ACQUISITION STRATEGIES

Why Buyers Form a New Company to Make the Acquisition

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An entrepreneur who already owns two businesses agrees to buy a third. Her lawyer's first suggestion isn't about price or diligence. It's to form a new company to be the buyer. The seller's lawyer, meanwhile, has a question of his own: if the buyer is a company that didn't exist last week, what stands behind its promises?

Buying through a newly formed entity is standard practice, for good reasons. But the structure affects liability, financing, taxes, and what the seller can actually collect if something goes wrong after closing.

Why Buyers Use a New Entity

Liability containment. The acquired business comes with its own risks, some of which the buyer won't know about until after closing. Holding it in a separate entity keeps those liabilities away from the buyer's other businesses and personal assets. That protection holds only if the entity is treated as a real company: adequately capitalized, with its own accounts and records. California courts can disregard an entity used as an owner's alter ego.

Lender requirements. Acquisition lenders usually want a clean borrower whose only business is the one they're financing. They typically take a security interest in its assets and a pledge of its ownership interests. For SBA loans, owners of 20% or more generally must also sign personal guarantees, so the entity limits risk but doesn't eliminate it.

Investors and rollover equity. A new entity gives the buyer a place to bring in co-investors, issue different classes of equity, and receive any equity the seller rolls over, all under one operating or shareholder agreement written for the deal.

Future acquisitions. A holding company can own several operating subsidiaries, add more over time, and later sell one without disturbing the others.

How the Structure Fits the Deal

In an asset purchase, the new entity buys the assets and becomes the operating company. In a stock or membership-interest purchase, the new entity buys the target's equity, and the target becomes its subsidiary. Either way, the new entity needs its own bank accounts, tax registrations, insurance, and often its own licenses and permits, since many don't transfer automatically.

Choosing the Entity Type

The choice between an LLC and a corporation has tax consequences that should be settled before formation. LLCs offer pass-through taxation and flexibility. A C corporation may be required for certain investors or for the federal qualified small business stock exclusion. S corporations come with ownership limits that can rule them out for deals with entity or foreign investors. In California, each LLC and corporation also owes at least the $800 annual minimum franchise tax.

The Seller’s Side of the Same Structure

A newly formed buyer may have no assets other than the business it just bought. That matters when the seller is owed money after closing through a seller note, an earnout, or indemnification payments. Sellers in that position should ask for some combination of the following:

A guarantee from the buyer’s parent company or principal owners.

Security for any seller note, even if it must be subordinated to the senior lender.

Escrows or holdbacks funded at closing rather than promises of future payment.

Covenants limiting distributions to the buyer’s owners while payments to the seller are still outstanding.

Final Thoughts

Forming a new company to make an acquisition is good practice for buyers, but it only works when the entity is properly set up, funded, and maintained. For sellers, the same structure is a reminder to look past the buyer’s name on the signature page and ask what assets actually stand behind it.

About the Author

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