PARKER | SMITH | FEEK

Oldco/Newco and the Transfer of Company Ownership

Issue Date: October 10, 2010

Transferring the ownership of an existing company can be a daunting process. In the most common scenario, employees without ownership interest seek to purchase a firm but lack sufficient capital to buy it outright. The current credit markets can make the process of obtaining a purchase loan difficult or even impossible. In addition, the purchase value of the company may be too high, based on projected future cash flow, when goodwill and other intangibles are considered. However, there are significant benefits to transferring ownership rather than establishing a new company. When facing RFP-based job procurement and surety bonding requirements, which would bar under-capitalized and inexperienced firms from entry into the construction industry, the new ownership benefits from the company's established track record, balance sheet and project resume.

Oldco/Newco is a method of transferring an existing company to a single party or a management group which bypasses the difficulties of an outright purchase or new business startup. Under this method, the existing business (Oldco) remains under the original owner's ownership and control. A new company (Newco) is formed by the individual or group that will manage future operations. Oldco executes a legal agreement to lease the Firm's office space, facilities, and even employees to Newco. This arrangement allows Newco to launch its operations with very little capital and, if Newco fails, Oldco and its assets are not at risk. However, if Newco succeeds, it will have the opportunity to purchase Oldco's equipment, facilities, and other assets including goodwill. The purchase will be based on real cash flow, not a bank loan, and while Newco is earning this capital it will benefit from Oldco's resume, bonding capacity, and experienced staff.

The Oldco/Newco process has five essential steps:

1. **Create a new entity:** The new entity may be an LLC, S corporation or a C corporation.
2. **Restructure the existing entity:** The existing business (Oldco) should be restructured, if necessary, as a pass through entity. If the owner of Oldco is not actively employed, cash flow to that owner in the form of compensation or equity distributions creates unnecessary FICA taxation. Restructuring the company as a pass through [pass-through entity] will bypass FICA taxation. FICA may not be an issue if the exiting owner of Oldco is retained as an employee.
3. **Establish a lease agreement:** The lease agreement under Oldco/Newco can be structured many different ways. Newco may lease existing equipment, employees and/or facilitie from Oldco. Both parties will have the ability to negotiate terms such as rates, duration of leases, and purchase options upon expiration.
4. **Create a management agreement:** The management agreement establishes an ongoing connection with the original ownership and the valuable experience they bring to the firm. It also determines the ongoing involvement of Oldco's exiting owner, including any oversight and control they will have over Newco. The agreement should outline financial arrangements, including both the transfer of cash from Newco to Oldco and eventual distributions of installment sale proceeds. (The cashflow generated by Newco's business operations and can be compared to a traditional transfer to insiders. Management fees in this context are for services rendered and subject to ordinary income tax; nevertheless, they can be advantageous because they provide ongoing income to the exiting owner and are not based on the transfer of tangible assets.) Alternative ways to distribute

continued >

income from Newco to the owner of Oldco might include indemnification agreements and/or licensing agreements.

5. **Continue business operations:** Newco will have the ability to contract with Oldco customers for new work, allowing an immediate transition of the company to new management. Newco will also have the ability to Joint Venture with Oldco and utilize Oldco's resume for RFP-type proposals, which allows for a more gradual transition. Workers compensation issues are analyzed and, depending on the conclusion, existing employees may be leased to Newco to increase continuity. Overall, this arrangement can satisfy an incoming management team's desire for immediate control and an original owner's desire for immediate exit while also providing needed support and continuity for ongoing operations.

The Oldco/Newco business transfer method is designed to give the original owners and the new management of a firm the best of all possible worlds by preserving assets, reducing costs, and limiting liability. It retains key management team members within an existing company by offering a path to ownership interest when they might otherwise form a new, competitive start-up. Oldco and its owner receive a longer and less risky stream of compensation than they would for the straight sale of equipment and hard assets, but the new management team is not required to pay a premium for any goodwill and intangibles. Whether or not traditional finance and purchase agreements are viable, Oldco/Newco offers a flexible and straightforward alternative that benefits both parties.

While the Oldco/Newco business transfer has obvious benefits from a surety perspective, it is a complex business transaction requiring the participation of key strategic parties, including attorneys, CPAs, bankers, and a well-versed surety representative. Commercial insurance programs may also be impacted by the ownership transfer. If you are considering an Oldco/Newco business transfer, contact your Parker, Smith & Feek representative for assistance in initiating the process with all strategic parties.