LAW360

Portfolio Media. Inc. | 860 Broadway, 6th Floor | New York, NY 10003 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Different Prices For S Corp. Shares: A Cause For Worry?

Law360, New York (October 05, 2011, 3:14 PM ET) -- Occasionally when a company is sold, shareholders will receive different prices for their shares. Two common examples:

- *Hold-outs:* Certain shareholders want to sell; others are quite happy with their dividend checks. To entice hold-outs to sell, buyers pay more for their shares.
- *Escrow*: A sale is agreed to, but a selling shareholder won't agree to the escrow. Maybe the shareholder is far removed from operations and doesn't want to be on the hook for a breach, or maybe the shareholder has institutional restrictions on delayed payments — e.g., some employee stock ownership plans or an investment fund that is winding down. To get the deal done, the shareholder doesn't have to participate in the escrow, and the other shareholders pick up the extra risk.

If the seller is an S corporation, both the seller and the buyer should consider whether differing prices could be regarded as a disproportionate distribution that would give rise to a second class of stock, thus invalidating S corporation status. If that were to occur, the S corporation would be subject to corporate-level tax. While a bad result, it is a manageable one.

However, if a disproportionate distribution is made in connection with a sale in which a Section 338(h)(10) election is made, the result could be a disaster. The S corporation would not be eligible for the election, and the buyer would not get a stepped-up basis in the S corporation's assets.

Second Class of Stock

S corporations may only have one class of stock. This means all of the corporation's stock must be entitled to the same distribution and liquidation rights.

The Internal Revenue Service regulations are generally favorable and allow some latitude for disproportionate distributions, though they do not clearly or explicitly bless every situation. Stock will be entitled to the same distribution and liquidation rights if the charter, articles, state law, and "other binding agreements relating to distribution and liquidating proceeds" provide equal rights.

Based on the IRS regulations, at first glance, a seller and a buyer should be able to conclude that differing consideration won't be a problem, as long as the articles and certificate provide that if the company were liquidating, the payments would be made to the shareholders pro rata.

Section 338(h)(10) Election

It may not be that simple, though, if a stock purchase agreement is considered an "other binding agreement" and provides for shareholders to receive differing consideration. If a buyer and seller agree to make a Section 338(h)(10) election, the company is deemed to sell its assets and then immediately liquidate.

The amounts actually paid to the selling shareholders are, for tax purposes, deemed paid by the company on liquidation. The IRS regulations helpfully conclude that if shareholders receive different consideration when a Section 338(h)(10) election is made, this won't cause the company to have more than a single class of stock "provided that the varying amounts [received by shareholders] are determined in arm's length negotiations with the purchaser."

The Real World

Often a buyer will actively negotiate for the holdout shares; and certainly buyers try to get as much escrow protection as possible. Yet on occasion a buyer will be satisfied to set a purchase price and then let the selling shareholders work out distribution details. Shareholders who are close to the company and motivated to sell might be willing to let other shareholders out of the escrow, in order to get the deal done. It is also not unheard of for selling shareholders to offer to make after-sale payments as an incentive to the holdouts.

If payments are negotiated with the seller, the seller and the buyer should be able to rely on the IRS regulations rule and conclude that the varying amounts were determined at arm's length with the buyer. If, however, the buyer doesn't know about, or actively participate in, the negotiations, there may be risk that the selling shareholders have entered into an "other binding agreement" that creates a second class of stock.

What To Do

Sellers and buyers who fit into the IRS regulations (because they negotiated the varying prices) do not have to worry about this issue too much. If, however, a deal does not fit into the IRS regulations, both the seller and the buyer at the least should consider whether a second class of stock could exist. Recent case law on the second class of stock issue as it relates to warrants should also spur buyers and sellers to think about this issue.

How concerned to be about this issue, and the likely outcome, depends on a number of factors, including the magnitude of the difference in payments, the details of the negotiations and whether other informal or formal agreements exist that would alter distributions.

For example, the parties should consider if, and to what extent, the buyer is, or should be, involved in negotiations with individual shareholders. While an exhibit to a purchase agreement that clearly spells out different amounts paid to different shareholders, or a purchase agreement that limits participants in an escrow, should be seen to evince at least the buyer's approval of the arrangement, the parties should consider whether this really means there was arm's length negotiation. This is not just a seller issue. If the Section 338(h)(10) election is invalid, the buyer won't receive a stepped-up basis in the assets.

If involving the buyer in the negotiations isn't practical, some support may be drawn from analogous sections of the IRS regulations dealing with second class of stock but addressing share repurchase agreements. While those regulations are beyond the scope of this discussion, they do address situations where differing consideration can be acceptable. Also informal IRS rulings before the IRS regulations are favorable, though again when the buyer is involved.

In PLR 9821006, for example, the IRS concluded that there was not a second class of stock in a sale, even though some shareholders received additional amounts at closing and weren't subject to the escrow in exchange for forfeiture of an earn-out. This ruling was based in part, however, on the conclusion that every shareholder would receive about the same value — whether or not a shareholder received the escrow or earn-out. Sellers and buyers should consider whether this ruling would apply if the amounts differed materially.

--By Lisa R. Pugh, Faegre & Benson LLP

Lisa Pugh is a partner in the Minneapolis office of Faegre & Benson.

The opinions expressed are those of the author and do not necessarily reflect the views of the firm, its clients, or Portfolio Media, publisher of Law360. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

All Content © 2003-2011, Portfolio Media, Inc.