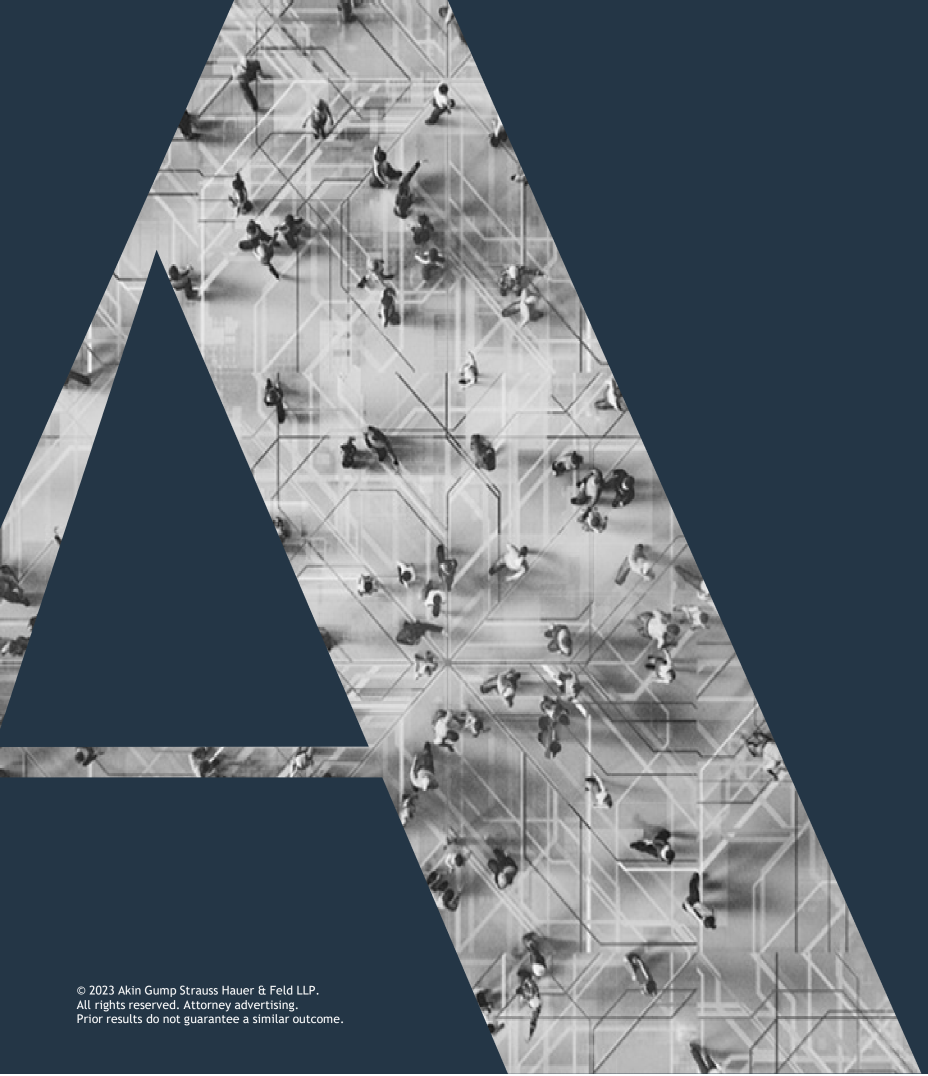

Deal Maker’s Boot Camp: M&A Basics

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Learning Objectives

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

M&A Basics

Basic Considerations

Transaction Structures

Acquisition Agreements

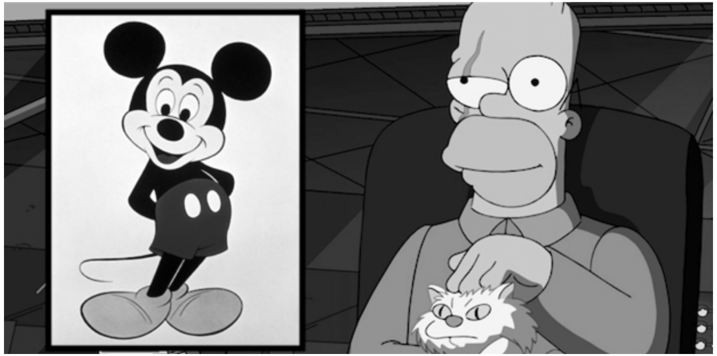
Basic Considerations

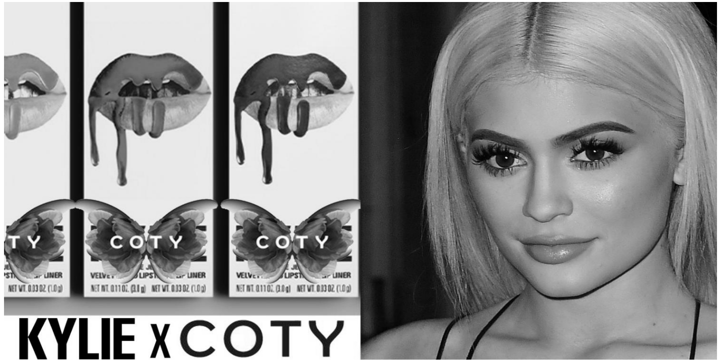
Basic Considerations

M&A Examples

Disney Acquires Fox in a $52.4 billion merger

Kylie Jenner sells 51% of Kylie Cosmetics to Coty for $600 million





Role of a Lawyer in the M&A Process

- If representing buyer, advise on structuring, assessing closing risk for legal matters (*e.g.*, regulatory), risk mitigation for potential contingent liabilities and go/no go decision
- If representing seller, advise on sale process and deal structure, minimizing post-closing liabilities, assessing closing risk for particular buyers and possibly evaluating bids from multiple buyers
- Due diligence
- Negotiation and documentation
- Getting to closing; post-closing matters

Motivations of Buyers and Sellers

What do the buyer and seller hope to get out of this?

- For a buyer—new investment, new product line, additional functionality, shortcut development cycle/time to market
- For a seller—liquidity for shareholders, access to capital or other resources if retaining an interest

What are each party's primary concerns?

- For a buyer—getting what they paid for, chain of title to key assets (*e.g.*, IP), projected synergies, contingent liabilities, stakeholder retention
- For a seller—deal certainty, speed to closing (and payment of purchase price), limiting liability under post-closing indemnity

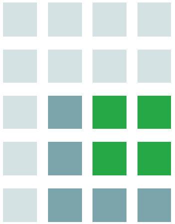
What is the proposed process for getting to a closing?

- What approvals are necessary (stockholder, board, customer/supplier, regulator, other key stakeholders)?
- Multi-party process (*e.g.*, auction) vs. bilateral negotiation?

Transaction Structures

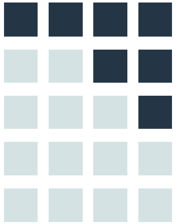
Transaction Structures

Asset Purchase



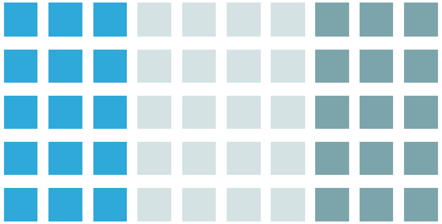
Buyer buys assets
from the company

Equity Purchase



Buyer buys equity directly
from equityholders

Mergers



Buyer buys a business by combining
multiple entities

Asset Purchase

Asset Purchase			
Purpose	**Requires**	**Risk**	**Good for**
Buyer buys a "business" or part of a business	Equityholder approval may be required if sale constitutes "all or substantially all" assets Often requires various transition agreements	Buyer often uses to leave liabilities behind Potential for successor liability May need to negotiate new contracts with employees and/or other counterparties	When the buyer wants to "cherry pick" certain target assets When, based on due diligence, buyer believes assets may not require numerous consents from third parties

Transaction Structures

Equity Purchase

Equity Purchase			
Purpose	**Requires**	**Risk**	**Good for**
Buyer buys equity of company directly from equityholders	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	Buyer is typically subject to economic exposure of the liabilities of target to a greater extent than with an asset deal	Target companies holding assets that would require multiple consents to transfer Private companies with limited equityholders

Mergers

Mergers			
Purpose	**Requires**	**Risk**	**Good for**
Combines two companies into a single entity • Direct Merger • Reverse Triangular Merger • “Double Dummy” Horizontal Merger	Board and shareholder consent if target corporation involved (different approval regime is possible for alternative entities, (*e.g.*, LLCs or LPs))	Surviving entity pools liabilities of merged companies	Companies with broad or diffuse equityholder base Often used in auction contexts

Transaction Timeline (Seller-Initiated Sale)

M&A Process: Typical Stages

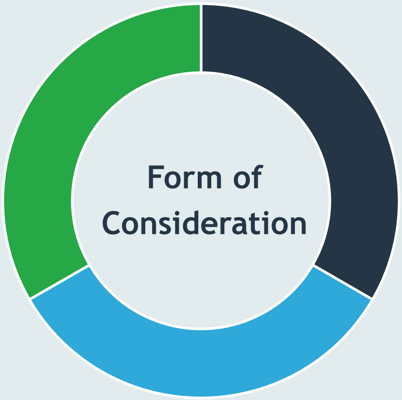
Phase 1 Initial Contact by Seller	Phase 2 Indicative Bids	Phase 3 Buyer Due Diligence	Phase 4 Binding Bids	Phase 5 Negotiate Contracts	Phase 6 Executory Period & Closing	Phase 7 Post-Closing
• Sign confidentiality agreement • Review information memorandum (auction)	• Provide indication of interest to seller • Begin initial due diligence • Assess financing alternatives and transaction structure • Tax structuring assessed	• Attend management presentation • Verify valuation assumptions • Review data room and conduct due diligence • Review definitive agreement	• Submit bid letter/ determine final bid terms • Submit comments to definitive agreement • Seller assesses bids • Obtain preliminary Board approvals	• Sign exclusivity agreement (if not signed previously) • Negotiate definitive agreement and ancillary agreements • Complete due diligence • Obtain final Board approval • **Sign definitive agreement**	• Satisfy conditions precedent (regulatory approvals, etc.) • Obtain financing • Prepare estimated closing statement • **Close transaction**	• Prepare final closing statement • Post-closing filings and notices

Acquisition Agreements

Acquisition Agreements

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

Purchase Price



Cash

Stock

- Fixed/floating/collar (ratio based)
- Rollover equity
- Fixed allocation/election (typically in public company deals)

Other

- Seller note
- Contingent payments

Purchase Price Adjustments

What:

Closing and post-closing price adjustments including working capital, cash, debt, unpaid transaction expenses and sometimes other items (*e.g.*, capital expenditures, deferred revenue, etc.)

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

Purpose:

- Working capital adjustment resolves differences between working capital needed to maintain operations and amount delivered at Closing
  - Generally takes into account current assets and current liabilities
  - Sellers prefer identifying specific line items from the balance sheet for certainty
  - Usually based on "normalized working capital" target (can be based on amount: normalized, zero, etc.); choice affects bid price
- Other adjustments reconcile base price to value delivered

Key Issues:

- Generally Accepted Accounting Principles (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 and to increase opportunities to introduce price reductions for additional liabilities
- 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.*, revenue or EBITDA)
- Other possible metrics:
  - Specific target metrics
  - Milestones (*e.g.*, winning long-term government contract)
  - Other key contingencies (*e.g.*, outcome of litigation or regulatory inquiry)

Why:

- Device for bridging a valuation gap
- Uncertainty about company's future prospects
- Transaction financed with future earnings

Other Considerations:

- Often requires complex negotiation of operating covenants imposed on buyer related to relevant metrics
- Potential for dispute is high

Representations and Warranties

What:

A statement of fact with respect to identified subject matters

Purpose:

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

Types:

- Fundamental
  - Organization
  - Authorization
  - No conflicts
  - No brokers
  - Affiliate transactions
- Regulatory
  - Tax
  - Employee benefits
  - Environmental
  - International trade; sanctions
  - Data privacy
- Operational
  - Customers and suppliers
  - Products liability
  - Real property
  - Financial statements/Internal controls
  - Intellectual property
- Others

Key Issues:

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 information technology (IT) person)

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

Representations and Warranties

Compare

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

A.

"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"

B.

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

Representations and Warranties

Disclosure Schedules

Disclosure Schedules:

1) Provide information to the buyer about the target (*i.e.*, **affirmative disclosures**) that parties determine to omit from the body of the acquisition agreement (including if it is too detailed or sensitive)
2) Qualify representations and warranties given in the acquisition agreement (*i.e.*, **negative disclosures**)

Example of a representation calling for **“affirmative disclosure”**	Example of a representation calling for **“negative disclosure”**
“Section 2.3(h) of the Disclosure Schedule sets forth the name of each of the subsidiaries of the target, and, with respect to each subsidiary: (A) the jurisdiction in which it is incorporated or organized; and (B) the number and class of shares or other equity interests thereof duly issued and outstanding, the names of all holders thereof and the number of equity interests held by each such holder, in each case, as of the date of this Agreement”	“Except as set forth in Section 2.3(t) of the Disclosure Schedule, (A) there are no, and there have not been any legal proceedings, pending or threatened in writing (or to the target’s knowledge otherwise) against the target or any of its properties or assets, or to the target’s knowledge, any of any of the target’s directors or officers, that would reasonably be expected to be, individually or in the aggregate, material to the target”

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 or other regulatory filings (e.g., HSR Act filings)
- Promise that parties take actions required for closing

Post-Closing Covenants:

- 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: Condition framework allows a buyer too many excuses not to close, so the definitive agreement is nothing more than a buyer option to acquire the target business
- Buyer's fear: Condition framework does not allow sufficient ability to avoid a closing, particularly based on adverse developments at the target business after signing

Examples:

Customary

- 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"
- No material adverse effects
- Receipt of regulatory approvals/termination of waiting periods
- Equityholder approval
- No legal restrictions

Negotiated, but Common

- Appraisal rights maximum
- Third-party consents

Highly Unusual/Mostly buyer Favorable

- Satisfactory due diligence
- Consummation of financing
- Completion of operational improvements
- Amendment of key contracts (e.g., credit facility or key supplier amendment)
- Entry into employment agreements
- Resolution of litigation/contingent liability

Acquisition Agreements

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:

- ✓ Officers' Certificate
- ✓ Officer/Director Resignations
- ✓ Required Consents
- ✓ Tax Certifications or Forms
- ✓ Escrow Agreement
- ✓ Payoff Letters; Lien Releases
- ✓ Shareholder, LLC, & LP Agreements
- ✓ Registration Rights Agreement
- ✓ R&W Insurance Policy
- ✓ Release Agreements
- ✓ Transition Services Agreement
- ✓ Employment Agreement(s)
- ✓ Management Equity Documents
- ✓ Stock Certificates (other certificated interests) with executed stock powers
- ✓ Operating Agreement (in midstream transactions)
- ✓ Basic Asset Transfer Documentation
  - Bill of Sale
  - Assignment and Assumption
  - IP Transfer Agreement
- ✓ Real Property or Other Special Asset Transfer Documentation

Termination Provisions/Fees

Purpose:

- Provide mechanisms by which the buyer and the seller can terminate the agreement and avoid a closing
- Important considerations include:
  - Potential impediments to closing within given timeframes
  - Cost-shifting in the event of deal failure
  - Termination fees (typically allocated based on which side is “at fault”)

Common Triggers:

- Mutual consent
- Failure to timely secure equityholder approval
- Breach resulting in the failure of a closing condition, that cannot be cured
- Outside date
- Regulatory prohibition (e.g., HSR, CFIUS)
- Failure to Close
- Financing failure

Issues:

- Clean hands for breach terminations
- Extension rights on outside date
- Financing failure termination right
- Which terminations trigger fees
  - “Wrong termination”/if terminated for x when could have terminated for y
  - Causation
- Quantum of fees

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

Risk Allocation: Indemnities

Survival

- Representations and Warranties
- Covenants

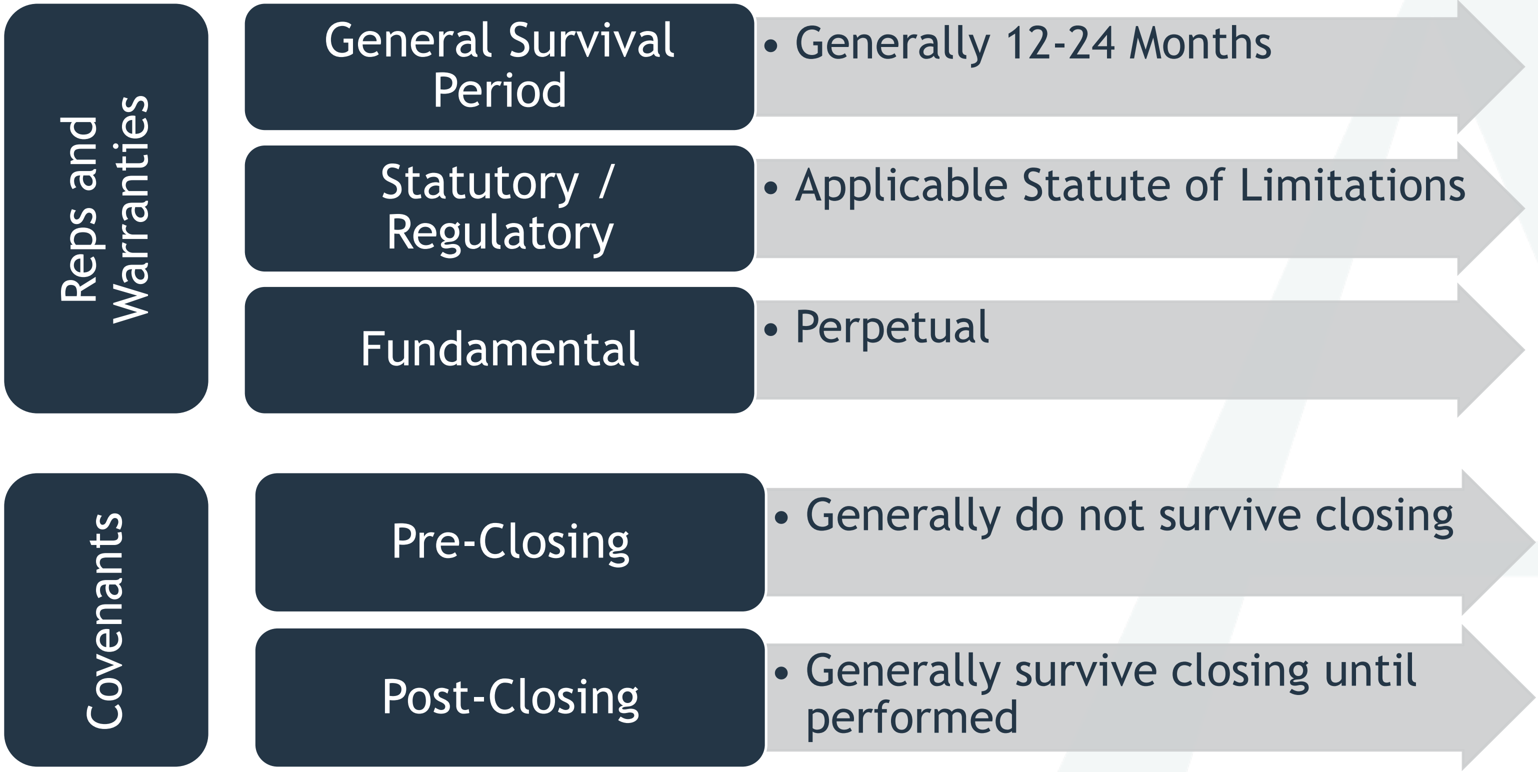
Deductible

- Quantum
- Tipping Basket vs. True Deductible
- De Minimis Deductible (a/k/a Mini Basket)

Caps

- Quantum
- Applicability

Survival/Time to Assert Claims



Limitations on Claims for Indemnification

Conceptual Limitations:

- Requirement of actual (not potential) loss
- Net of insurance proceeds and sometimes tax benefits
- Net of other recoveries under the contract (e.g., purchase price adjustments)

Risk Allocation: Escrows

What

A portion of the purchase price held back until a later date

Key Considerations

- Escrow Amount
- Timing of Release

An escrow can serve as credit support to satisfy:

Other Considerations

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: R&W Insurance

Purpose:

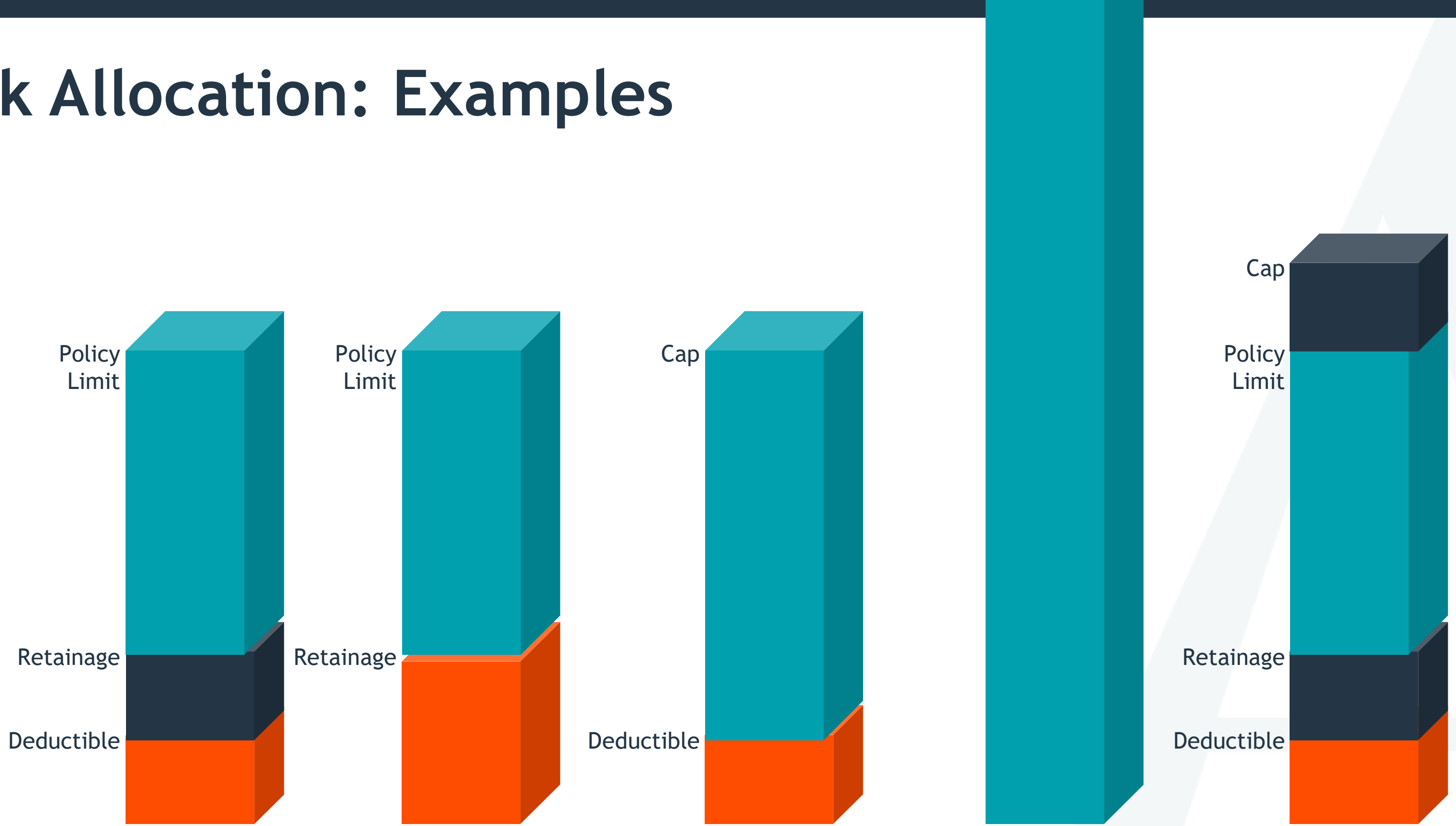
- Limit or eliminate seller's liability while also providing buyer coverage
- May be cost of admission for an auction process
- Shorten negotiations over agreement

Other Considerations:

- For carve-outs, consider timing of quality of earnings (or standalone financials)
- Impact on legal due diligence process
- Allocation of policy cost
- Allocation of deductible ("skin the game" issue)
- Impact of buyer's knowledge

- Seller Perspective
  - Want RWI to be sole source of recourse
  - But understand that buyer may need additional coverage
- Buyer Perspective
  - May need additional coverage and/or seller credit support
  - Escrow for some (often 50%) or all of the retention under RWI policy
  - Even without escrow, contractual right to indemnity for some (often 50%) or all of the deductible
  - Specific indemnity for policy exclusions
  - Indemnity for seller breach of covenant
  - Coverage on fundamental reps in excess of policy limit

Risk Allocation: Examples



Questions?

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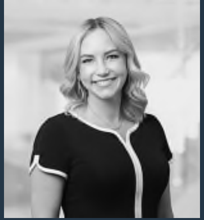

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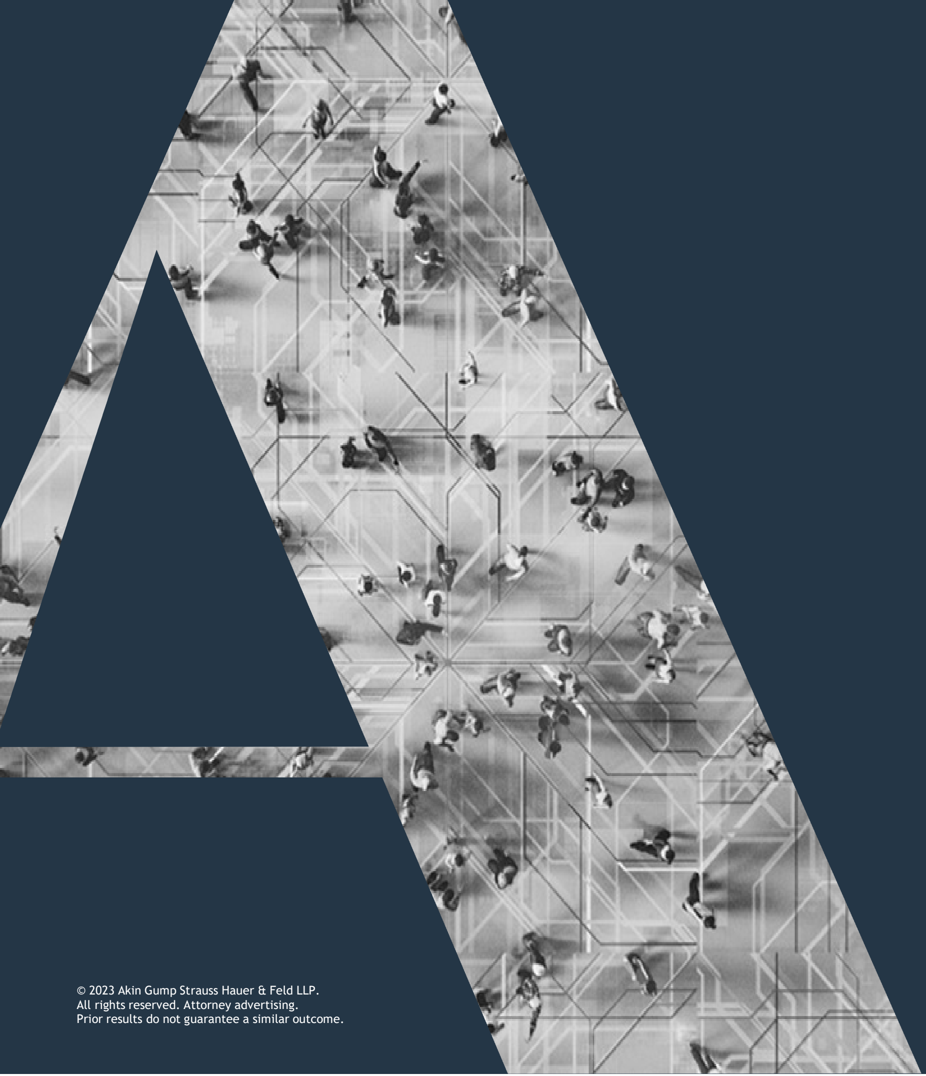

Thank You!