Barnes

Securities Compliance in M&A

A deal lawyer's playbook: securities issues, rollover structures and seller wealth protection

Dallas Bar Association Securities Section · February 2026 · Jason T. Barnes

KEY QUESTION

Is any form of consideration a security?

Rollover equity, seller notes and earnouts are routinely treated as non-securities. Economic substance controls, not the label the parties chose.

01 The regulatory framework in M&A

Federal securities laws

The 1933 Act governs offers and sales of securities, even in private deals. The 1934 Act adds antifraud, reporting and broker rules.

State blue sky laws

State registration and exemption requirements overlay federal exemptions. Often overlooked under deal-timeline pressure.

Exemptions and safe harbors

Section 4(a)(2) and Rule 506(b) or (c) are the workhorses. Section 3(a)(9) exchanges have strict conditions.

02 Characterizing the seller's consideration

INSTRUMENT	THE TEST	WHAT TO DO AT ISSUANCE
Rollover equity	*Howey*: investment of money in a common enterprise with an expectation of profits from others' efforts. LLC and LP interests almost always qualify.	Identify and document the exemption when issued. A securities memo or opinion should accompany any rollover, whatever the deal size.
Seller notes	*Reves*: every note is presumed a security unless it resembles a recognized non-security, judged on purpose, distribution, expectations and other regulation.	Run the analysis; do not treat the note purely as a loan instrument.
Earnouts	Contingent consideration tied to future performance can be a security depending on structure.	Analyze for exemption compliance at issuance, not after a dispute arises.

03 Disclosure and antifraud

- **Rule 10b-5** reaches material misstatements and omissions in any securities transaction, registered or not.
- **The disclosure record** includes management presentations, CIMs, data room materials and seller representations.
- **Projections** need cautionary language; separate business judgment from factual representation.
- Securities counsel should review investor-facing materials before they go out.

04 Deal-level issues to spot early

- **Broker status:** advisers paid transaction-based compensation may need registration. The 2023 M&A broker exemption (§15(b)(13)) is narrow and fact-specific.
- **Accredited investor status:** Rule 506(c) requires verification; under 506(b), do not rely on stale questionnaires at closing.
- **Mischaracterized instruments** undermine the exemption analysis and can surface years after closing.

05 Structuring the rollover: three lenses at once

Equity or debt

Drives tax, securities and bankruptcy treatment. Thin capitalization, high stated interest and no amortization suggest equity. Hybrids need both analyses.

Tax

Section 721 (partnerships) or 351 (corporations) deferral; conditions must be met at closing. Section 707 disguised sale rules; boot is taxable when received.

Governance

Observer versus board seat. Approval rights over new debt, acquisitions and changes in the business. Budget and key-person provisions for continuing sellers.

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Seller rights and post-closing exposure

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06 The under-negotiated rights checklist

RIGHT	WHY IT MATTERS	BASELINE ASK
Information	Without it, a minority holder cannot independently assess the value or condition of the investment.	Audited annual financials, quarterly management accounts, notice of material transactions
Anti-dilution and preemptive	Absent express terms, later financings and incentive plan issuances can dilute rollover holders substantially. Full-ratchet and weighted-average protection differ enormously.	Preemptive rights to maintain percentage; defined anti-dilution mechanics
Tag-along and drag-along	Tag protects the minority in a sale; drag protects the majority. Both must be negotiated, not assumed.	Same price and terms on any sponsor exit
Put rights	The strongest seller protection for an illiquid position.	Defined pricing formula (EBITDA multiple or book value) and timing
Exit timeline	Rollover equity is illiquid by definition.	Understand the expected exit path before accepting rollover consideration

07 Earnouts: economics, tax and securities

- **Expect less than the maximum.** SRS Acquiom: earnouts in 24% of 2025 private-target deals outside life sciences; some payout in about 59% of earnout deals; about 21% of aggregate maximum earnout value paid.
- **EBITDA earnouts** are exposed to post-closing accounting elections, overhead allocation and intercompany charges.
- **Negotiate before signing:** earnout-specific accounting covenants, change-of-control acceleration, binding dispute resolution.
- **Tax:** capital gain versus ordinary income characterization; installment treatment under §453 defers gain but needs upfront structuring.

08 Insurance coverage gaps

- **R&W insurance** generally excludes known breaches, scheduled matters, purchase price adjustments and forward-looking statements. It often does not cover securities claims based on pre-closing disclosure.
- **D&O tail** must be negotiated before closing; six years is common and often cut to save cost.
- **Indemnification** in governing documents should survive for a defined period and be funded.
- **Key-person coverage** on continuing sellers is routinely left unaddressed.

09 After closing

- **The regulatory tail:** securities claims carry limitation periods of one to five years depending on the claim; some run from discovery.
- **Representations** given by former owners can create personal exposure if they prove false, even without fraudulent intent.
- **Public buyer stock:** affiliates face Rule 144 volume limits and holding periods; lock-ups restrict selling and hedging.

Three questions every seller should answer at closing

1. What exactly do I hold?
2. When can I sell or transfer it?
3. Who is responsible for telling me when something changes?

Keep securities counsel, a tax advisor and a wealth manager engaged at closing, with a post-closing compliance calendar prepared in advance.

Analyze every instrument.
The title of the document does not control the legal analysis.

Rollover equity and seller debt are under-negotiated.
Sellers leave rights on the table, and buyers can be exposed when those rights are not harmonized.

Closing is not the end.
Post-closing exposure needs a coordinated advisory team organized before closing.

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