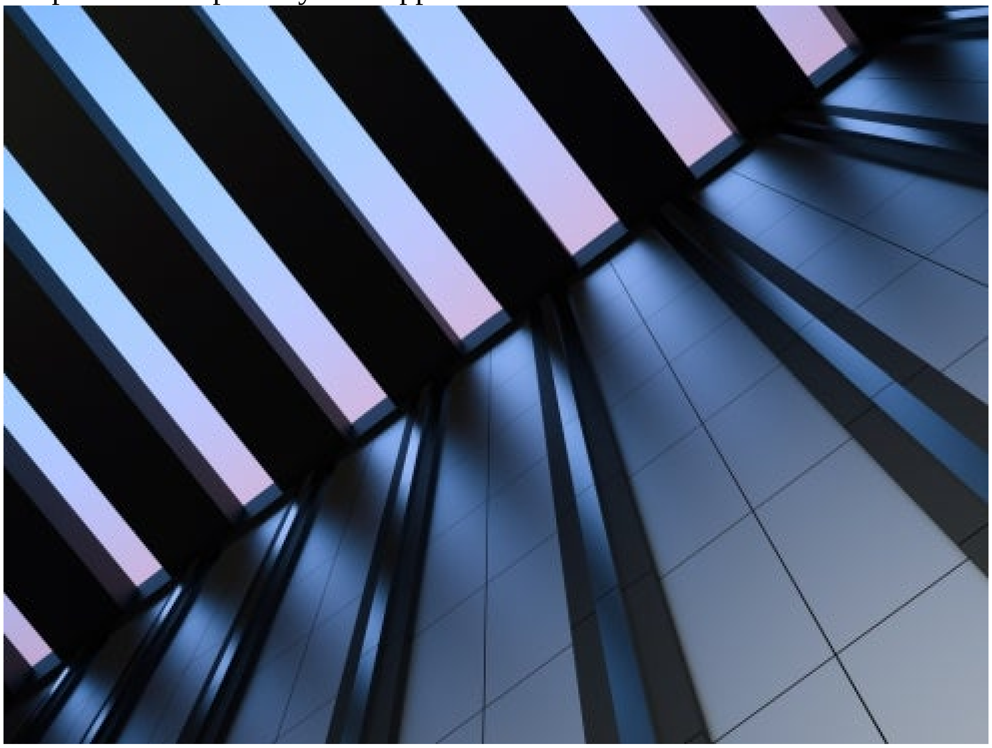
Updates
December 29, 2023
Corporate Transparency Act Applied to M&A



The Corporate Transparency Act (CTA), designed to combat the use of shell companies for illicit purposes and increase ownership transparency in corporate structures, takes effect on January 1, 2024.

As discussed in more detail in The Corporate Transparency Act: What To Know and Expect Starting January 1, 2024, the CTA will require an estimated 30 million entities not specifically exempted under the CTA—known as Reporting Companies[1] —to identify and report to the U.S. Department of the Treasury Financial Crimes Enforcement Network (FinCEN) detailed information on themselves, their Company Applicants, and the owners, officers, and control persons that constitute their Beneficial Owners. Prospective buyers and target companies should carefully consider how these new CTA regulations may apply to the complicated corporate structures commonly used in mergers and acquisition (M&A) transactions. In addition, in the M&A context, these regulations will mandate new processes for forming acquisition vehicles, additional filing requirements upon the consummation of a transaction, additional considerations in due diligence, and changes to employment and operating agreements. This Update addresses how these CTA regulations will apply to corporate structures commonly used in the M&A context and impact the M&A process.

Application to Acquisition Structures

Q: Is an entity a Reporting Company under the CTA?

The CTA defines "Reporting Company" to include any U.S. entity and any foreign entity registered to do business in the United States that is not specifically included in one of 23 exemptions. While exempt entities are not considered Reporting Companies or required to file under the CTA, note that an exemption that applies to one entity in a corporate structure may not apply to other entities in that structure so every entity must be evaluated separately. The following exemptions are particularly relevant to entities and structures commonly found in the M&A context:

- The **Large Operating Company Exemption** applies to entities that have more than 20 U.S.-based full-time employees, an operating presence in the United States, and more than $5 million in gross receipts or sales in the prior year as evidenced by the entity's federal income tax return.
- The **Pooled Investment Vehicle (PIV) Exemption** applies to entities that (1) qualify as a "pooled investment vehicle"—either an investment company, as defined in section 3(a) of the Investment Company Act of 1940 (15 U.S.C. 80a– 3(a)) or an entity that would be an investment company but relies on Section 3(c)(1) or (7) of that act, and is identified on the Form ADV by an exempt registered investment adviser (RIA) (or will be in the next annual update) and (2) are operated or advised by a RIA, venture capital fund adviser, broker or dealer, credit union, or bank.
- The **Public Company Exemption** applies to entities that are "issuer[s] of a class of securities registered under section 12 of the Securities Exchange Act of 1934" or "[r]equired to file supplementary and periodic information under section 15(d)" of that act. Functionally, this exemption covers entities that are colloquially referred to as U.S. public companies.
- The **Subsidiary Exemption** applies to subsidiary entities that are "controlled or wholly owned, directly or indirectly" by one or more parent entities that are themselves exempt under any exemption other than the following: (1) pooled investment vehicles (discussed above), (2) money services businesses/money transmitters, (3) inactive entities, and (4) entities assisting tax-exempt entities.

For more detailed discussion of these and other exemptions, see The Corporate Transparency Act: What To Know and Expect Starting January 1, 2024. To illustrate challenges in applying these common exemptions, consider the following examples:

Example 1: Is a special purpose vehicle (SPV) formed to acquire a target company exempt?

Because an SPV has no operations or employees, SPVs will most often need to rely on the Subsidiary Exemption and depend on its parent entity's exemption status. However, as noted above, subsidiaries of a parent entity exempt under the PIV Exemption are not eligible for the Subsidiary Exemption. So, a newly formed SPV that is wholly owned and controlled by a financial buyer—for example, a private equity fund entity that is exempt under the PIV Exemption—will likely be a Reporting Company unless the entity can claim the subsidiary exemption on another basis (e.g., where ownership interest in the SPV is controlled by an exempt RIA). On the other hand, a newly formed SPV that is wholly owned and controlled by a strategic buyer—for example, a public company or a company exempt under the Large Operating Company Exemption—may be exempt.

Example 2: Is a holding company exempt?

A holding company that sits a level above the operating company and does not have independent operations will likely not be exempt. First, a holding company that is a subsidiary of a fund entity will fail to qualify for the Subsidiary Exemption for the same reasons detailed above with respect to SPVs. Second, since holding companies commonly do not have any employees or standalone operations, it will likely fail to qualify for the Large Operating Company Exemption, regardless of whether it files consolidated tax returns with its operating company group. Third, it will not be able to rely on any exemptions applicable to the operating company by virtue of the Subsidiary Exemption as the Subsidiary Exemption is strictly applied only to entities downstream in an ownership chain from an exempt entity (not parent or sister companies).

Example 3: Is an operating company a Reporting Company?

While the Large Operating Company Exemption will be commonly applied to operating companies, a careful analysis must be conducted to confirm qualification. A company that appears to qualify at first glance may fall short for one of the following common reasons: (1) the company's employees are spread across several affiliated entities and the exemption does not allow companies to consolidate employee headcount across affiliated entities to meet the 20 full-time U.S.-based employee threshold requirement; (2) the company is in its first year of operations and does not have filed tax returns from the previous year to evidence the gross receipts requirement; or (3) the company is a disregarded entity for tax purposes and, as such, does not appear to be the tax filer within the definition adopted under the CTA, notwithstanding the fact that its revenue is reported on tax returns filed by the parent holding company. For more detailed discussion of the Large Operating Company Exemption, see Think Public and Large Companies Are Entirely Exempt From the Corporate Transparency Act? Think Again.

Example 4: Is a joint venture held by two or more large operating companies a Reporting Company?

The Subsidiary Exemption allows for a subsidiary entity to be controlled or wholly owned, directly or indirectly, by one or more exempt parent entities. So, even though a joint venture is not wholly owned by a single entity, if its parent entities are otherwise exempt under a qualifying exemption (for example, the Large Operating Company Exemption), it may be able to benefit from the Subsidiary Exemption.

Q: Who are the Beneficial Owners of a Reporting Company under the CTA?

Unlike other Know Your Customer requirements that companies may have grown accustomed to in the M&A context, beneficial ownership under the CTA encompasses more than those individuals that, directly or indirectly, hold equity interests in an entity. Under the CTA, a Beneficial Owner includes any and all individuals who, directly or indirectly, either (1) own or control at least 25% of the ownership interests of a Reporting Company or (2) exercise "substantial control" over a Reporting Company. An individual exercises "substantial control" of a Reporting Company if they (1) serve as a "senior officer," (2) have authority over the appointment or removal of any senior officer or a majority of the board of directors, (3) direct or have substantial influence over important decisions, or (4) have any other form of substantial control over such Reporting Company. Given the ambiguity of this concept, this will be a highly fact-based analysis. Companies should consider the following common scenarios in the M&A context:

Example 1: Is a member of the board of directors considered a Beneficial Owner?

The size of the board will be a critical factor in answering this question. If the Reporting Company is managed by a small board of directors, FinCEN will be more likely to conclude that each director is a Beneficial Owner. For larger boards, a factual analysis will need to be done to determine whether each director exercises substantial control over the Reporting Company. Factors to consider as part of this analysis include the roles and duties of any committees of the board, whether the director is an independent director, and whether a director taken alone or with a subset of other directors (such as, the sponsor appointed directors) controls a majority of the voting power or holds any special consent or veto rights.

Example 2: Is an officer of a Reporting Company considered a Beneficial Owner?

FinCEN has explicitly included the president, CEO, CFO, COO, general counsel/chief legal officer, or "any other person, regardless of title, who performs similar functions" to be a Beneficial Owner. Officers who only perform ministerial functions, like a secretary or treasurer, or officers of a subsidiary may not necessarily have the requisite control to be considered a Beneficial Owner.

Example 3: Are the limited partners of a sponsor fund entity that holds a majority position in a Reporting Company considered Beneficial Owners?

The sponsor fund entity in this example would be a Beneficial Owner as it meets the 25% ownership threshold. The CTA explicitly provides that if a Beneficial Owner is an exempt entity, the name of such Beneficial Owner must be reported, but the Beneficial Owners of such exempt entity do not need to be reported. So, if the sponsor fund entity itself is exempt (for example, under the PIV Exemption), then the limited partners of such fund (regardless of whether they meet the beneficial ownership threshold) will likely not need to be reported. However, if the sponsor fund entity is not exempt, then any limited partner who meets the Beneficial Owner threshold (25% or substantial control) would likely need to be reported.

Example 4: Is a third-party lender to a Reporting Company considered a Beneficial Owner?

A creditor is specifically exempt if its beneficial ownership is based solely on "rights or interests for the payment of a predetermined sum of money." An interest must be presently capable of being realized to matter for purposes of beneficial ownership, so most types of collateral held by creditors would likely not be considered as beneficial ownership. However, if a creditor's rights include convertible equity or a level of control in decision-making, such creditor may become a Beneficial Owner.

Q: Who are the "Company Applicants" of a Reporting Company under the CTA?

In addition to reporting Beneficial Owners, a Reporting Company will need to report its Company Applicant(s) (at least one but maximum two)—(1) the individual who directly and physically files the document that creates the domestic entity or registers a foreign entity, and (2) the individual who is primarily responsible for directing or controlling such filings. With respect to any entities newly formed in connection with an M&A transaction (for example, an acquisition vehicle, merger subsidiary, holding company, or blocker entity), the Company Applicants will often be (1) the third-party corporate service provider who files the document and (2) a member of the legal deal team who directs such filing. It is worth noting that while Reporting Companies formed on or after January 1, 2024, will need to provide the information or FinCEN identifier for their Company Applicants in the initial report, the Company Applicant information will not need to be updated or referenced in subsequent filings for any Reporting Company.

Impact on the M&A Process and Documents

Q: What CTA filings are required in connection with an acquisition?

Given the breadth and strict filing deadlines of the CTA, thoughtful consideration should be given to the applicability of the CTA and timing of any required CTA filings in every M&A transaction.

With respect to an entity formed in connection with an M&A transaction (for example, an acquisition vehicle, merger subsidiary, holding company, or blocker entity) that is a Reporting Company, an initial CTA report will need to be filed within 30 days of formation (or 90 days for entities formed in 2024). However, if such Reporting Company subsequently is dissolved, ceases to exist, or becomes exempt and remains so when the filing obligation arises at the end of the applicable 30- or 90-day period, then no initial filing should be required as the information reported in a CTA filing must be true as of the filing date and there is no contemplated mechanism for reporting historical information. By way of example, this caveat would be especially relevant for a newly formed merger subsidiary that is the nonsurviving party in a merger effective before such merger subsidiary's filing deadline. Absent additional guidance from FinCEN to the contrary, if such nonsurviving merger subsidiary ceases to exist as a result of such merger under the applicable state's merger statute, such merger subsidiary would have no initial filing obligation.

In addition to these initial CTA reports, an updated CTA report needs to be filed within 30 days (or 90 days in 2024) of any of the following: (1) changes to a Reporting Company's reported information (such as a change to the Reporting Company's legal name), (2) changes to a Reporting Company's Beneficial Owners or the information reported by such Beneficial Owners, (3) a Reporting Company that has previously filed an initial report qualifies for an exemption, and (4) a Non-Reporting Company no longer qualifies for an exemption. Thus, a CTA report will need to be filed within 30 days (or 90 days in 2024) after the consummation of many M&A transactions, including any transaction in which the target company is a Reporting Company.

When CTA reports are required to be filed in connection with a transaction, the deal teams should consider whether interim period and post-closing covenants are appropriate to include in the definitive acquisition agreement. Examples include covenants requiring the Reporting Company to make a CTA filing within the applicable period or update seller beneficiary ownership information or requiring the parties to cooperate with one another in connection with CTA filings.

Q: What is a buyer's potential liability for CTA-related violations of a target company?

Generally, violations of the CTA reporting obligations can be met with penalties of $500 for each day a violation is outstanding, up to a maximum of $10,000, and criminal penalties of up to two years imprisonment. Any person (including entities) involved in the filing process can be held liable if they willfully, or with willful blindness, provide or attempt to provide false or fraudulent information to FinCEN in a CTA report, or if they fail to report complete or updated information to FinCEN. As with other types of regulatory liability, if a target company has liabilities for CTA-related violations, these liabilities will likely transfer to a buyer as its successor-in-interest. Consequently, a buyer's due diligence in an M&A transaction should include CTA-related diligence appropriately tailored to the target. Specifically, purchasers should request (1) copies of CTA filings or receipts thereof, as available, (2) any communications with FinCEN or other governmental agencies related to the CTA, and (3) information on corporate structure, ownership, and governance sufficient for the buyer to make an independent assessment of whether the target qualifies as a Reporting Entity under the CTA, and if so, its Beneficial Owners. Relatedly, buyers should ensure the definitive acquisition agreement includes representations by the target that (1) the beneficial ownership information provided during the due diligence phase is complete and accurate and addresses beneficial ownership under the CTA, and (2) the target (and any subsidiaries or affiliated entities) is in compliance with the CTA. For target companies that exhibit red flags during due diligence, a buyer may consider conducting an independent assessment of beneficial ownership and/or adding special indemnification provisions in the definitive acquisition agreement. Adequate indemnification for any liabilities may be critical in the event representation and warranty insurance providers mark compliance with CTA as a heightened area of diligence and exclude or limit coverage of certain CTA-related issues. For a detailed discussion on CTA liability and the exposure of senior officers and directors, see Corporate Transparency Act Will Require Disclosure of Senior Officers and Directors of Many US and Foreign Companies .

Q: What other transaction documents may be impacted?

The CTA requires individuals to provide specified information to a Reporting Company, or risk being held liable for "causing a violation" of the CTA. In addition to the foregoing due diligence considerations and changes to definitive acquisition agreements, parties in an M&A transaction would be wise to consider CTA-related updates to other transaction documents (such as rollover agreements, employment agreements, and operating agreements) to require directors, officers, and significant shareholders to provide beneficial ownership information, so that Reporting Companies can collect, track, compile, and update such information more efficiently.

In sum, the CTA presents a new regulatory landscape that will require a close look at corporate structuring and have meaningful implications in M&A transactions. Many ambiguities remain as to how the CTA will apply to the scenarios described above, necessitating an entity-by-entity, fact-driven analysis in most cases. Perkins Coie continues to closely monitor additional developments in the CTA implementation process, and our lawyers are available to discuss these and any related issues as they arise.

Endnote
[1] It is worth noting that no CTA filing will be required after the winding down or dissolution of a Reporting Company or if there is a change in the basis for Beneficial Ownership (such as a change in officer title or percentage ownership) as long as the status as Beneficial Owner remains the same.

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