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Securities Compliance *in Mergers & Acquisitions*

Navigating Securities Issues, Rollover Structures, and Seller Wealth Protection

PROGRAM OVERVIEW

Program Roadmap

01

Securities Compliance: The Broad Landscape

Core regulatory framework, disclosure obligations, and deal-level exposure

~15 min

02

Rollover Equity & Seller Debt

Securities characterization, negotiation gaps, and protective rights

~20 min

03

Seller Wealth & Post-Closing Exposure

Insurance coverage gaps, earnout structures, and personal liability tail risk

~15 min

SECTION 01

Securities Compliance: The Broad Landscape

What every M&A professional needs to recognize: the foundational regulatory framework; where exposure arises; and how to spot the issues before they become problems.

1.1 The Regulatory Framework in M&A

1

Federal Securities Laws

- Securities Act of 1933 governs offers and sales of securities, even in private deals
- Exchange Act of 1934 imposes reporting, anti-fraud, and proxy rules on parties to a transaction
- Key question in every deal: Is any form of consideration a 'security' under federal law?

2

State Blue Sky Laws

- State-level registration and exemption requirements overlay, and sometimes conflict with, federal rules
- Exemptions vary widely: what works in Delaware may not work in California or Texas
- Often overlooked under deal-timeline pressure; can create post-closing rescission rights for holders

3

Exemptions & Safe Harbors

- Section 4(a)(2) private placement and Rule 506(b)/(c) Reg D exemptions are the workhorses of M&A securities compliance
- Accredited investor standards have real teeth, and erroneously verifying or qualifying an investor **voids the exemption** and creates liability
- Section 3(a)(9) exchange exemptions apply to rollover and restructuring scenarios, conditions are strict

1.2 Disclosure Obligations & Anti-Fraud Exposure

1

Material Information Standards

- Rule 10b-5 prohibits material misstatements and omissions in connection with any securities transaction
- “Materiality” is fact-specific but broadly construed: if it would matter to a reasonable investor, it is material
- Seller representations in reps & warranties carry independent securities law significance, they are part of the disclosure record

2

Private Deal Disclosure Traps

- No registration requirement does not mean no disclosure obligation, anti-fraud rules apply to all transactions
- Financial projections and forward-looking statements create special risk without adequate cautionary language
- Management presentations, CIMs, and data room materials are all part of the disclosure record that can be scrutinized later

3

Practical Risk Management

- Maintain a clean, organized document trail, informal communications and emails can become evidence in subsequent litigation
- Distinguish between business judgment statements and factual representations, the difference matters legally
- Ensure securities counsel reviews all investor-facing materials before they are distributed or presented

1.3 Most Common Securities Issues at the Deal Level

1

Mischaracterized Instruments

- Seller notes, earnouts, and rollover interests are routinely mischaracterized as non-securities instruments
- Economic substance controls over form, courts look at the totality of the arrangement, not the label parties applied
- Mischaracterization voids available exemptions and creates rescission rights for holders, often surfacing years after closing

2

Broker-Dealer Registration

- Advisors receiving transaction-based compensation may trigger federal broker-dealer registration requirements
- The M&A broker exemption (enacted 2023) is narrow, eligibility requires careful, fact-specific analysis
- Unregistered finders accepting success fees in securities transactions face significant regulatory and civil exposure

3

Accredited Investor Verification

- Rule 506(c) requires affirmative verification by the issuer, mere investor self-representation is not sufficient
- Rule 506(b) permits self-certification, but the sophisticated investor standard is not automatically met
- The most common shortcut: relying on stale questionnaires without re-verifying investor status at the time of closing

SECTION 02

Rollover Equity & Seller Debt

The most under-negotiated securities in M&A. How rollover instruments are characterized under federal law, why they are so frequently mistreated, and what rights sellers should insist on before signing.

Liability Protections vs. Seller Economics in M&A

Navigating the Balance of Risk and Reward with Rollover Equity or Seller Notes



Liability Protections

Risk Mitigation

- Reps & Warranties
- Indemnification
- Escrows & Holdbacks



Buyer Protection

Limiting Risk Exposure

Seller Payout

Maximizing Returns





Seller Economics

True Seller Value

- Rollover Equity
- Seller Notes
- Earn-Outs

Key Considerations



Alignment of Interests



Risk vs. Reward Balance



Exit Value & Deal Structure

2.1 Securities Characterization of Rollover Interests

1

When Rollover Equity Is a Security

- Investment of money in a common enterprise with expectation of profits from others' efforts, the Howey test applies to rollover equity just as it does to any other investment
- LLC and LP interests almost always qualify as securities; the fact that it is a "rollover" does not change the legal analysis
- Failing to recognize this means no exemption is identified or documented at issuance, a critical and often irreversible compliance gap

2

Seller Notes as Securities

- Seller-held promissory notes may be securities depending on purpose, trading characteristics, and risk profile of the instrument
- The Reves "family resemblance" test: notes are presumed securities unless they resemble a known non-security category such as a consumer loan
- Parties routinely treat seller notes purely as loan instruments without any securities law analysis, creating significant exposure for both sides

3

Exemption Documentation

- Even when an exemption clearly applies, it must be affirmatively identified, analyzed, and documented at the time of issuance
- Section 3(a)(9) exchange exemption for reclassifications, conditions are strict and highly fact-specific; reliance requires counsel analysis
- A securities law memo or counsel opinion should accompany any rollover issuance regardless of deal size or sophistication of the parties

2.2 The Under-Negotiated Rights Problem

1

Information Rights

- Sellers rolling equity frequently receive no contractual right to periodic financial information about the company they now hold as a minority investor
- Without information rights, a minority holder has no way to independently assess the value or condition of their ongoing investment
- Minimum baseline to insist on: audited annual financials, quarterly management accounts, and notice of material transactions

2

Anti-Dilution & Preemptive Rights

- Absent express contractual provisions, rollover holders can be diluted to near-zero through subsequent financing rounds or incentive plan issuances
- Full-ratchet vs. weighted-average anti-dilution protection, the economic difference is enormous for a seller holding a meaningful minority stake
- Preemptive rights give holders the right to maintain their percentage ownership, and are routinely omitted from rollover term sheets and LLC agreements

3

Transfer & Liquidity Provisions

- Rollover equity is illiquid by definition, sellers must understand the exit mechanism and timeline before accepting rollover consideration
- Tag-along rights protect minority holders in a sale; drag-along provisions protect the majority, both must be negotiated explicitly, not assumed
- Put rights with defined pricing formulas (EBITDA multiple, book value) provide the strongest seller protection and should be a minimum ask in any rollover negotiation

2.3 Structuring Rollover Instruments Correctly

1

Equity vs. Debt: The Real Analysis

- The equity/debt characterization drives tax treatment, securities law analysis, and bankruptcy priority, it cannot be left to label alone
- Courts and the IRS look beyond the instrument's name: thin capitalization, high stated interest rates, and absence of amortization schedules all suggest equity recharacterization
- Hybrid instruments (preferred equity, convertible notes, PIK instruments) require analysis under both frameworks simultaneously

2

Tax Treatment of Rollover

- Section 721 non-recognition for contributions to partnerships; Section 351 for corporations, the conditions must be met precisely at closing
- Disguised sale rules under Section 707 can recharacterize what appears to be a tax-free rollover as a fully taxable sale, a frequent and costly surprise
- Boot received alongside rollover consideration triggers immediate gain recognition, even sophisticated sellers are regularly caught off guard by this rule

3

Governance Rights in Practice

- Board observer vs. board seat, the difference between access to information and the ability to exercise real influence over the business
- Approval rights for major decisions: incurring additional debt, making acquisitions, or changing the nature of the business should be negotiated as protective provisions
- Budget approval rights and key-man provisions protect sellers who remain operationally involved and whose continued involvement was a condition of the deal

SECTION 03

Seller Wealth & Post-Closing Exposure

The ecosystem that transaction counsel does not build for you. Insurance coverage gaps, earnout economics, and the regulatory tail risk that sellers rarely see coming until it is too late to act.

3.1 Insurance Coverage Gaps in M&A Transactions

1

R&W Insurance: What It Doesn't Cover

- Representations & warranty insurance does not cover known breaches, fraud by the insured, purchase price adjustments, or forward-looking statements
- Sellers commonly believe R&W insurance protects them from securities law claims arising from their pre-closing disclosures, it typically does not
- Most policies explicitly exclude known liabilities, forward-looking representations, and regulatory matters flagged in the disclosure schedules

2

D&O and Tail Coverage

- Post-closing D&O coverage for selling company officers and directors requires explicit tail policy negotiation before closing, it does not happen automatically
- Standard D&O policies lapse at closing; a 6-year tail is the market standard but is frequently omitted or shortened in cost-cutting negotiations
- Securities claims against former officers based on pre-closing conduct can surface years after closing, when tail coverage has expired or was never obtained

3

Filling the Gaps

- Sellers should conduct a thorough insurance audit before closing: what continues, what lapses at closing, and what requires specific tail riders to extend
- Key-person life and disability coverage on rollover participants, whose continued involvement is often central to the deal rationale, is routinely left unaddressed
- Indemnification provisions in corporate governing documents should expressly survive the merger for a defined period and be backed by available funding

3.2 Earnout Structures: Economics, Tax & Securities Implications

1

Earnouts as Securities

- Contingent consideration tied to future performance metrics can constitute a security subject to federal registration and anti-fraud requirements
- Sellers holding earnout rights in publicly traded acquirers must comply with Rule 144 volume and holding period limitations and insider trading restrictions
- Even in private deals, earnout instruments should be analyzed for Reg D exemption compliance at the time of issuance, not after a dispute arises

2

The Valuation Gap Problem

- Sellers routinely overvalue earnouts at signing, empirical data consistently shows that fewer than 50% of earnouts result in full payment to the seller
- EBITDA-based earnouts are particularly susceptible to post-closing manipulation through accounting elections, overhead allocation, and intercompany charges
- Sellers must negotiate earnout-specific accounting covenants, change-of-control acceleration provisions, and a binding dispute resolution mechanism before signing

3

Tax Treatment of Earnout Payments

- Earnout payments are typically characterized as ordinary income or capital gain depending on the nature of the underlying asset sold, the distinction has enormous economic consequences
- Installment sale treatment under Section 453 defers gain recognition but imposes interest charges and requires careful upfront structuring to preserve
- Earnout recipients may receive a Form 1099 years after closing with no advisor in place to contextualize the tax obligation or explore mitigation strategies

3.3 Post-Closing Compliance & Personal Liability Exposure

1

The Regulatory Tail

- Securities law claims carry statutes of limitation of one to five years depending on the specific claim; some discovery-based periods extend the window significantly longer
- Former owners who provided deal representations face ongoing personal exposure if those representations later prove false, even without fraudulent intent
- Sellers frequently dissolve their legal and advisory relationships at closing, leaving themselves unrepresented if claims or regulatory inquiries arise afterward

2

Lock-Up and Affiliate Restrictions

- Sellers receiving registered securities in a public company transaction become affiliates subject to Rule 144 volume limitations and mandatory holding periods
- Lock-up agreements negotiated at signing restrict the ability to sell or hedge, but sellers routinely lack clarity on when restrictions expire and what procedures must be followed
- Violation of lock-up restrictions or affiliate trading rules creates both securities law liability and potential indemnification exposure under the transaction agreements

3

Building the Post-Closing Ecosystem

- Sellers need a coordinated advisory team, securities counsel, wealth manager, and tax advisor, aligned and engaged at the time of closing, not weeks or months later
- A post-closing compliance calendar should be prepared before closing, covering lock-up expiration dates, Form 4 reporting obligations, and Rule 144 trading windows
- Three questions every seller should be able to answer at closing: What exactly do I hold? When can I sell or transfer it? Who is responsible for telling me when something changes?

KEY TAKEAWAYS

Three Things to Take Away

1. Every instrument in an M&A deal must be analyzed for securities law characterization. The title of the document chosen by the parties does not control the legal analysis.

2. Rollover equity and seller debt are routinely under-documented and under-negotiated; sellers leave meaningful rights and protections on the table in nearly every transaction. If you do not harmonize these rights the sellers are harmed, and buyers can be exposed.

3. The closing table is not the end of a seller's securities law obligations; post-closing exposure requires a coordinated advisory ecosystem, organized before closing, and maintained for the full duration of all post-closing obligations.

Questions & Discussion

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