyers. Such joint acquisitions are made using a variety of entities and structures, including partnerships, corporations, and limited liability companies.

One of the most common structures uses as the principal investment vehicle a limited partnership (LP) managed by a general partner (GP) jointly controlled by the investors in proportion to their respective equity interests.

For illustrative purposes, this Client Alert will assume a joint acquisition vehicle is structured in this manner, but the provisions, concepts, and issues discussed below are generally applicable to most other joint acquisition vehicles as well.

The LP agreement usually contains various limitations on the right of the limited partners to transfer their LP units or interests (LP units), including certain rights and obligations of a limited partner initiating a transfer (a transferring LP) and the other limited partners (non-transferring LPs).

These rights and obligations include tag-along and drag-along rights and ROFO or ROFR rights.

- A tag-along right is the right of a non-transferring LP to participate in a sale of LP units initiated by a transferring LP.
- A drag-along right is the right of a transferring LP to require non-transferring LPs to participate in a sale.
- A ROFO is the right of a non-transferring LP to pre-emptively purchase a portion of the LP units that a transferring LP proposes to transfer to a third party.
- A ROFR is the right of a non-transferring LP to purchase a portion of the LP units that a transferring LP proposes to transfer to a third party at a price and on other terms that match the price and terms that have been tentatively agreed to with that third party.

Although these provisions are well-established in corporate documentation and are a principal part of most joint acquisition vehicles, a number of important issues in the provisions are often not identified and addressed.

> Tag-along, drag-along, ROFO, and ROFR provisions are generally long, complex provisions that raise a number of substantive and procedural issues for the parties to joint acquisition arrangements.

Consequently, when a limited partner seeks to sell LP units, it can be unclear whether some or all of these provisions are implicated, and if so, the extent to which the rights apply and how they should be implemented.

TRANSFER RESTRICTIONS: SOME ISSUES AND POTENTIAL SOLUTIONS

Several of the often-overlooked issues with these provisions, and some possible ways to resolve them, are discussed below.

Indirect transfers

Transfer provisions in LP agreements, including tag-along, drag-along, ROFO, and ROFR provisions, often provide that they apply to "direct and indirect" transfers of LP units.

An indirect transfer is generally interpreted to mean a transfer of equity or ownership interests in an entity (an upstairs entity) that directly or indirectly holds a limited partner's LP units. However, most LP agreements fail to provide exactly which indirect transfers trigger application of these provisions, or the extent to which transfer restrictions apply to indirect transfers.

For example, does a transfer of any percentage of the ownership interests of an upstairs entity trigger their application, or just a transfer of a significant percentage (e.g., 30%) or a majority of those ownership interests? How far up the ownership chain does the concept of an indirect transfer reach? Do indirect transfers have potential regulatory consequences that should be addressed through the transfer restriction provisions?

These can be particularly complex and important questions for private equity and other financial buyers that often use complex acquisition structures and desire the flexibility to transfer ownership interests in upstairs entities (often they provide that such provisions are not applicable to such transfers to affiliates).

Presumably, these provisions should not be triggered by the transfer of small minority interests in upstairs entities and should not reach many levels above the entity holding the LP units, although parties may wish to consider having the provisions apply to any transfer of ownership interests in any upstairs entity that is undertaken primarily for the purpose of evading application of the provisions.

When these provisions apply to indirect transfers, the parties should also consider specifying how they should be implemented in the event of a sale.

For example, in a tag-along or drag-along transaction, should the non-transferring LP have the right (like the transferring LP) to transfer ownership interests in the entity that holds its LP units (or another upstairs entity) rather than directly transferring its LP units?

The exact manner in which these provisions are implemented in indirect transfers can have tax and other economic consequences for non-transferring LPs. The non-transferring LPs arguably should not be disadvantaged in any such transaction (particularly a drag-along transaction in which they may be participating against their will) as compared to the tax and economic treatment enjoyed by the transferring LP.

The mechanics for indirect transfers can also have tax and other economic consequences for the third-party transferee, which in turn may negatively impact the price for which the transferring LP can sell LP units.

ROFO vs. ROFR

Many LP agreements used as joint acquisition vehicles mislabel ROFOs and ROFRs, or use a hybrid of the two, and the implications of using one over the other may not be fully appreciated.

As noted above, under a ROFO, a transferring LP must first offer to the non-transferring LPs (or invite the non-transferring LPs to make an offer to purchase) any LP units it wishes to transfer to a third party. Such rights are generally allocated among the non-transferring LPs pro rata based on the number of LP units they own.

If the non-transferring LPs do not purchase all the offered LP units, the transferring LP can thereafter generally sell them to the third party at a price and on other terms no more favorable to that third party than the price and terms offered to the non-transferring LPs.

If the third party buyer offers a price that is less than that offered by the non-transferring LPs or negotiates for more favorable deal terms than were offered to the non-transferring LPs, or if a specified period of time has passed since the LP units were offered to the non-transferring LPs, the transferring LP may need to re-run the ROFO process, which could delay or disrupt the third-party sale.

Under a ROFR, the transferring LP first strikes a tentative deal (or at least receives a firm offer) from a third party and then presents the price and other terms offered by the third party to the non-transferring LPs and allows the non-transferring LPs to match such terms.

The ROFR process introduces conditionality and delays the ability of the transferring LP to close the sale to the third party, which may disincentivize third parties to spend resources to participate in a sale process.

Because of the delay and disincentives involved with a ROFR, a ROFO may be preferable from the perspective of a transferring LP who desires liquidity, particularly if the transferring LP can test the market for its LP units, has some flexibility regarding the terms it can reach with a third party, and if it needs to re-run the ROFO, can do so on an expedited basis.

Regardless of whether an LP agreement contains a ROFO or a ROFR, prior to commencing a sale process for some or all of its LP units, a transferring LP may wish to approach the non-transferring LPs to see if there are mutually agreeable terms on which they would willing to waive their ROFO or ROFR rights.

Non-cash consideration

Many tag-along, drag-along, ROFO, and ROFR provisions provide that a third party sale triggering the application of some or all of these provisions must be for cash consideration. Because these provisions are often triggered by any third-party sale, this can limit any third-party sale to all-cash transactions.

It is possible to provide that the consideration can include non-cash consideration such as marketable securities, which may provide the limited partners with flexibility that will enhance the marketability and sale price of the LP units.

However, non-cash consideration may be more valuable to the transferring LP who negotiated for this form of consideration than to non-transferring LPs, for which non-cash consideration may pose tax, regulatory, or other issues.

In a tag-along sale, this should not be problematic — if the non-transferring LP is not interested in receiving the non-cash consideration, it can elect not to participate in the sale.

In a drag-along sale in which a non-transferring LP may be forced to participate against its will, it should have the option of receiving the non-cash consideration or cash equal to the fair market value (FMV) of that consideration.

Similarly, in a ROFO or ROFR transaction in which the consideration offered by a third-party buyer (either initially in the case of a ROFR, or following an initial ROFO process) includes non-cash consideration, the non-transferring LP should be able to match the third-party buyer's offer by offering the transferring LP an amount of cash equal to the FMV of the non-cash consideration.

If non-transferring LPs have the right to elect to receive cash equal to the FMV of any non-cash consideration, the limited partners will need to agree on a mechanism to determine that FMV, which may be left up to the GP acting in good faith or a third-party valuation firm.

Tag-along cutbacks

Most tag-along provisions provide that if one or more non-transferring LPs want to participate in a sale and the third-party buyer is unwilling to buy all the LP units offered by the transferring LP and the tagging LPs, the LP units that each of the sellers can sell in the transaction will be reduced pro rata based on the percentage of the total number of LP units held by each of them.

In this case, the transferring LP will not be able to able to sell all the LP units it originally intended to sell, which may be particularly problematic if the transferring LP wanted to sell all its LP units and will now be left with a number of LP units that is insufficient to give it any governance rights (or at least the governance rights it wishes to have).

This problem can be addressed by permitting the transferring LP to terminate the sale transaction in these circumstances.

Timing issues

Most ROFO and ROFR provisions require the sale to the third-party buyer to be consummated with a specified time period after the non-transferring LPs notify the transferring LP that they will not exercise their ROFO or ROFR rights, or it is determined that all the conditions for exercise of those rights (e.g., that the non-transferring LPs must agree to purchase *all* the offered LP units) are not satisfied.

Similarly, some tag-along provisions provide that the decision of non-transferring LPs to participate in a sale can be revoked if the sale is not consummated with a specified time period.

However, sometimes these provisions provide for a set period of time (e.g., 90 or 120 days), which may not be long enough to obtain all required regulatory approvals for the third party sale. Accordingly, this time period should provide for extension to allow for receipt of all required regulatory approvals.

KEY TAKEAWAYS

Tag-along, drag-along, ROFO, and ROFR provisions are generally long, complex provisions that raise a number of substantive and procedural issues for the parties to joint acquisition arrangements.

While many of these issues are obvious and are effectively addressed in the provisions, some issues, including those discussed above, are often not identified or fully appreciated until it is too late.

In negotiating and drafting these provisions, parties and practitioners should think carefully about the specific rights and obligations they entail, and how they will be implemented in a real-world context.

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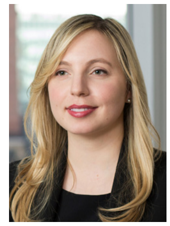

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