



M&A Trends

The ABA Deal Points Study and Tales from
the Front Lines

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Overview

- My text today: recent M&A experience and market data
 - 5 recent deals ranging from \$15-\$50 million (with earnouts)
- Great M&A reference: The 2007 ABA Report
 - <http://www.abanet.org/dch/committee.cfm?com=CL560003>
- The report sampled 143 publicly available acquisition agreements on relevant topics
 - 2006 deals, info compiled in 2007
 - No 2008 report out yet
 - Like Kelley Blue Book: a trailing indicator but useful



Deal Points Study Sample Detail

- 269 reported deals; 126 were thrown out as inapplicable (special circumstances)
- ~ 2/3 were all cash
 - Stock deals may not be coming back soon
- \$25-\$500 million (about 2/3 under \$100 million)
- wide collection of industries
- Private targets
 - public targets present different challenges
- About half sold by founders; a third sold by investors



General Provisions

- Simultaneous sign and close
 - More rare than your bus. dev. team might think
 - Very few in my experience (1 or 2 over the past 5 years)
 - About one in eight sampled deals
 - Easier with smaller deals
 - 3d party consents usually sought post-signing:
 - Stockholders
 - Key contracts
 - Regulatory authorities



Financial Provisions: Working Capital

- Over 2/3 had post-closing price adjustments; of those:
 - Nearly 70% had a working capital adjustment
 - 2/3 of the W/C tests had an estimate at close vs. 1/3 solely post-close (usually estimate at close is set by seller)
 - Most w/c tests do not have a “cushion,” but (from a recent deal):
 - “Notwithstanding the foregoing or anything to the contrary contained herein, the Working Capital shall be deemed to be equal to zero unless the Working Capital as set forth on the Closing Working Capital Statement is greater or less than the Working Capital Target by more than [\$100,000]”



Financial Provisions: Working Capital

- Buyer prepares the w/c statement nearly 80% of time
- Standard is usually “GAAP consistent with past practice” (72%)
 - Though a seller recently proposed just “GAAP” (only 14% of deals)
- 78% of w/c deals do not have a separate escrow
 - Of those, over half pay shortfalls out of the general escrow
 - The remainder generally are paid directly by sellers
 - But: I’d advise a buyer to use a separate escrow



Financial Provisions: Earnouts

- Rare in the '07 study (only 20% of deals)
- More prevalent recently
 - ~70% of my deals in past 12 months
 - Complicated to draft / negotiate
- Typical earnout triggers:
 - Revenue (30%)
 - Income / EBITDA (37%)
 - Special triggers (26%)
 - Product launch; drug approval



Financial Provisions: Earnouts

- Drafting / definition challenges
 - Defining “net sales”
 - Net of returns, freight, etc.
 - If a product, are there qualifications for what it needs to do?
 - Functionality?
 - Must use target’s IP? How do you define IP?
 - Obligations of acquiror to maximize target’s earnout? (only 1/3 of earnout deals)
 - Invest in / protect the technology?
 - Run target’s business consistent with past practice?
 - How is success measured?
 - Revenues / earnings as measured using seller’s old metrics or Buyer’s?
 - If earnings, how are costs allocated? How to treat new hires?
 - Lots more...but transactional lawyers are cheaper than litigators...



Financial Provisions: Earnouts

- Other wrinkles
 - Accelerate on change of control?
 - I got it recently, but only 11% of lawyers negotiating earnouts were as successful
 - Can buyer offset against target's indemnity obligations?
 - Yes in about half of earnout deals (52%)



Target's Reps

- The function of reps:
 - Buyer diligence: buyer is paying full price and wants to know about imperfections
 - Basis for indemnity: puts risk of unknown problems on seller (private deals only)
- Qualifiers: shift the risk back to buyer
 - E.g., “knowledge:
 - “seller complied with the law *to its knowledge*”
 - E.g., “materiality”
 - “seller owns all *material* intellectual property”
 - Either would reduce buyer’s ability to be “made whole” for violations
- Breadth of the M&A process, especially the reps, requires creation of a deal team for both buyers and sellers:
 - BD / senior management
 - HR
 - Licensing / IP
 - Finance / tax
 - The lawyer is the quarterback



Reps of Particular Interest

- “seller’s internal controls are sufficient”
 - A growing minority in 2007 study
 - Likely a function of CEO / CFO certifications and SOX internal control tests for public companies
 - Those controls were loosened somewhat recently (May '07; July '08)
 - Less important in smaller deals (i.e., immaterial deals)
 - Best timing for closing is right after quarter end
 - Unfortunately makes SOX applicable to private companies



Reps of Particular Interest

- “seller has no undisclosed liabilities” (93% of deals)
 - “...of a nature required to be disclosed by GAAP” (~1/3) (not a good formulation for buyers)
 - “except as disclosed in the balance sheet and those incurred since the date of the balance sheet in the ordinary course” (83%)
- “seller has complied with the law” (99% of deals)
 - “to its knowledge” (10%)
 - “and has not received a notice of its violating the law” (77%)
 - “or notice of an investigation” (32%)



Reps of Particular Interest

- “no rep contains an untrue statement or omits to state a material fact necessary to make any other rep not misleading” (52%)
 - “and seller has provided all facts that may adversely affect its assets, business, prospects, results of operations or financial condition” (10%)
 - “to seller’s knowledge” (26%)



Reps Requiring Special Attention

- Some reps require input from specialized counsel:
 - E.g., taxes
 - Seller has paid all taxes, filed all returns, isn't being audited, hasn't extended, isn't part of a group, won't have 280G problems, etc.
 - “materially complied” with tax law may not be enough comfort
 - Requires coordination of tax counsel with the finance / tax group
 - Benefit plans
 - Meant to insure there are no hidden liabilities under ERISA or tax code
 - The key is to limit the qualifiers and have them reviewed by experts
- You may need other special reps
 - regulatory compliance
 - others specific to your or target's industry



Covenants

- Standard covenants include:
 - Seller will conduct the business in the ordinary course
 - Seller won't take certain enumerated actions agreed to be "material" without buyer consent, such as:
 - Incur new debt
 - Amend its articles
 - Sell off material assets
 - Enter / amend material agreements
 - Issue new stock
 - Increase salaries / benefits



Covenants

- Target will continue to provide diligence access
- No public announcements
- Both sides will work together to try and close
- Employment arrangements
 - What employees will be offered jobs, who is required to come, and what benefits and salaries will be offered
 - Set expectations on salary and benefits post-closing
 - Credit under buyer's benefit plans for past service with the target and credit for deductibles already paid (buyer's plan terms permitting)
 - HR help is crucial



Covenants

- Indemnification of target’s directors and officers
 - Six years!
- No-shop / no-talk
 - Fraught with peril
 - Buyer wants deal certainty; Delaware courts want boards to be able to consider superior deals
 - Fiduciary “outs” less common for private targets
 - Work-arounds
 - Voting agreements from a control group of stockholders
 - » *Omnicare* said you can’t pair voting agreements with a “force the vote” provision (together they make the deal a “fait accompli”)
 - One current approach: get consent of a control group shortly after signing
- Post-closing tax issues
 - Who prepares tax return; who is responsible for the taxes



Conditions

- Preserve buyer's ability to "walk away" if it sours on the deal
 - Seller wants certainty, buyer wants flexibility
- Typical conditions (assumes delayed closing). Buyer can kill the deal unless:
 - Reps are true at closing (99%)
 - And were true when made (60%)
 - Only "materially" (60%); or "except as would not have a material adverse effect" (38%)
 - Eliminate materiality "double dip" (75%)
 - There has been no "material adverse change" (78%)
 - There are no legal proceedings (68%)
 - Of those, 76% were specific to litigation regarding the transaction, while 24% were regarding any litigation
 - Pending and threatened (65% of deals with this condition)
 - "material" litigation: 44% of deals with this condition (expressed in a number of ways, half of these used "material adverse effect")
 - Buyer receives a legal opinion from target's lawyer (70%)



Conditions

- Other typical conditions not covered by the study:
 - Seller has performed its obligations
 - Less than x% entitled to dissenters' rights
- Other things that must be in place pre-close
 - Offer letters accepted
 - Benefit plans terminated
 - Required consents obtained
 - Closing / good standing certificates delivered



Indemnification

- Survival of reps
 - 1-2 years for “general” reps
 - 7% expired between 0 and <12 months
 - 26% expired at 12 months
 - Another 43% expired between 12-18 months (inclusive)
 - Another 19% expired between >18-24 months (inclusive)
 - Only 5% went longer than 24 months
 - Indefinitely for some, to statute of limitations for others



Indemnification (Survival of Reps)

- Reps excluded from the general expiration
 - Taxes (67% of the time; usually for SOL)
 - Capitalization (59%; usually indefinitely)
 - Authority (54%; indefinitely)
 - Employee benefits (39%; SOL)
 - Fraud (37%; indefinitely)
 - Environmental (37%; SOL)
 - Breach of covenants (36%; indefinitely)
 - Intentional breach of reps (16%; indefinitely)



Indemnification

- Who pays buyer for indemnity claims?
 - Everyone pro rata (35%)
 - Everyone jointly and severally (41%)
- Any exclusion to the type of damages?
 - Limited to “out of pocket” (3%)
 - Excludes “diminution in value” (10%)
 - Excludes “incidental damages” (16%)
 - Excludes “consequential damages” (31%)
- Who fights claims made by unrelated 3d parties that could lead to indemnification?
 - Usually buyer, but subject to negotiation



Indemnification

- Deductibles and Baskets
 - “Basket”: claims must exceed a minimum threshold, after which all claims paid (34%)
 - “deductible” first \$___ in claims are not paid (56%)
 - Of deals with thresholds, 62% set it at ½% or less of the deal’s value, with another 28% at ½ to 1% of deal value.
 - Threshold applies to:
 - Breaches of reps (100%)
 - Covenants (55%) (high in my experience)
 - Other indemnity claims (39%)
 - Carveouts
 - Fraud (55%)
 - Cap rep (52%)
 - Authority rep (47%)
 - Tax rep (42%)
 - Intentional breach (32%)
 - Breach of covenants (22%)



Indemnification

- Claim thresholds
 - Claims must be above \$X or they're not paid at all (18%)
- Materiality “double dip”
 - 22% expressly eliminate double-dip on materiality
- Caps on indemnity
 - Purchase price: 7%
 - Less than purchase price: 88% (of deals with caps, 44% were equal to the escrow amount)
 - 64% were at 15% or less of deal value (median of ~10%)



Indemnification

- Carveouts from caps
 - Fraud (64%)
 - Capitalization (46%)
 - Authority (43%)
 - Taxes (40%)
 - Intentional breach of reps (36%)
 - Breach of covenants (16%)
- Indemnity as the exclusive remedy (77%)
 - Excludes intentional misrepresentation (40% of the 77%)
 - Excludes fraud (81% of the 77%)



Indemnification Escrows / Holdbacks

- 75% of deals with rep survival have an all cash escrow / holdback
- 51% say the escrow / holdback is not the sole remedy; 32% say it is
- Escrow values
 - 79% of deals with escrows set it at 15% or lower
 - 21% are at 10%
- I tend to see higher escrows and escrow as sole remedy (with exceptions for fraud)



Indemnification

- Other special indemnity items?
 - Taxes (31%)
 - Specifically identified risks (51%)
 - Included certain liabilities, dissenters' rights payments, transaction expenses
- Offsets to liability
 - Tax benefits to buyer? (31%)
 - Insurance proceeds? (63%)
 - Required to mitigate? (22%)



Disputes

- Governing law
 - Delaware 43%
 - NY 20%
 - Other 37%
- Waiver of jury (20%)
- ADR (31%)
 - Binding (77% of the foregoing)
 - AAA (66%)
 - Expenses
 - Loser (27%)
 - Split (34%)
 - Arbitrator awards it (30%)



Key Definitions

- “material adverse effect”
 - Affects the reps and the conditions to closing
 - “we have no problems except as would not have a MAE”
 - Popular exclusions from the MAE definition:
 - Changes in the economy at large
 - Changes in industry
 - Changes coming from deal announcement
 - Failure to meet projections
- “knowledge”
 - Actual vs. deemed knowledge



Who is this guy?

Thanks for having me.

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