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NATIONAL CAPITAL REGION

MANAGING REGULATORY RISK IN M&A TRANSACTIONS: UPDATE 2023

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INTRODUCTIONS

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AGENDA

- Introduction
- M&A Process & Integration
- Antitrust Considerations
- Trade & National Security Considerations
- Q&A

M&A PROCESS & INTEGRATION

WHY ARE WE DOING M&A ANYWAY?

- Major consolidation of two companies
- "Tuck In" or "Add On" acquisition – all assets of the target may or may not be important
- Acqui-hire – real value is the know-how and the people who can build what you need
- Approach to M&A differs based on rationale for M&A – different structures (such as asset vs. stock sale) make more sense based on different rationales (note that tax concerns are also important in deal structuring)
- Earnouts serve to bridge valuation gaps between buyer and seller, but do result in enhanced post-deal litigation risk

CORE PHASES OF M&A

- Due Diligence – Enhanced assessment of risks and outcomes, with an eye towards understanding risk and informing integration process

- Transaction – Focus on structure, valuation, and documentation, with an eye towards minimizing known and unknown risks via contractual protections

- Integration – When the M&A is over, the real work begins, informed by diligence process

AREAS OF FOCUS FOR COUNSEL ON THE SELL-SIDE

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- Before an acquisition is on the horizon is the time to organize company data so that you can respond quickly to an acquirer – act like you're always for sale
- Consider how to put together a data room, who the custodian of various types of data will be, and where the gaps are (and how to close them)
- In a sale process, production of diligence materials and preparation of disclosure schedules is often the long straw – knowing where your data is and how to find answers to questions is important
- The way to scare your potential buyer is to say "I don't know" in response to their diligence questions

AREAS OF FOCUS FOR COUNSEL ON THE BUY-SIDE

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- Will the deal bring desired outcome, value, and purpose?
- Does the seller seem to have their business under control? Red flags often emerge in the diligence process
- Key employees – how to retain them. Think about a threshold of employees to be in seats at closing, non-competes, retention packages, etc. Then, show them the love and the cultural fit when they arrive
- Key contracts – Do they contain change of control provisions or need to be updated post-closing? Getting ahead of integration is key

DILIGENCE

- By the time legal gets involved, a decision has usually been made at the management level with respect to a possible transaction

- Diligence is about finding red flags / blockbuster issues that could derail a transaction as well as preparing for integration

- Items legal focuses on, among others: IP validity, any non-standard or high risk obligations in contracts, regulatory compliance, and employee issues

- Key to identify your diligence team and clearly delineate roles and expectations

- For a buyer procuring representation and warranty insurance, start the process early

INTEGRATION

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- Consider the approach to contract assignment and assumption
- Redundancies (common customers / vendors) / how to streamline
- What pain points are you inheriting? – problem contracts, relationships, employees
- Signature / decision-making authority
- Moving over to “Buyer paper” – transitioning off of seller forms and models
- Have a plan for what real integration looks like at various points in time
- Integrating people can be the hardest part – lead with a culture to make people feel welcome and to avoid a talent flight post-M&A
- Earnouts can make integration substantially harder
- Transition services may be necessary for carve out transactions

CARROTS AND STICKS: KEEPING THE TEAM AROUND AFTER A DEAL

- A number of devices are used by buyers to maximize the probability of a management team staying with the company after a deal
- Post-deal non-competes have enhanced enforceability as compared to post-employment non-competes (even for employees in California)
- Buyers are increasingly requiring management to "revest" a portion of their deal proceeds, i.e., defer receipt of those proceeds for a period of time subject to their continued employment (this leads to negotiations over "cause" and "good reason" provisions, among others)
- Buyers often incentivize management through grants of RSUs or other equity (beyond a typical employment package)

RWI CHANGES THE GAME

- Representation and Warranty Insurance (RWI) is very common in transactions with financial buyers and increasingly common in transactions with strategic buyers
- RWI policies must be procured by the buyer, but whether buyer or seller bears the cost is a negotiated point
- RWI shifts risk of representation breach (for non-fundamental representations generally) away from sellers and toward a third-party insurer
- Deals with RWI as a result may have more fulsome representations
- Insurers require a thorough diligence process and report
- Note that known matters cannot be insured

ANTITRUST
CONSIDERATIONS

ANTITRUST: A PRIMER FOR THE GENERALIST

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- Whether or not antitrust filings will be required in connection with a deal will impact both deal timing and certainty of deal closing (as well as what happens after a deal) – these are key issues to get ahead of early and to socialize internally to properly set expectations

- If a deal is over a certain threshold size in the US, or if a target has significant ex-US revenue, pre-merger notification filings may be required and should be discussed early with counsel

- Regardless of whether a filing will be required, if a deal is competitively sensitive antitrust counsel should be consulted regarding sensitives around information sharing

- Care should be taken in creating deal-related documents, especially for deals that are competitively sensitive or with respect to which a filing may be required

M&A-RELATED ANTITRUST FRAMEWORK

- Hart-Scott-Rodino Antitrust Improvements Act of 1976 (“HSR”)
  - Requires filing a notification with the DOJ and the FTC if certain thresholds are met

- Foreign premerger notification requirements

- Section 7 of the Clayton Act, 15 U.S.C. § 18
  - Prohibits certain mergers and acquisitions and interlocking directorates
  - Allows private rights of action

- Section 5 of the Federal Trade Commission Act, 15 U.S.C. § 45
  - Prohibits certain mergers and acquisitions

HSR: SIZE OF TRANSACTION TEST

- Financing rounds may require certain investors to submit HSR premerger notifications to the DOJ and FTC and await expiration of the 30 day HSR waiting period before closing.

- HSR can be triggered by an acquirer obtaining holdings valued above a monetary threshold, which is $111.4 million in 2023 (adjusted annually for changes in nominal GNP).

- The size of transaction is based on the sum of the value of voting securities to be acquired plus those already held of the issuer.

- Where the size of transaction does not exceed a higher threshold ($445.5 million in 2023), HSR will be triggered only if each party independently meets a "size of person" test. For example, if the issuer (together with any parent entity) lacks the requisite assets or sales revenue (on a worldwide basis), no filing is required, even if the acquiring entity (together with any parent entity) meets the requisite value of assets or sales revenue.

HSR: SIZE OF PERSON TEST

- One party must have total assets or annual net sales of $222.7 million or more.
- The other party must have total assets or annual net sales of $22.3 million or more, but if the acquired party is not engaged in manufacturing, it must have annual net sales of $222.7 million or more or total assets of $22.3 million.
- Note that these thresholds apply to the size of the parties, and not merely to the size of the acquiring entity and the acquired entity, so it is necessary to look to the ultimate parent entity of each and include all entities controlled by it.
- These thresholds are adjusted annually for changes in nominal GNP, with the next adjustment likely to occur around February 2024.

HSR: POTENTIAL EXEMPTIONS

- Where HSR size thresholds are met, a transaction may nonetheless be exempt from HSR requirements. For example, certain acquisitions of shares of foreign issuers that lack a significant nexus (assets/sales) with the US
- Note that an acquisition of non-corporate interests (such as LLC interests and similar interests in non-US entities) cannot trigger HSR unless "control" of the entity is obtained. In the case of non-corporate interest, "control" is defined as the right to 50% or more of such entity's profits or assets upon dissolution.
- There is an HSR exemption for acquisitions "solely for the purpose of investment" that result in holdings of 10% or less of an issuer. Because the exemption is construed very narrowly as requiring purely passive intent with no intention of participating in the basic business decisions of the issuer, it is generally not relied upon for venture investments.
- The DOJ/FTC may extend the HSR waiting period by issuing a "second request" to enable such agencies to review the deal's competitive impact.
  - Complying with a second request is expensive and time consuming.

HSR: CIVIL PENALTIES

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- Potential penalties for failing to file are substantial: a maximum of $50,120 per day of the violation as of 2022 (subject to automatic annual inflation adjustment) in addition to negative publicity.
- To date, all of the agencies' roughly 60 HSR violation cases have settled before trial. In almost every case, the underlying transaction was not challenged as a substantive antitrust violation.
- The agencies typically have not sought penalties for a first violation that is technical, seemingly inadvertent, and subsequently self reported. Nevertheless, sophisticated investors have paid significant penalties for second such HSR violations involving minority stock acquisitions.
  - Recent examples include: Berkshire Hathaway ($896,000), MacAndrews & Forbes ($720,000), and John Malone ($1.4 million).
- And the agencies have sought and obtained penalties as high as $11 million for minority acquisitions that were not viewed as inadvertent (e.g., ValueAct).

CLEAN TEAM AGREEMENTS

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For strategic acquisitions or where there is a competitive overlap or competitively sensitive information is being shared as part of due diligence:

- Determine whether a Clean Team Agreement (CTA) is needed, what kind, and customize if/as needed
- Review documents before sharing with the other side – should there be a clean team / clean room?
  - Competitively Sensitive Information (CSI) is any non-public information that may allow one party to predict the other party's pricing or output strategies or influence its own competitive decisions.
  - CSI is current or future prices, fee schedules, pricing policies, pricing formulas, plans or other competitive terms of sale (e.g., financing) regarding a company's products.
- Not just a process. This really matters.
  - https://www.ftc.gov/news-events/blogs/competition-matters/2018/03/avoiding-antitrustpitfalls-during-pre-merger
  - Penalty for inappropriate sharing of information same as for gun jumping: up to $50,120 per day
  - Reputational risk with agencies and delay of transaction as agency may be sidetracked by investigating information sharing
  - Improper information sharing can also violate Sherman 1 and FTC Section 5

RISK SHIFTING PROVISIONS IN MERGER AGREEMENTS

- Antitrust risk management and allocation - key negotiating point

- Efforts Clauses
  - Hell or High Water
  - Best Efforts
  - Reasonable Best Efforts

- Litigation and Divestitures

- Break-up and Reverse Break-Up Fees

PREVENTING BAD/UNHELPFUL DOCUMENTS

- Issue is not document management, it's document creation
- Assume agencies will see every relevant document
- Ensure consistency across internal and external documents
- Control document creation by company and allies
- Train business people
  - How to avoid creating bad documents
    - Some communications are better made by phone or in person
  - How to create good documents
  - Writing emails creates a permanent record (good and bad)
- Recent DOJ/FTC challenges highlight internal "bad" documents about the proposed deal
  - DOJ complaint challenging Visa/Plaid (Nov. 2020) stated: "By acquiring Plaid, Visa would eliminate a nascent competitive threat"

AFTER THE DEAL IS SIGNED

- Strict rules on role of buyer between signing and closing
- Buyer must avoid exercising control – “gun jumping”
- Much more ”shades of gray” than “black and white”
- Strikes most business people as counter-intuitive
- Purchase Agreement will have carve outs from “ordinary course” decisions
  - Those need to be drafted with gun jumping in mind
- Seek antitrust experts’ guidance for:
  - press statements
  - internal messaging
  - external/customer messaging – trade shows
  - joint sales calls?

M&A-RELATED ENFORCEMENT TRENDS & DEVELOPMENTS

- Suspension of Early Termination and “Close at Own Risk” Letters
  - In February 2021, citing the change in administration and high volume of filings, FTC, with DOJ’s support, announced a temporary suspension of granting early terminations of the HSR waiting period while FTC reviewed its procedures for granting early termination
  - FTC subsequently announced that for transactions where it had not been able to fully investigate during the HSR waiting period, FTC would issue letters warning the parties that FTC had an ongoing investigation and that the parties may close “at their own risk.”

- Prior Notice & Approval
  - FTC reinstated a historical policy to include language in merger settlements that require prior notice and approval of further transactions in the relevant market, even if they would not otherwise be reportable under the HSR Act

- Asserting Greater Control Over Divestiture Buyers
  - FTC stated it would require buyers of assets divested as part of a merger consent decree to become a party to the consent agreement for purposes of requiring buyers to seek prior approval of any future sale of those assets for a minimum number of years.

M&A-RELATED ENFORCEMENT TRENDS & DEVELOPMENTS

- In February 2023, DOJ withdrew its nearly 30-year-old guidance on information exchanges in the healthcare industry, including the "safety zone" for benchmarking that the antitrust agencies had suggested also applied to participants in other industries.
- In July 2023, FTC and DOJ proposed an overhaul of merger review process with proposed major changes to HSR filing requirements and their Merger Guidelines.
- The proposed revisions to the HSR filing process would require parties to submit drastically more information, and different types of information, than parties are currently required to submit with an HSR filing.
  - If these proposed changes go into effect through the requisite notice and comment rulemaking process, companies should except to expend significantly more resources on HSR filings, even for deals with no overlap.
- The proposed Merger Guidelines reflect this Administration’s aggressive view of mergers generally and provides a roadmap for how the Antitrust Agencies will analyze a proposed transaction involving actual or potential competitors.

M&A-RELATED ENFORCEMENT TRENDS & DEVELOPMENTS

- There are 13 new proposed Merger Guidelines, which now cover vertical and horizonal mergers in one document for the first time.
- The most significant changes reflected in the new proposed Merger Guidelines include:
  - Lowering the mathematical threshold (Herfindahl-Hirschman Index (HHI) value) for finding that a market is concentrated and permissible increases to HHI resulting from a merger.
  - Presumption of anticompetitive merger where the combined market share is more than 30 percent regardless of the overall level of concentration in the relevant market.
  - Increased focus on the elimination of nascent competitors or potential new entrants through acquisitions.
  - Greater attention to how deals will affect various points in the supply chain, including labor markets.
  - The impact of minority acquisitions on a given market and the potential for improper collusion between the minority owner and the company.

ANTITRUST CONSIDERATIONS: CONCLUSIONS

- Engage antitrust counsel early on in the process.
- During the diligence phase, remain mindful of sharing competitively sensitive information and implement clean rooms/clean teams, as needed.
- Consider whether the transaction would trigger higher scrutiny, and therefore will require a longer review by the Antitrust Agencies, which would impact the cut-off date and risk shifting provisions in agreements.
- Maintain internal controls that protect against improper information sharing.
- Be mindful of the interlocking directorship prohibition for minority investments.

TRADE AND NATIONAL SECURITY CONSIDERATIONS

KEY INTERNATIONAL TRADE REGULATIONS

- Import Regulations
- Export Regulations
- Economic Sanctions (OFAC)
- Anti-Boycott laws
- Anti-Corruption and Anti-Bribery Laws (FCPA and UK Bribery Act)
- CFIUS

KEY INTERNATIONAL TRADE REGULATIONS' RISKS

- Understand potential risks
  - Legal compliance requirements and penalties for violations
  - Reputational risk
  - Economic and political risk

MOST COMMON CFIUS QUESTIONS

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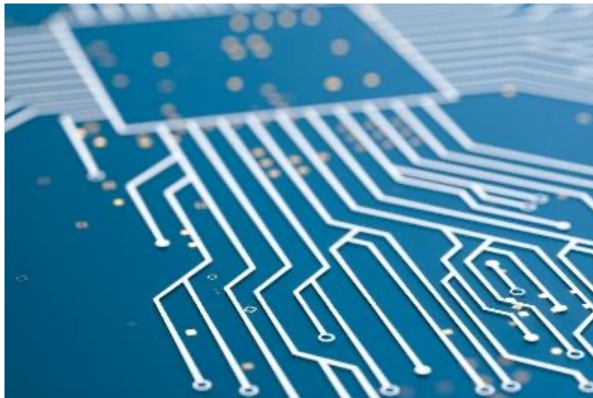
- What Happens if the Parties Do Not Make the CFIUS Filing?
- Are There Penalties?
- What Is the Mandatory Declaration?
- Is There an Exception for Certain Countries?
- What if We Are Going to Be Limited Partners?
- What Should I Learn About the Target Company That Might Signal if an Investment Could Trigger a CFIUS Review?
- What Do I Need to Know About My Company to See if It Has a CFIUS Issue?
- What Is the Difference Between the Short Form (Declaration) and the Long Form (Notice)?

DUE DILIGENCE

- Nature of business
- Does the Company have relevant and appropriate anti-corruption and trade control policies?
- What goods, technology, services does the company have?
- Nature of Customers



DUE DILIGENCE

- Tailor diligence questions to the risk posed by the business
  - Are there government or military customers (increased corruption risk, export controls)?
  - High risk jurisdiction (increased corruption and sanctions risk)?
  - Does the business understand U.S. compliance requirements?
  - Is the business U.S. or foreign?

- Increased scrutiny by investors and insurers

OFAC RECOMMENDED COMPLIANCE FRAMEWORK

<u>Five essential components for compliance</u>:

- **Management commitment** to compliance
  - Review and endorse policies
  - Provide adequate resources
  - Delegate autonomy
  - Appoint dedicated compliance officer
- **Risk assessment**
  - Evaluate exposure to sanctions, minimize risks
- **Internal controls**
  - Conduct sufficient due diligence
  - Identify red flags
- **Testing/auditing** of controls
- **Training**
  - Provide knowledge
  - Communicate responsibility
  - Hold accountable

NEGOTIATING AGREEMENTS

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- Tailor trade compliance representations to address risks
- Consider indemnities if concerns remain
- Review R&W insurance
  - Many policies explicitly exclude anti-corruption, sanctions, and export violations

CLOSING AND POST-CLOSING

- For foreign companies especially, ensure that legal trade with U.S. prohibited parties is terminated prior to closing
- Trade compliance integration is key
- Audit suppliers, customers, distributors, other agents based on risk profile
- Review import and export classifications where appropriate

COMPLIANCE BEST PRACTICES – PRACTICAL TIPS

- Review and assess for OFAC risk all company operations and contacts with non-U.S. individuals, entities, and locations.
- Know your customer and complete thorough due diligence
- Perform restricted party and destination screenings of all parties to transactions.
- Prior to authorizing or completing transactions, review all available information about parties, including names, addresses, telephone numbers, email addresses, and, IP addresses.
- Provide training and compliance materials to employees to prevent violations.
- Block online users from sanctions destinations, as necessary.
- Impose trade obligations on other parties in transactions – SHARE THE RISK!