

# Nuts & Bolts of M&A

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# Agenda

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- Hypothetical: Introducing Target Co.
- Overview of the Players and the Process
- Board Considerations
- Confidentiality and Due Diligence
- Deal Structures
- Client's Bid for Target Co.
- Representations and Warranties Insurance
- Form of Consideration
- Definitive Agreement
- Earn-Outs
- Employee Issues
- Regulatory Considerations



# Hypothetical: Introducing Target Co

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- Target Co., a Delaware corp., is a U.S.-based company that manufactures durable paneling for military and civilian use
- Target Co. is owned as follows:
  - 55% - private equity sponsor (PES)
  - 25% - founder and founder's children and their trusts
  - 10% - management and employees
  - 10% - others (including rollover shareholders from prior acquisitions)
- Target Co is a direct competitor of Client. Client is a Delaware corporation whose common stock is traded on the NYSE
- Target Co has engaged XYZ investment bank to run a sale process. Client has been invited to participate in the process
- Client believes that Target Co will transact for between \$100 - \$125 million, which represents a 6-7x multiple of Target Co's EBITDA. Client is planning to bid for Target Co. on a cash free/ debt free basis and will pay the purchase price with a mix of cash and common stock



# The Players

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- Board(s)
- Deal Teams for Buyer / Seller
- Controlling Shareholders
- Investment Bankers for Buyers/Sellers
- Outside Counsel to Buyers/Sellers
- Significant Other Third Parties
  - Lenders and their Counsel
  - Regulators
  - R&W Insurance Underwriters
  - Material Customers / Vendors



# The Auction Process for Target Co

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- Teaser
- Confidentiality Agreements
- CIM / Due Diligence
- Indications of Interest
- Management Presentations / Additional Due Diligence
- Letters of Intent and Exclusivity
- Negotiating Definitive Agreements
- Signing
- Regulatory Approvals and Other Third Party Consents
- Closing

# Board Considerations

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- Business Judgement - presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company
- Revlon – if the board decides to embark on a transaction that will result in a change of control, the board must undertake a process reasonably designed to maximize value to shareholders
- Entire fairness – requires the board to demonstrate both a fair process and a fair price



# Confidentiality Agreement

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- Prohibits Buyer's disclosure or use of Seller's confidential information other than for the specified purpose and subject to customary exceptions
- Scope of "Representatives" (counsel, financial and accounting advisors, financing sources)
- Customary period of confidentiality – 1-3 years (except trade secrets)
- Non-solicitation of Seller's employees. Customary time period is 1-2 years.
  - FTC and DOJ Guidance for HR Professionals – "Naked wage-fixing or no-poaching agreements among employers ... are per se illegal under the antitrust laws. That means that if the agreement is separate from or not reasonably necessary to a larger legitimate collaboration between the employers, the agreement is deemed illegal without any inquiry into its competitive effects. ..."
- In-house counsel should have a process to coordinate non-solicitation obligations between HR and legal



# Due Diligence; Competitive Issues

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- Purpose and scope of Buyer's due diligence – Buyer wants to identify any problems and test and confirm its assumptions about the target. Important to have a comprehensive, organized response
- Diligence is often bifurcated with financial, economic and product diligence undertaken earlier in the process to confirm Buyer's economic assumptions regarding the transaction, with legal and other confirmatory diligence undertaken after a letter of intent has been signed
- The exchange of information between two competitors may violate various antitrust laws, including Section 1 of the Sherman Act, which prohibits agreements in restraint of trade, such as competitors colluding in the pricing of products, and Section 5 of the FTC Act, which prohibits unfair methods of competition and deceptive acts or practices
- If the transaction is reviewed, regulators will look carefully at information sharing to determine whether there has been illegal or inappropriate sharing of competitively sensitive information



# Due Diligence; Competitive Issues Continued

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- Competitively sensitive information may include sales and promotional plans, pricing data, strategic plans, customer and supplier information, product performance data, R&D plans, cost data, and plant and/or equipment performance data
- Target should segregate competitively sensitive information from other materials and provide limited access
- Buyer should consider (i) using a third party consultant or creating a “clean team” to review competitively sensitive information and (ii) entering into a clean team agreement with the target
- The clean team should exclude persons who are (i) involved in the day to day operations of buyer’s competing program, (ii) directly responsible for the persons referenced in clause (i), and (iii) responsible for competitive decision-making for the competitive program (i.e., pricing, marketing, or other operational or strategic details)
- Clean team can provide findings in high-level or summary form (which should be reviewed by legal before begin transmitted internally)



# Common Private Deal Structures

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- Sale of Assets
- Sale of Stock
- Merger

# Sale of Assets

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- Often preferred by Buyers
- Method for acquiring (a) all or substantially all of the assets of Seller, (b) select assets of Seller or (c) a division of Seller
- Useful in acquiring distressed companies or companies with significant liabilities because, with limitations, liabilities remain with Seller unless assumed by Buyer
- Tax:
  - Good for Buyer – Buyer gets stepped-up tax basis in assets acquired
  - Bad for Seller – If Seller is a C-corp, result is two levels of tax for Seller's stockholders
- Approvals:
  - Board approval and stockholder approval (generally a majority required)
  - Third-party consents to assign contracts (for government contracts, novation required)

# Sale of Stock

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- Often preferred by Sellers
- Method for acquiring (a) all or part of the stock of a closely-held private company or (b) a subsidiary of a public company
- Assets and liabilities remain within the legal entity (target) and Buyer becomes the owner of target
- Need all stockholders to be a party to the purchase agreement – therefore, can be impractical if large number of stockholders
- Tax:
  - Buyer receives purchase price basis in the stock
  - Target's basis in its assets does not change. For stepped-up basis in target's assets (note: gross-up of Seller incremental taxes likely required):
    1. Partnerships – treated as a purchase of assets for federal tax purposes
    2. S-corps - 338(h)(10) election or F Reorg
    3. Separate elections for state tax purposes (if required)
  - If target is a C-corp, avoids double taxation for Sellers



# Merger

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- Method for acquiring a public company or a private company with a large number of stockholders
- Governed by state law and statutory requirements vary from state to state
- All assets and liabilities of business transfer to Buyer
- Approvals:
  - Board approval and stockholder approval (generally, majority or two-thirds)
  - Compared to stock purchase, minority stockholders cannot block a merger but can exercise statutory appraisal rights
- Can be tax-free, depending on the type of consideration



# Client's Bid for Target Co.

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- Letter of Intent
  - Summary of principal terms (\$120 million enterprise value, determined on a cash free, debt-free basis with a normalized level of working capital, structured as a merger, management to be offered employment agreements) – non-binding
  - Binding provisions:
    - Exclusivity
    - Due diligence access
- Mark-up of Auction Draft Purchase Agreement or Memo
- Client has decided to obtain a representations and warranties insurance policy



# Representation and Warranty Insurance – Overview

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- Shifts indemnification risk to third-party insurance providers
- Provides coverage (either directly to buyer or to seller for claims asserted by buyer) for losses arising from breaches of seller's representations and warranties in the definitive purchase agreement, subject to negotiated exclusions
- Seller benefits with a cleaner exit from the business and receives more of the sale proceeds at closing by reducing/eliminating the need for an escrow or holdback
- Buyer benefits with a more competitive bid in a competitive auction, having a credible source of recovery for losses with clearly defined procedures, and preserving the relationship with the seller(s) (e.g., management of target, rollover sellers)

# Representation and Warranty Insurance – Underwriting Process for a Buy-side Policy

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- Buyer will engage an insurance broker to receive preliminary indications (usually based on an initial draft of the definitive agreement)
- Broker will negotiate on behalf of Buyer to firm-up indications
- Buyer will select an underwriter and negotiate a non-binding indication letter (NBIL). Buyer's counsel will negotiate the policy and provide diligence materials and memos (e.g., quality of earnings, tax analysis, legal due diligence memo) to the underwriter
- Underwriting calls with advisors
- Underwriter will propose exclusions from coverage
- Buyer will conduct additional diligence and/or negotiate exclusions and finalize the policy



# Representation and Warranty Insurance – Economics

Item	Terms	Target Co Example*
Coverage	10% – 15% of EV	10% of EV (\$12 million)
Premium; Underwriting Fee	Premium: 2-4% of coverage; Fees \$30K - \$40K	Premium: 3% (\$360K) + \$40K = \$400K
Other Fees	Broker fees (varies) and taxes and related fees (~4% of premium)	Commission: \$40K + \$14.4K taxes = \$54.4
Retention	0.5% - 1.0% of EV; drops down after 12 months	0.8% of EV (\$960K); drops to 0.4% after 12 months (\$480K)
Survival	3 years general 6 years for fundamental + pre-closing tax indemnity	Same

- Client to obtain buy-side policy. Assumes Client bid for Target Co is \$120 million on a cash free / debt free basis



# Form of Consideration – Target Co Bid

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- Client has agreed to purchase Target Co for \$80 million of cash (balance sheet cash + drawdown from buyer's credit facility) and common stock with an initial value of \$40 million
- Common stock will be issued pursuant to Regulation D in an offering exempt from registration under the Securities Act. Target Co. shareholders who are not “accredited investors” will receive cash in lieu of shares
- Client will undertake to register the shares post-closing
- A bifurcated signing and closing will be needed. The parties will need to determine how to address changes in Client's stock price during interim period



# Definitive Agreement - Purchase Price Adjustments

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- Used to sync present assumptions with present performance and to ensure that Seller preserves its financial condition during the transaction negotiation process
- Adjustment done at closing based on estimates and verified by post-closing audit
- Two Common Types of Adjustments
  - NWC v. Net Assets
    - Net Working Capital = current assets – current liabilities
      - ✓ More commonly used for non-industrial businesses (e.g., service companies) or those without significant hard assets
    - Net Assets = total assets – total liabilities
      - ✓ More commonly used for industrial businesses or those with significant hard assets
  - Treatment of Existing Debt
    - Buyer assumes indebtedness and adjusts purchase price. Lender consent needed
    - Buyer pays off indebtedness at closing and adjusts purchase price. Payoff letter needed



# Definitive Agreement - Reps and Warranties

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- Representations and warranties are statements of fact about the business being sold
- Areas covered: Financial statements, liabilities, environmental, material contracts, litigation, employees, tax, intellectual property, asset quality, customers, suppliers, etc.
- Potential source of liability through Buyer's indemnification remedy
- Also serve a due diligence function as exceptions are set forth in the Disclosure Schedules
- Impacts allocation of risk

# Definitive Agreement - Timing for Closing

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- Transactions often structured as either simultaneous sign and close or signing with delayed close
- Considerations for using simultaneous sign and close approach
  - Usually faster process, with less delays
  - No interim period risk – parties are not bound to transaction until moment everyone is ready to close
  - Usually not a workable approach if significant governmental or third party consents or conditions are required to complete transaction
- Considerations for using initial signing with delayed close
  - Use of this approach is often driven by desire to have binding deal agreed to in advance of approaching government or third parties for approvals (i.e. HSR filing, regulatory license transfer, significant customer or supplier contract assignment) or completion of certain conditions (obtaining financing, union negotiations, completion of financial audit, discussions with key clients)
  - Need to understand and allocate interim period risk – when can parties get out of the deal if facts or circumstances change in the interim?
  - Need to understand potential length of delay period



# Definitive Agreement - Covenants

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- Sets forth the parties' obligations between signing and closing and post-closing
- Key pre-closing covenants
  - Diligence Access
  - Operating in the ordinary course
  - Satisfaction of conditions / notification of breaches
  - Exclusivity
- Key post-closing covenants
  - Cooperation / Transition
  - Noncompetition Agreements
  - Confidentiality



# Definitive Agreement - Conditions

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- Conditions that must be satisfied prior to a party being obligated to close the transaction
- Heavily negotiated
- Key conditions
  - Accuracy of representations and warranties (bring-down certification)
  - Performance of covenants
  - No litigation re: transaction
  - Material Adverse Changes (“MAC”)
  - 3rd party consents (e.g. landlord consents and estoppels)
  - Government consents (e.g. HSR)
  - Employment Agreements
  - Due Diligence
  - Financing
  - Legal Opinions
  - Other deliverables (good standing, certified charter documents)



# Indemnification

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- Buyer's remedy to seek recourse against Seller for losses suffered as a result of violations of the acquisition agreement
- Often used to recoup losses from (a) breaches of reps or covenants and (b) special indemnities
- Consider joint and several vs. individual (and not joint) liability among stockholders
- Common limits:
  - Caps
  - Thresholds or deductibles
  - Survival period for representations and warranties
- Fraud typically be carved out from any limitations
- Fundamental and regulatory reps are also often carved out from limitations





# Survival Periods for Reps and Warranties

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- How long does Buyer have to determine that a representation or warranty was inaccurate?
- Differing survival periods based on types of representations and warranties:
  - Operational matters (e.g., contracts, litigation, customers, suppliers, financial statements) – 1 to 2 years; Buyer will want to get through at least one full audit cycle
  - Regulatory matters (e.g., environmental, employee benefits, taxes, intellectual property) – statute of limitations or 5 to 7 years
  - Fundamental matters (e.g., authorization, capitalization, title to equity, title to assets) – forever



# A Surprise in the Target Co Transaction

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- Target Co. has subcontracts with 2 large defense contractors to manufacturer durable paneling to client specifications. This paneling is used on U.S. military vehicles
- Target Co has discovered that one of its employees is a non-U.S. person and may have been exposed to technical data controlled under a U.S. munitions list category. If such exposure occurred, it would constitute a violation of the International Traffic in Arms Regulations (ITAR)
- Target Co has submitted an initial notification of this issue to the Directorate of Defense Trade Controls and is undertaking a full internal review to determine whether an ITAR violation has occurred
- Client is concerned that Target Co. will lose its subcontracts and has determined to reprice the deal by lowering the cash payment by \$20 million and offering an earnout subject to the subcontracts being retained



# Earn-Outs

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- Used to sync present assumptions about the future with future performance. Earn-outs are deferred purchase price contingent on the performance of the company during a specified post-closing time period.
- Considerations:
  - Determine formula up front
  - Measure right kind of behavior (e.g., increases in revenue, EBITDA) and keep determination simple, clear
  - Avoid long earn-out periods (e.g., > two years)
  - Determine dispute resolution mechanisms
  - Determine acceleration triggers
  - Seller control issues



# Employee Issues

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- Confidentiality concerns prior to deal being announced
- Seller's concern about well-being of employees after the closing
- Employment agreements for key employees
- Retention bonus agreements



# Common Regulatory Considerations

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- HSR Pre-merger notification
  - Size of the transaction test - \$119.5 million
  - Size of the person test - \$222.7 million / \$23.9 million
- CFIUS Review
  - TIDs business: critical Technology, critical Infrastructure or sensitive personal Data
  - Mandatory filings for transactions involving a foreign investment in (i) a TIDs business if a foreign government holds a substantial interest in the investor and/or (ii) critical technology that would require a license (e.g., ITAR/EAR) to import, export or transfer the technology
- Federal Contractor Issues
  - Foreign ownership, control and influence (FOCI)
  - Organizational conflicts of interest (OCI)