M&A NUTS AND BOLTS:

WHAT YOU NEED TO KNOW FOR A SUCCESSFUL TRANSACTION

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Agenda

- Introduction of Panelists
- Discussion Topics:
  - Review of M&A Timeline
  - Term Sheets and LOIs
  - Purchase Agreement
  - Representations & Warranties
  - Closing
  - Litigation Risk

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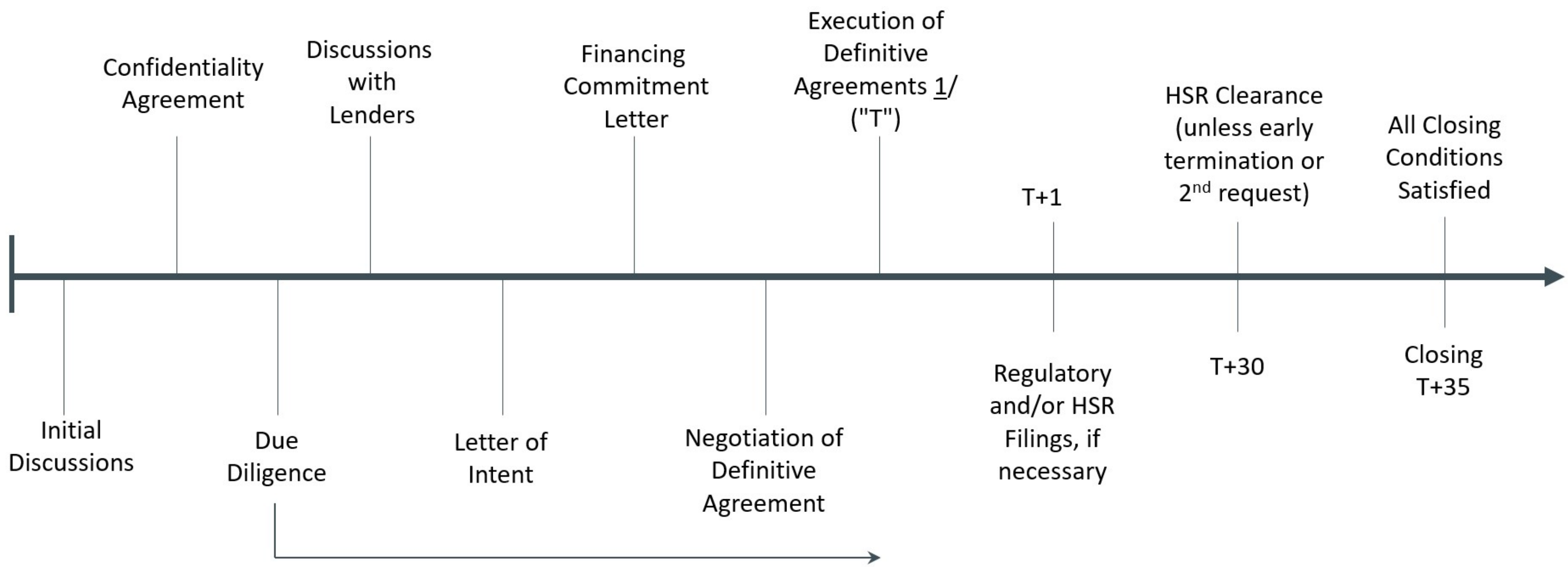
M&A TIMELINE

Sample M&A Timeline



1/ Transactions not requiring HSR or other regulatory approval can and often do sign and close simultaneously.

*HSR – Hart-Scott-Rodino

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The M&A Transaction Process

- Usually takes 6 to 9 months from beginning to end, assuming no significant delays.
- Possible sources of delay/difficulty include:
  - Difficulty identifying the right Target.
  - Target stockholders with unrealistic sale price expectations.
  - Competition from other Bidders.
  - Issues with Target discovered during due diligence.
  - Protracted/difficult negotiation process.
  - Buyer having issues obtaining financing to consummate transaction.
  - Delays obtaining “change of control”–triggered governmental approvals and contractual consents.

Types of Agreements/Documents

- Confidential Information Memorandum (CIM)/Teaser
- Nondisclosure Agreement (NDA)
- Letter of Intent (LOI)
- Definitive Purchase Agreement
- Employment Agreement for Target’s Key Executives
- Noncompete Agreements

Investment Bank-Identified Opportunities

- For investment bank-identified opportunities, first “Teaser,” then CIM, then management presentations:
  - Teaser is 2- to 3-page summary of Target’s business. It doesn’t include any of Target’s confidential information, so Buyer doesn’t need to sign an NDA.
  - If sufficiently interested by the information in the Teaser, Buyer will sign an NDA and receive the CIM prepared by Target’s investment bank.
  - CIM is comprehensive 20- to 30-page description of Target, including detailed information about its business, customers, suppliers, markets, competition, management team, financial statements, and projections.
- Next steps are management presentations and due diligence:
  - Management presentations are face-to-face or phone meetings between Target’s management team and Buyer.

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Investment Banking Considerations for M&A – Role of the Investment Banker

Deal Marketing/Management

Initial target list
Serve as interface with potential buyers
Move the process along
Help select the winning bidder

Financial Modeling

Serves as basis for Negotiation
Relied on to finance deal
May be challenged in litigation

Raising Capital for Transaction

Debt financing - banks
Debt financing – mezzanine and sub debt
Equity

Investment Banking Considerations for M&A (cont.) Investment Banker Legal Concerns

Securities Law Compliance for M&A Financing

Private placement exemption(s)

Need for registered securities (S-4)

Importance of due diligence – shield under ‘33 Act from damages

M&A Fairness Opinions: “fair from a financial point of view”

What is “fairness”? – Football field analysis

Likelihood of post-deal litigation in public deals

Work with counsel to ensure compliance with board’s fiduciary duties (business judgment rule v. total fairness)

Information confidentiality issues

Insider trading concerns

Reg FD

Business secrets – customer and employee solicitation

Existing Buyer Business Relation Targets

- The process may be less structured.
- Often Target doesn't have a Teaser or CIM prepared and proceeds, at least initially, without engaging an investment bank, although it may be well-advised to engage one to help protect its interests.
- There is always the possibility that Buyer's interest in a potential transaction puts Target "into play," and its management team then engages an investment bank to seek competing bids and conduct an auction.
- That is particularly the case if Target is publicly traded and its board is concerned about stockholder lawsuits alleging fiduciary duty breaches unless an auction or a "market check" is conducted, or a "go-shop" structure is used, to help ensure Target stockholders receive a fair price.
- Next step is for Buyer to sign an NDA and start its due diligence process on Target.

Confidentiality

Seller

- Information disclosed only for evaluation of transaction
- Broad nondisclosure provisions in place prior to any disclosure
- Includes oral disclosures
- Long-term restrictions

Confidentiality (cont.)

Buyer

- Concerned about the liability if engaged in similar business
- Limited restriction period
- Standard exceptions
  - Developed by Buyer independently
  - Disclosed by third party without a duty to Seller
  - In the public domain
  - Disclosed by Seller to others without requiring confidential treatment
  - Disclosed with permission of Seller

Legal Due Diligence

- Not just a “check the box” exercise for advisors only
- Look **ahead** as well as **behind**
- Review Target’s equity and debt documents, contracts, intellectual property, labor, environmental, tax, litigation, and regulatory matters
- Usually “phase one” environmental analysis of industrial companies
- Background checks – Known “shady” characters rarely change their tune
- Focus on “change of control” triggers in contracts and regulatory approvals
- Open communication between legal, operational, and financial diligence teams
- Instruct the legal team where you want to go
  - Confirmatory diligence of modeling efforts
  - Identify key contingencies that may inform the investment decision (i.e., litigation risk and exposure; regulatory considerations; customer/supplier concentration)
  - Make sure lawyers are operating in the “real world” and that corporate legal team has appropriate control of regulatory legal team

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Legal Due Diligence (cont.)

- Intangible anecdotal benefit
  - Take advantage of the face time that lawyers typically put in at the Target to double-check and fill in color to the Target's "story"
  - The casualty of virtual data rooms: On-site almost universally better than off-site; amazing what lawyers can learn just by being there (e.g., face-to-face discussions when questions arise, and "Hey, what's in this file cabinet?")
- Post-closing improvements
  - Identify areas in which "best practices" can be deployed post-closing
  - "Clean up" the Target for exit
  - Pay to scrub the company once
  - Don't forget to implement

Structuring It: Acquiring the Target

- Basic forms
  - Stock purchase
  - Asset purchase
  - Merger
  - Recapitalization
  - Going private
- Each of these forms can be structured to allow for “equity rollover” by some or all of the Target’s existing stockholders
  - Key question is whether the rollover transaction will be tax-advantaged from the view of Target’s existing stockholders

Summary of the Structure of a Deal

- Decide early which deal structure is most desirable, whether you are a Buyer or a Seller.
- Get the best tax and legal advice obtainable and research it completely.
- Be prepared to argue your desired deal structure with the other side, and be willing to bargain for your optimum position.

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TERM SHEETS AND LOIs

Purpose of Term Sheets and LOIs

- Clarifies fundamental terms before committing significant resources – “meeting of the minds”
- Provides jump start to negotiations – “Deal Momentum”
- Creates moral obligations
- Creates binding exclusivity through “no-shop” provisions

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Letter of Intent – Key Principles

- Hitting key business and legal points while marketing buyer as a potential partner
- Winning the deal while preserving flexibility
- LOI v. term sheet v. both
- Auction-specific considerations
  - Auction procedures compliance
  - Memo v. mark-up (a/k/a "Blame the Lawyers Strategy")
- Is it binding?
  - What conditions remain to be satisfied?
  - What due diligence remains to be done?

What to Include in the LOI?

Always Include	Sometimes Include	Never Include
• General Valuation (Fixed Or Range) • Adjustment Mechanisms • Deal Breaker Conditions • Clarification Of Binding Effect/Expenses • Exclusivity/No Shop • Diligence Out • Confidentiality • Initial Thoughts Re: Transaction Structure • Flexibility Enhancers (*e.g.*, *Customary* Reps, Indemnification, Escrow, etc.) • Clean Termination Procedure	• Indemnification Parameters • Escrow Terms/Range • Survival Period Of Reps • Management Carry • Equity Rollover • Financing Arrangements • Employment Arrangements • Corporate Governance Matters • HSR Payment Obligations • Contingencies/Conditions to Close (*i.e.*, Gov't. Approvals, Consents, Access, MAC, Litigation, etc.) • Fees paid to Fund (*i.e.*, Management Fee, Reimbursement of Expenses)	• Binding Closing Obligation • Guarantee By Buyer • Break Up Fees Payable By Buyer • Earnest Money Deposits

Standstill and Exclusivity Agreements

- Seller:
  - Prefers to wait until a definitive purchase agreement is signed.
- Buyer:
  - Wants "no-shop" provision with penalty for violation.
  - No investment in due diligence or legal and accounting expenses if Seller is free to talk to others.
  - Should negotiate a break-up fee if "fiduciary out" is exercised.
- Standstills occur only in the public company context (where the buyer has the ability to make open market purchases or a tender offer for the Target company's shares).
- Exclusivity can occur in both public and private company deals.
  - Sellers need to keep in mind their fiduciary duties to stockholders.
- Exclusivity terminates if deal is not closed by a specified date.
- These provisions are often located in the Confidentiality Agreement.

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Binding vs. Nonbinding Terms

- Typically, most terms are expressly nonbinding.
- “Except for the sections entitled Exclusivity, Confidentiality, and Expenses and this Section 10, which shall be binding, this letter of intent represents the present intentions of the parties only and shall not be binding until such time, if ever, that the parties negotiate, execute, and deliver a Definitive Agreement reasonably satisfactory to the parties. This letter of intent is not intended to impose any obligation whatsoever on either party, including without limitation an obligation to bargain in good faith or in any way other than at arm’s length. This paragraph supersedes all other conflicting language.”
- Traditionally binding provisions:
  - Exclusivity
  - Confidentiality
  - Expenses

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PURCHASE AGREEMENT

Purchase Consideration (Part 1)

- "Cash is king" in M&A transactions.
- Buyers sometimes try to "bridge valuation gaps" with Target expectations using non-cash consideration like Buyer stock, Seller notes, and earnouts.
- Buyer stock:
  - Can enable use of "tax-free" merger structure.
  - More attractive if Buyer is publicly traded and Target stockholders receive either registration rights or freely tradeable shares at closing.
  - Requires Target to do "reverse due diligence" process on Buyer.
  - Need to understand the terms and conditions of the Buyer stock received – e.g., preferred vs. common stock.
  - If Buyer is privately held, former Target stockholders will usually be required to sign Buyer's stockholders agreement containing right of first refusal, tag-along and drag-along provisions.

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Purchase Consideration (Part 2)

- Seller notes:
  - Unsecured promissory notes issued by Buyer to Target's stockholders.
  - Usually subordinated to Buyer's senior debt – subordination terms are a key negotiation point (e.g., current pay allowed as long as no default).
  - Can enable Target stockholders to defer taxable income from transaction into future tax years when lower tax rates apply.
- Earnouts:
  - Target stockholders get additional purchase consideration if Target business meets financial performance goals after closing.
  - Since Buyer controls Target business after closing, key negotiation point is Buyer's obligation to provide funding, personnel, and other support.
  - Also carry-forwards if Target business misses earnout goals in a given year.

Purchase Price Adjustments

- Adjustments are used to match present assumptions with present performance.
  - Funded indebtedness
  - Net working capital/net worth
  - Cash on hand at closing
  - Collection of accounts receivable
- Closing v. post-closing adjustments.
- Compensates parties for certain changes in Target's balance sheet over time from when purchase price was negotiated to closing of transaction.
- Earnouts used to bridge valuation differences and sync present assumptions about the future with future performance.
- Sometimes an adjustment is also made based on accounts receivable actually collected post-closing vs. amounts on Target's financial statements (less reserves) or third-party appraised value of inventory vs. amounts on Target's financial statements (less reserves).

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Funded Indebtedness

- Treatment of existing Target debt:
  - Buyer assumes indebtedness and adjusts purchase price; or
  - Target is purchased “debt-free” and debt is paid off at closing, with corresponding purchase price adjustment.
- “Funded indebtedness” commonly includes:
  - Borrowed money or other interest-bearing indebtedness.
  - Capital lease obligations.
  - Obligations to pay the deferred purchase or acquisition price for goods or services, other than trade accounts payable or accrued expenses incurred in the ordinary course of business, on no more than 90-day payment terms.

REPRESENTATIONS & WARRANTIES

Representations & Warranties

- Pages of detailed statements in the purchase agreement about Target’s business, covering all areas that could potentially create liability for Buyer or otherwise reduce Target’s value to Buyer.
- Deviations from “The Perfect World” – Seller will provide to Buyer “disclosure schedules” with exceptions to the reps and warranties, describing any instances in which Target’s business deviates from a “perfect world” in which, for example, it doesn’t have any litigation, regulatory problems, or contractual disputes.

Functions of Reps & Warranties

- Due diligence confirmation
  - Disclosure schedules help confirm due diligence.
  - Sometimes reveal issues that provide grounds to renegotiate purchase price or terminate the deal.
- De facto purchase price adjustment
  - Through indemnification of Buyer by Seller for losses resulting from breach of Seller's reps & warranties, purchase price paid by Buyer is effectively reduced to more accurately correspond to the actual value of Target's business.
- Certainty of closing
  - "Bring-down" closing condition lets Buyer walk away from the deal if Target's business adversely changes between signing and closing and if Seller's reps and warranties are not true as of closing.
  - "Tight" reps and warranties – Give Buyer more leeway to refuse to close.
  - "Loose" reps and warranties – Give Seller greater certainty of closing.

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Reps & Warranties – Qualifiers / Carveouts

- Sellers favor “loose” reps and warranties, including lots of “knowledge,” “materiality,” and “Material Adverse Effect” qualifiers, which are usually resisted by Buyer.
- “Knowledge” qualifiers only hold Target stockholders responsible for misrepresentations that Buyer can prove Target “knew” about.
- “Materiality” and “Material Adverse Effect” qualifiers excuse Target stockholders from liability for failure to disclose matters not “material” to Target’s business or that would not result in a “Material Adverse Effect” on Target.

Indemnification

- Provides a means for Buyer to seek recourse against Target for losses suffered as a result of violations of the Acquisition Agreement.
- More broad than damages for breach of contract because it includes reimbursement for attorneys', accountants', and other fees.
- Often also a "tax indemnity" provision requiring Target stockholders to compensate Buyer for all pre-closing tax liabilities of Target.
- Indemnification payments effectively reduce the purchase price paid by Buyer to Target stockholders.
- Heavily negotiated in privately held acquisitions.

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Indemnification – How Does Buyer Get Paid?

- Stock and merger deals – Target stockholders are responsible for providing indemnification to Buyer.
- Asset deals – Target entity provides the indemnification, sometimes with guarantees from the Target stockholders.
- Absent deep-pocket Sellers, escrow is the primary source of indemnification.
- Joint and several vs. separate (not joint) liability among selling stockholders.
- Each Target stockholder is solely responsible for indemnification concerning its individual actions (e.g., reps concerning ownership of its shares and breach of its noncompete/nonsolicit covenants).
- "Reps and warranties" insurance is becoming an increasingly popular way to satisfy Target stockholders' indemnification obligations.

Reps & Warranties Insurance

- A source of recovery to the insured if Target stockholders' reps and warranties in the purchase agreement are (unintentionally) inaccurate.
- Has gone from being virtually nonexistent to very common, particularly in M&A transactions involving private equity.
- Benefit is that Target stockholders can reduce the transaction consideration placed into escrow (typically 1%-5% of total transaction consideration, rather than 10%-20%) and their indemnification exposure, while Buyer still has recourse for a larger amount through claims against the policy.
- Coverage adds expense but can expedite negotiating the purchase price agreement.
- That is particularly true for negotiating the materiality thresholds in the reps and warranties, the escrow amount, and the indemnification deductible/threshold and cap.

Pre-Closing Covenants

- Target required to operate its business in the ordinary course.
  - Buyer consent is required for Target to take certain major actions.
  - Balance Buyer's desire for protection vs. "gun jumping" liability.
- Exclusivity – Target can't do an M&A deal with anyone other than Buyer.
  - Usually restricts not only doing deal, but also responding to inquiries or providing information to other potential buyers.
  - "Fiduciary out" common in deals involving publicly traded Targets.
- Parties required to use commercially reasonable efforts to obtain governmental approvals and contractual consents.
  - Need a coordinated effort in which parties keep each other reasonably apprised of all material developments in the process.
  - Sometimes Buyer requests extraordinary actions to obtain antitrust and Committee on Foreign Investment in the United States (CFIUS) approval, e.g., forced divestment of divisions and conduct restrictions.
- Where Buyer is obtaining financing, usually a covenant requiring Target to use commercially reasonable efforts to assist Buyer's debt arrangement process.

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Noncompetes and Nonsolicits

Buyers of businesses often seek to "protect their investment" by restricting Seller from taking actions after closing that would damage the Target business.

- **Noncompete Covenant** – Prohibits Seller from entering into business in competition with Target after closing.
- **Nonsolicit Covenant** – Prohibits Seller from soliciting Target employees and customers after closing.
- **Nondisparagement Covenant** – Prohibits Seller from making disparaging statements to third parties about Target's business, management, employees, etc.
- **Key Negotiated Points:**
  - Scope of noncompete and carve-outs
  - Duration of noncompete and nonsolicit

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Noncompetes and Nonsolicits – Enforceability

- Enforceability depends on the following factors:
  - Duration
  - Geographic area
  - Nature of restricted activity
  - Persons restricted
- M&A transaction-related noncompetes (as opposed to those in employment agreements) are often either totally or partially exempted from state law limitations on enforceability because:
  - The Buyer of a business is entitled to be protected from the Seller competing with it;
  - The Seller has received adequate consideration for the noncompete through payment of the purchase consideration; and
  - The unequal bargaining power often present in employment agreement noncompetes isn't present with M&A transaction-related noncompetes.

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Termination Provisions

- Available by mutual consent.
- Available to a nonbreaching party without liability.
- In nondefault situations, what other grounds are there for termination?
- Seller wants grounds for termination to be limited and nondiscretionary.
- Buyer wants conditions for exit to be broad, especially if due diligence has been limited.

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CLOSING

Closing Conditions

- Usually there is a period of time between when the purchase agreement is signed and when closing occurs.
- Signing and closing occur separately because:
  - Need a signed purchase agreement to obtain some regulatory approvals (e.g., HSR and FCC).
  - Buyer wants to “lock” Seller into the deal as soon as possible.
  - Seller won’t contact customers/suppliers re: “change of control”–triggered contractual consents without signed purchase agreement.
- Noncontroversial closing conditions:
  - HSR Act antitrust and (if applicable) CFIUS national security clearances received (discussed below).
  - No injunctions prohibiting consummation of the transaction.
  - Material compliance with covenants between signing and closing.
  - Repayment of Target debt and release of liens in “debt-free” deal.

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HSR Antitrust Filing

- Hart-Scott-Rodino (HSR) Act filing – Detailed schedule of economic data about Buyer and Target filed by the parties in M&A transactions satisfying certain specified financial tests.
- Financial tests are "inflation-adjusted" each year
  - Size of transaction test
  - Size of person test
- Only need to make HSR filing if both tests are satisfied.
- Purpose of HSR filing:
  - "Flags" transactions that would adversely affect competition in the marketplace and enables U.S. government to stop or modify them.
  - Key consideration is whether transaction reduces number of competitors in a given market – interpretation of "market" is key.
- HSR Act "waiting period":
  - Transaction deemed approved if 30-day "waiting period" expires without "second request" from U.S. government for additional information.
- Second request sometimes allows the parties to "walk away" from the transaction.

CFIUS National Security Filing

- Committee on Foreign Investment in the United States (CFIUS) filing.
- Joint filing made by Buyer and Target with interagency group of U.S. federal government agencies led by the U.S. Treasury Department.
- CFIUS can block “covered transactions” – acquisitions by non-U.S. Buyers of U.S. Targets that would create “national security risks.”
- Not just acquisitions of defense contractors, but also of “critical infrastructure” (e.g., telecom networks) and “critical technologies.”
- Theoretically voluntary, but mandatory in practice, since CFIUS can “unwind” transactions after the fact.
- The risk of CFIUS blocking a transaction varies significantly depending on whether Buyer is located in a country that is an ally of the United States (UK, Japan) or not (China, Russia).
- Timeline:
  - Initial 30-day “review” period with subsequent 45-day “investigation” period, after which the U.S. president has 15 days to make a decision.
  - However, CFIUS can request that parties withdraw their filing to give CFIUS more time to consider (common for Chinese acquisitions).

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Closing Conditions

Negotiated Closing Conditions

- Financing contingency (most important).
- Standard for reps & warranties “bring-down” closing condition (true closing or “MAE” standard).
- No Material Adverse Effect having occurred to Target between signing and closing. Both scope of definition and carve-outs in all material respects will often be heavily negotiated.
- Which “change of control”–triggered contractual consents are required for closing.
- Whether de minimis “change of control”–triggered governmental approvals of state and local regulatory authorities are required for closing.
- Target management team members having signed new employment agreements with Buyer.
- Cleanup/handling of issues with Target identified by Buyer in the course of its due diligence.

LITIGATION RISK

Always Assess Deal Terms in Light of Potential Litigation Risks and Costs

Pre-Agreement Disputes

<u>Case Study</u>: Litigation over NDA “use” clauses

Pre-Closing Disputes

<u>Case Study</u>: COVID-19 MAE litigation

Post-Closing Disputes

<u>Case Study</u>: Successor liability claims

THANK YOU

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