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Balancing Minority Equityholder Rights and Acquirer's Ability to Consolidate Under **U.S. Accounting Rules**

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The consolidated financial statements for the results of operations and financial position of a group of companies are required to be presented as if all of the companies were a single company in accordance with FASB's Accounting Standards Codification (ASC) 810-10-10-1.

There is a presumption that consolidated financial statements are more meaningful than separate financial statements and that they are usually necessary for a fair presentation when one of the entities in the consolidated group directly or indirectly has a controlling financial interest in the other entities. In general, a parent company is required to consolidate the financial information of another company if it has a "controlling financial interest" in the other company.

When a company acquires at least 50 percent but less than 100 percent of the equity interests of a private target company (a Minority Interest Acquisition), it can be difficult to ascertain whether the acquirer has obtained a controlling financial interest for purposes of the financial accounting rules. Minority equityholders will typically retain very limited control over the target company in a Minority Interest Acquisition and often negotiate certain rights over significant actions of the company to protect their interests. Such rights and protections may include the right to receive certain information about the target company or review books and records of the target company, preemptive rights, the ability to require the target company or the other equityholders to purchase their equity at a certain time or under certain circumstances (i.e., a "put right") or "tag along" rights, or the right to designate a member of the target company's board of directors (or managers) or have board observer rights. Minority equityholders often insist on

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having certain consent rights or require unanimous board approval (if minority equityholders have a board seat) before the target's management (which is typically controlled by the acquirer) can make certain decisions or take certain actions that could have an adverse impact on the minority equityholders. These rights include the company's ability to (1) change the target's business or enter into a new line of business; (2) dissolve or liquidate the target; (3) amend or terminate any organizational or governing document; (4) sell the target or issue any equity interests of the target; (5) acquire or dispose of assets or equity interests outside the ordinary course of business; (6) incur certain indebtedness or encumber assets; (7) make certain distributions or redemptions; (8) enter into, terminate or amend material contracts; (9) approve or materially change the budget; (10) enter into any affiliate transaction; or (11) hire or fire certain employees or substantially change their compensation.

If an acquirer in a Minority Interest Acquisition desires to consolidate for financial accounting purposes, tension can arise between the acquirer obtaining an adequate controlling financial interest in the target for financial statement accounting purposes and minority equityholders retaining adequate rights and protections—especially where an earnout or other contingent consideration is involved and/or the minority equityholders' remaining equity interests will be sold to the acquirer pursuant to puts and calls in subsequent years.

In this article we will first explain the financial statement consolidation rules generally in connection with Minority Interest Acquisitions and propose potential solutions to balance minority equityholders rights and protections and an acquirer's ability to consolidate under the financial statement consolidation rules.

Financial Accounting Consolidation Rules Applicable to Minority Interest Acquisitions. ASC 810 provides two financial accounting consolidation models under U.S. GAAP—the variable interest model and the voting interest model. The starting point in considering whether an entity is eligible for consolidation is to determine whether such entity is a variable interest entity (VIE). If it is determined that the entity is not a VIE or a scope exception from the VIE model applies (e.g., the subsidiary entity is a non-profit, employee benefit plan, governmental entity, or investment company), you then analyze the relationship of the entities under the voting interest model. The special rules under ASC 810 applicable to limited partnerships and the rules under the International Financial Reporting Standards (IFRS) are beyond the scope of this article.

> Minority equityholders will typically retain **very limited control over the target company** in a Minority Interest Acquisition and often negotiate certain rights over significant actions of the company to protect their interests.

Variable Interest Model. Under the VIE model, the reporting entity must have a variable interest in a legal entity. A variable interest is generally an economic relationship with a legal entity that absorbs risk or is entitled to the rewards of the entity. A legal entity is generally any legal structure used to conduct activities or to hold assets.

If a reporting entity has a variable interest in a legal entity, then it must determine whether the legal entity is a VIE. If any one of the following 3 criteria is satisfied, the company is a VIE.

(1) The entity lacks sufficient equity at risk, e.g., the company is not sufficiently capitalized or highly leveraged.

(2) The equity investors at risk as a group lack the characteristics of a "controlling financial interest", i.e.:

• The power to direct the most significant activities of the legal entity.

• The obligation to absorb the expected losses of the legal entity.

• The right to receive the expected residual returns of the legal entity.

(3) The legal entity is structured with disproportionate voting rights, and substantially all of the activities involve or are conducted on behalf of an investor with disproportionately few voting rights.

If the legal entity is a VIE, you next determine whether the reporting entity has a "controlling financial interest" in the legal entity, and thus, is the VIE's primary beneficiary. A reporting entity will be deemed to have a "controlling financial interest" in a VIE if it has both the power to direct the activities of the VIE that most significantly impact the VIE's economic performance (the "power criterion") and the obligation to absorb losses or the right to receive residual returns of the VIE that could potentially be significant to the VIE.

Part of the power criterion analysis is determining the party that makes the significant decisions or controls the activity or activities that most significantly affect the VIE's economic performance, including whether there is another party that has to consent to important decisions or that can force the reporting entity to take certain actions. Protective rights, e.g., approval or veto rights that do not affect the activities that most significantly impact the entity's economic performance, are permissible. In contrast, a single reporting entity that has the unilateral ability to exercise substantive rights to block or participate in *all* of the activities that most significantly affect the VIE's economic performance, would preclude a reporting entity's ability to consolidate for financial reporting purposes.

Voting Interest Model. If an entity being considered for consolidation is not a VIE, you then move to the voting interest model to determine whether control exists. Under the voting interest model, a reporting entity is presumed to control another entity if it owns, directly or indirectly, more than 50 percent of the outstanding voting shares of the entity. However, that presumption may be overcome if a noncontrolling equityholder has substantive participating rights in decisions that allow it to effectively participate in certain significant financial and operating decisions that are in the ordinary course of business.

> The parties may wish to engage an accountant with **detailed knowledge of these rules** to determine the extent of the rights and protections that are available to minority equityholders while still preserving an acquirer's ability to consolidate the target.

Some rights of a noncontrolling equityholder are considered merely protective rights or not significant and do not overcome the presumption of consolidation by the majority owner. In contrast, substantive participating rights give noncontrolling equityholders the ability to participate in key recurring business decisions of the company may overcome the presumption of consolidation by the majority owner. ASC 810-10-25-13 and ASC 810-10-55-1 provide factors and examples to help reporting entities determine whether noncontrolling rights represent protective rights or substantive participating rights, including:

- Amendments to articles of incorporation or partnership agreements of the investee (protective)
- Pricing of transactions between the owner of a majority voting interest through voting interests and the investee and related self-dealing transactions (protective)
- Liquidation of the investee or a decision to cause the investee to enter bankruptcy or other receivership (protective)
- Acquisitions and dispositions of assets that are not expected to be undertaken in the ordinary course of business (protective)
- Issuance or repurchase of equity interests (protective)
- Incur additional indebtedness to finance an acquisition that is outside the ordinary course of business (protective);
- Location of the investee's headquarters (non-substantive participating)
- Name of the investee (non-substantive participating)
- Selection of auditors (non-substantive participating)
- Selection of accounting principles for purposes of separate reporting of the investee's operations (non-substantive participating)
- Acquisitions and dispositions of assets that are expected to be undertaken in the ordinary course of business (may be substantive participating rights)
- Right to agree, approve or veto annual financial budget of the company (substantive participating)

• Right to agree and approve selection, appointment, compensation of the CEO of the company (substantive participating)

• If reasonably possible or probable that the investee will need to incur the level of borrowings that requires noncontrolling equityholder approval in its ordinary course of business (substantive participating)

• Rights relating to dividends or other distributions may be protective or participating and should be assessed in light of the available facts and circumstances, e.g., rights to block customary or expected dividends or other distributions (may be substantive participating) and rights to block extraordinary distributions (protective)

• Rights relating to an investee's specific action in an existing business may be protective or participating depending on facts and circumstances, e.g., if investee had the ability to purchase, rather than lease, the property without requiring approval of the noncontrolling equityholder, then the right to block the investee from entering into a lease would not be substantive

• Provisions that govern what will occur if the noncontrolling equityholder blocks the action of an owner of a majority voting interest need to be considered to determine whether the right of the noncontrolling equityholder to block the action has substance, e.g., if blocking approval of an operating budget, simply defaults to last year's budget adjusted for inflation, and if the investee is a mature business for which year-to-year operating budgets would not be expected to vary significantly, then the rights are not substantive

• Rights relating to the initiation or resolution of a lawsuit may be considered protective or participating depending on facts and circumstances, e.g., if lawsuits are a part of the entity's ordinary course of business, then the rights may be considered substantive participating.

Potential Solutions to Provide Adequate Rights and Protections for Minority Equityholders in Minority Interest Acquisitions. From an acquirer's perspective, a minority equityholder's substantive participation rights under the applicable financial consolidation accounting model in connection with a Minority Interest Acquisition could preclude the acquirer from consolidating the target. From the minority equityholders' perspective, the financial accounting consolidation rules can operate to severely limit their continuing rights and protections regarding Minority Interest Acquisitions.

To mitigate such limitations and to protect minority equityholder interests, at a minimum you can provide that minority equityholders have all of the rights deemed to be protective rights under the consolidation rules. You can also provide minority equityholders with review and comment and/or meaningful consultation rights in lieu of consent rights with respect to the items that constitute or are reasonably likely to constitute participating rights or substantive participating rights under the applicable facts and circumstances. If the majority equityholder, board or manager takes or causes the company to take or fail to take specified actions regarding operations or business decisions that could adversely impact a minority equityholder's interest the minority equityholder may require the majority equityholder to purchase the minority equityholders' interests at a premium or if the minority equityholder is also an employee of the entity, an employment agreement can allow the minority equityholder to terminate the employment relationship for good reason and require the acquirer to pay substantial severance.

Balancing these rights can be difficult and the consolidation analysis turns on the facts and circumstances of the entities and the business as a whole. The parties may wish to engage an accountant with detailed knowledge of these rules to determine the extent of the rights and protections that are available to minority equityholders while still preserving an acquirer's ability to consolidate the target.