Leveraged recapitalization transactions have long been a preferred structure for private equity/LBO investors, by permitting acquisitions of controlling interests in companies without creating goodwill on the books of the target. Even with the advent of the FASB’s favorable new rules eliminating the amortization of goodwill, we expect the leveraged recap structure to remain favored. However, the SEC recently announced positions that restrict the circumstances under which leveraged recap treatment will be available.

The SEC’s push-down accounting (recap) rules permit a financial buyer to acquire up to 94.9% of a target’s voting stock without stepping up the basis of the target’s assets for book purposes. The SEC’s new guidance focuses on two requirements for this treatment. First, the target company must be an existing entity which is not formed or altered to facilitate the transaction (reincorporation can result in violation of this test). Second, the minority investors in the transaction (i.e., those holding the 5.1% or greater interest), including those who “roll-over” their interest, must be truly separate from the investor group that acquires the controlling interest. If not, they will be deemed to be part of the “collaborative” acquiring group, rendering recap accounting unavailable because more than 94.9% will have been acquired.

The SEC’s new guidance will have its greatest impact on the second of these two requirements because it limits the rights which can be granted to minority investors. Some of these rights, such as guaranteed board seats, represent significant deal points, and their prohibition may make leveraged recap transactions substantially less appealing to minority investors. The SEC’s guidance outlines factors to be considered in determining whether a minority investor is “substantive” and “independent” from the new controlling investor or collaborative group. These include:

- Having capital and operations separate from its investment in the target and being independent from and unaffiliated with all other investors;
- Having a stake in the target which is not contingent or conditional upon the investment of others; and
- Not having material relationships with any other party to the transaction.
The SEC's guidance also makes clear that the minority investor must have all of the risks and rewards of stock ownership. In that regard, the minority investor must:

- Invest at fair value;
- Use funds from its own resources not guaranteed by other investors;
- Be at risk only for its own investment in the target, and not guarantee or provide funds for another; and
- Share fully in the risk of investment (no cap on upside or downside).

Further, the minority investor:

- May not solicit other deal participants to invest in the target;
- Must be free to vote its shares in all matters;
- Must not have rights disproportionate to its ownership (i.e., a guaranteed board seat or consent rights over corporate actions); and
- Must not have restrictions on the ability to sell its shares, except as provided by law and restrictions that are customary in closely held companies.

The practical application of the SEC's guidance is as yet unclear. However, it is probable that customary protections sought by roll-over investors in private equity transactions may be used by the SEC to defeat recap accounting treatment, particularly in transactions in which management holds the retained interest. Accordingly, negotiation of recap transactions may become more difficult, and protections that private equity investors customarily expect may become problematic. We recommend early review of term sheets in transactions for which recap accounting will be sought in order to assess compliance with the SEC's new guidance.

If you would like to discuss further the SEC’s new guidance with respect to leveraged recap accounting, please call:

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