Getting the Deal Done

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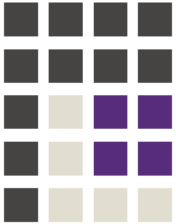
Learning Objectives

- Learn about different M&A transaction structures
- Understand acquisition agreement terms and architecture of acquisition agreements

Transaction Structures

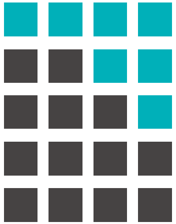
Transaction Structures

Asset Purchase



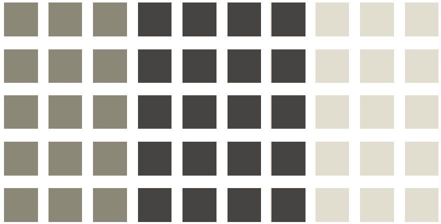
Acquiror buys assets from the company

Equity Purchase



Acquiror buys equity directly from equityholders

Mergers



Acquiror buys a business by combining multiple entities

Transaction Structures

Asset Purchase

Purpose:

Acquiror buys a "business" or part of a business

Requires:

Equityholder approval may be required if sale constitutes "all or substantially all" assets

Often requires various transition agreements

Risk:

Acquiror often uses to leave liabilities behind

Potential for successor liability

May need to negotiate new contracts with employees and/or other counterparties

Good for:

When the buyer wants to "cherry pick" certain target assets

Acquisition of assets may not require numerous consents from third parties

Transaction Structures

Equity Purchase

Purpose:

Acquiror buys equity of company directly from equityholders

Requires:

Every equityholder must participate in order to end up with 100% ownership (equityholder agreement can facilitate such participation)

No separate statutory approvals needed from target equityholders

Risk:

Buyer typically subject to economic exposure of the liabilities of target to a greater extent than with an asset deal

Good for:

Target companies holding assets that would require multiple consents to transfer

Private companies with limited equityholders

Transaction Structures

Mergers

Purpose:

Combines two companies into a single entity

- Direct Merger
- Reverse Triangular Merger
- “Double Dummy” Horizontal Merger

Requires:

Board and shareholder consent if target corporation involved (different approval regime is possible for alternative entities, (*e.g.* LLCs or LPs))

Risk:

Surviving entity pools liabilities of merged companies

Good for:

Companies with broad or diffuse equityholder base

Often used in auction contexts

Transaction Timeline (Seller-Initiated Sale)

M&A Process: Typical Stages

Phase 1 – Initial Contact by Seller

- Review information memorandum (auction)
- Sign confidentiality agreement

Phase 2 – Indicative Bids

- Provide indication of interest to seller
- Begin initial due diligence
- Assess financing alternatives and transaction structure
- Tax structuring assessed

Phase 3 – Buyer Due Diligence

- Attend management presentation
- Verify valuation assumptions
- Review data room and conduct due diligence
- Review definitive agreement

Phase 4 – Binding Bids

- Submit bid letter/ determine final bid terms
- Submit comments to definitive agreement
- Seller assesses bids
- Obtain preliminary Board approvals

Phase 5 – Negotiate Contracts

- Sign exclusivity agreement (if not signed previously)
- Negotiate definitive agreement and ancillary agreements
- Obtain final Board approval
- **Sign definitive agreement**

Phase 6 – Executory Period & Closing

- Satisfy conditions precedent (regulatory approvals, etc.)
- Obtain financing
- Prepare estimated closing statement
- **Close transaction**

Phase 7 – Post-Closing

- Prepare final closing statement
- Post-closing filings and notices

Acquisition Agreements

Acquisition Agreements

- Purchase Price and Structure
- Working Capital Adjustments
- Earn Outs
- Representations and Warranties
- Covenants
- Closing Conditions
- Termination Provisions/Fees
- Risk Allocation

Purchase Price and Structure

Form of Consideration

- **Cash**
- **Stock**
  - Fixed/floating/collar (ratio based)
  - Rollover Equity
  - Fixed allocation/election (typically in public company deals)
- **Other**
  - Seller Note
  - Contingent Payments

Certain Adjustments

- Deducts for debt, transaction expenses, bonus payments, partial-period expenses, etc.
- Increases for certain capex and for (unrestricted) cash
- Dissenters' rights

Working Capital Adjustments

What:

Post-closing price adjustment

Element of an acquisition agreement most likely to give rise to post-closing disputes

Purpose:

Resolve differences between working capital needed to maintain operations and sale price

- Generally takes into account current assets and current liabilities
- Identifying specific line items from the balance sheet is critical
- Usually based on "normalized working capital" (can be based
on amount: normalized, zero, etc.); choice affects bid price

Key Issues:

GAAP vs. historical practices

- Sellers may favor historical practices to compare "apples to apples"
- Buyers may favor GAAP to protect against errors in previous accounting

Estimate at closing with post-closing true-up

Earn Outs

What:

Additional consideration based on post-closing events and/or performance

- Can be based on financial metrics (*e.g.*, EBITDA)
- Other possible metrics:
  - Top line
  - Bottom line
  - Specific target metrics
  - Milestones (*e.g.*, winning long-term government contract)

Why:

- Device for bridging a valuation gap
- Uncertainty about company's future prospects
- Transaction financed with future earnings
- Seller will continue to manage the property

Other Considerations:

- Complex negotiation of operating covenants imposed on buyer often arise in context of earn outs
- Potential for dispute is relatively high

Representations and Warranties

What:

- A statement of fact with respect to identified subject matters

Purposes:

- Provides purchaser a potential walk right
- Basis for post-closing indemnity
- Due diligence

Types:

- Fundamental
  - Organization
  - Authorization
  - No conflicts
  - No brokers
  - Affiliate transactions
- Statutory
  - Tax
  - Employee benefits
  - Environmental
- Others

Key Issue:

- Qualifications
  - Materiality
  - Knowledge
  - Time and quantitative thresholds
  - GAAP

Representations and Warranties

Materiality Qualifiers

"Seller is and has been in compliance with all applicable Laws **in all material respects**."

"Since the Balance Sheet Date, there has not been any **Material Adverse Effect**."

Key Terms: "**Material Adverse Effect (or Change)**"

Seller will often negotiate carveouts to the MAE definition, such as adverse changes arising from changes in law or to the economy.

Buyer will often counter by trying to eliminate some carveouts and adding a disproportionality standard to others.

Even when very detailed, it can be difficult to ascertain what constitutes a MAE, but we know it's a higher standard than "materiality."

Factors taken into consideration include durational significance, adverse economic consequences compared to target's value, and sheer magnitude of economic derogation of target

Representations and Warranties

Knowledge Qualifiers

"No litigation is pending or, **to seller's Knowledge**, threatened against the Acquired Company."

Generally two knowledge standards:

- "Actual" knowledge
- "Constructive" knowledge

Ascertain the correct knowledge group

- Typically includes target company's c-suite and other key employees (*e.g.*, key sales person or key IT person)

Standards can be bifurcated (*e.g.*, with "actual" knowledge of one group & "constructive" knowledge of another group)

Representations and Warranties

Disclosure Schedules

Disclosure schedules are generally **exceptions** to the representations.

If seller knows of any reason why the representations won't be true, then seller should disclose those exceptions on a schedule.

"**Except as set forth on Schedule Y**, no Hazardous Materials exist at any property or facility owned or operated by the Acquired Company."

Representations and Warranties

Compare

Which representation is easier for a seller to make? Which would buyer want seller to make?

"Except as set forth on Schedule X, to the seller's knowledge, all of the Acquired Company's material receivables are good and collectible receivables."

"All of the Acquired Company's receivables are good and collectible receivables."

Covenants

Interim Operating Covenants:

- Assure the buyer that the acquired business will not change significantly between signing and closing
- Make clear list of prohibited activities and thresholds, such as:
  - Acquisitions and divestitures
  - Capital expenditures outside of budget
  - Dividends
  - Mergers
  - Affiliate transactions
  - Change of accounting policies

Other Pre-Closing Covenants:

- Operate in ordinary course of business between signing and closing
- Access to information/facilities
- Financing (agreement to obtain financing under debt commitments, cooperation of the target)
- Competition filings (*e.g.*, HSR Act filings)
- Promise that parties take actions required for closing

Covenants

Post-Closing Covenants:

- Can be (and typically are) imposed on both buyer and seller
- Assure buyer that restrictions will be imposed on sellers to prevent actions that degrade value of target business on a post-closing basis
- Assure seller that buyer will not act in a manner that, had seller known of such action, may have caused seller not to do the deal with buyer

Examples:

- Confidentiality
- Noncompete
- Nonsolicit
- Treatment of target employees
- Cooperation in ongoing litigation
- Restrictions on operating target business during an earnout period

Closing Conditions

Purpose:

- Identify what must be done for transaction to close
- Seller's fear:
  Optioning its business
- Buyer's fear:
  Being locked into a bad deal

Examples:

- Bring down of representations & warranties
  - "Each of seller's representations and warranties must have been true and correct **[in all material respects]** as of the date of this Agreement, and must be true and correct **[in all material respects]** as of the Closing Date as if made on the Closing Date, without giving effect to any supplements to the Schedules."
- Receipt of regulatory approvals/termination of waiting periods/third-party consents
- Equityholder approval
- No legal restrictions
- Material performance of covenants
- Receipt of debt financing
- No material adverse effects
- Appraisal rights maximum
- Satisfactory results of diligence (exceptionally rare)

Closing Deliverables

Purpose:

- Cement the contractual architecture of the deal when consideration is paid
- Important to finalize material closing deliverables before signing acquisition agreement; otherwise, a party may have leverage between signing and closing to change the terms of the deal

Examples:

- ✓ Shareholder, LLC, & LP Agreements
- ✓ Registration Rights Agreement
- ✓ R&W Insurance Policy
- ✓ Release Agreements
- ✓ Transition Services Agreement
- ✓ Employment Agreement(s)
- ✓ Management Equity Documents
- ✓ Required Consents
- ✓ Escrow Agreement
- ✓ Payoff Letters; Lien Releases
- ✓ Stock Certificates (other certificated interests) with executed stock powers
- ✓ Officer/Director Resignations
- ✓ Operating Agreement (in midstream transactions)
- ✓ Officers' Certificate

Termination Provisions/Fees

Purpose:

- Provide mechanisms by which the buyer and the seller can extricate from a deal
- Important considerations include:
  - Potential impediments to closing within given timeframes
  - Cost-shifting in the event of deal failure
  - Termination fees

Issues:

- Mutual consent
- Failure of a closing condition that cannot be cured (*e.g.*, reps and warranties not being true and correct at closing or failure of a party to comply with pre-closing covenants)
- Drop dead date
- Financing failure
- Regulatory prohibition (*e.g.*, HSR, CFIUS)

Risk Allocation: Indemnities

Why:

- Indemnification provisions generally provide a “box” around liability and prescribe a process for assertion of claims

What:

- Complex of contractual provisions defining:
  - Time periods during which claims may be brought
  - Damages recoverable
  - Limitations on damages
- Some aspects of indemnification can be pro-buyer and some can be pro-seller

Issues:

- “Exclusive Remedy”
  - Extra-contractual claims: fraud and negligent misrepresentation
- Sandbagging/anti-sandbagging
- Mitigation covenant
- “Double-dip” prohibition (and interaction with working capital adjustment)
- Materiality scrape
- Line-item indemnities
- Definition and calculation of damages

Risk Allocation: Indemnities

Survival	Deductible/ Threshold	Caps
• Representations and Warranties • Covenants	• Tipping Basket vs. True Deductible • Size of Basket/Threshold • De Minimis Carve-out (Mini-Basket)	• Size • Applicability

Risk Allocation: Escrows

What:

- Portion of the purchase price held back until a later date

Purposes:

- Credit support to satisfy:
  - Post-closing obligations
  - Working capital and indemnity
  - Potential liabilities (litigation, environmental)

Key Issues:

- Nature of seller matters (shell vs. operating company)
- Size
- Timing of release

Risk Allocation: R&W Insurance

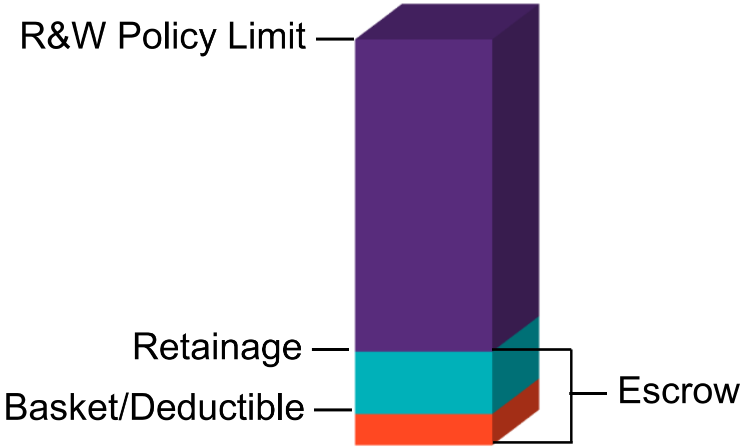
Purposes:

- Limit or eliminate seller's liability while also providing buyer coverage
- Distinguish buyer's bid in an auction
- Shorten negotiations over agreement (or does it?)

Other Considerations:

- For carve-outs, consider timing of quality of earnings (or standalone financials)
- Party bearing cost of policy
- Exclusions
- Impact of buyer's knowledge

Sample Risk Assumption:



Questions?

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Thank You!