

Deal or no deal

May the Force Be with You: practical advice for the legal department preparing a company for sale

November 7, 2019



Deal or no deal

May the Force Be with You: practical advice for the legal department preparing a company for sale

Panelists



Antony Walsh
Partner, UK



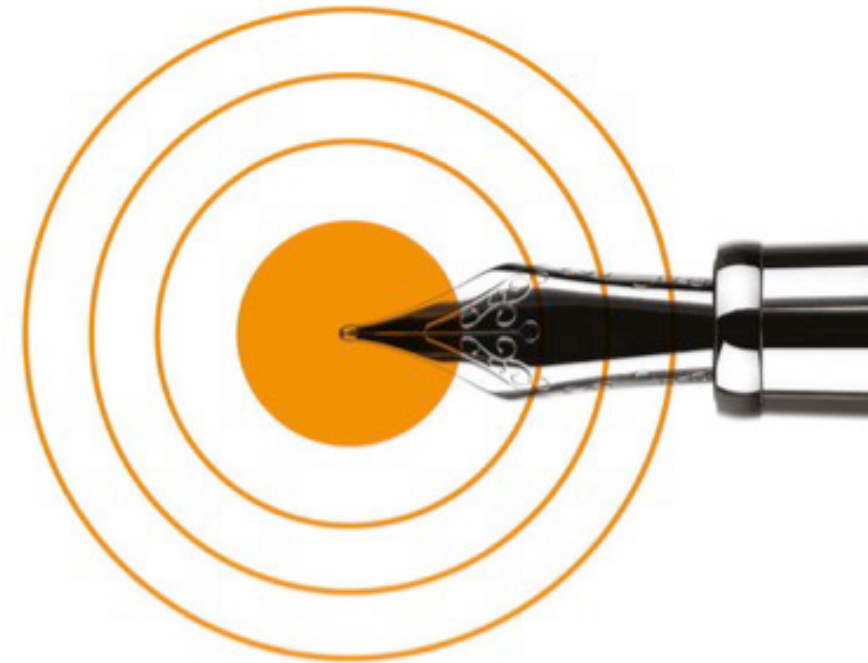
Taylor Kiessig
Partner, US



Kathleen Blaszk
Partner, US



Samantha Von Hoene
*Chief Legal Officer,
Enjoy Technology Inc.*



The global market



Current state of the global market

- **2018 saw a strong year for M&A; in 2019 M&A volumes have stabilized:**
 - first half 2019 aggregate global deal values down to US\$15.4bn vs US\$18.3bn in first half 2018
 - however US “megadeals” (greater than \$10 billion in size) continue to be a significant driver of activity in 2019 – deal value in North America was up 16% in H1 2019 despite volume being down 22%
 - cross-border “megadeal” volumes decline, potentially due to increased geopolitical tensions
 - energy and power sector (11%) and industrials (22.6%) show double digit value increases
 - public deal multiples down from a median of 13.7x (2018) to 13x in 2019, however, the average multiple paid for high-tech companies has increased from 14.1% in 2018 to 31.2% in 2019*



Structuring the deal



Structuring the deal

- what is being sold?
 - equity of an entity versus assets
 - if equity, what type is the tax classification of the entity (corporation, partnership, disregarded entity)?
- US v non-US
 - sale of non-US subsidiary presents additional complexity
- importance of modelling
 - what is the expected tax cost
 - will structure impact pricing (e.g., whether buyers will pay a premium for a deal that delivers a step up in the basis of the target assets)
- cash sale or open to alternatives?
 - buyer equity or JV
 - IPO
 - spin-off



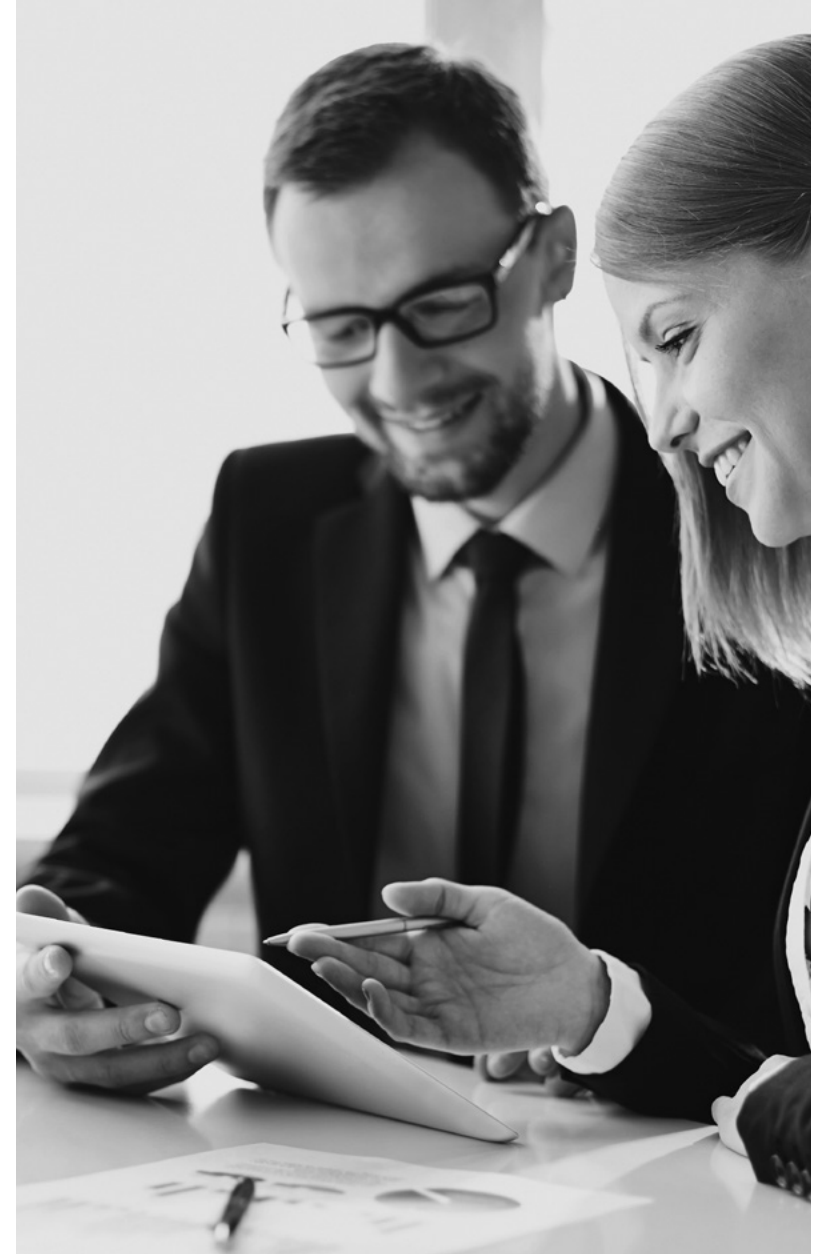
Structuring the deal

Acquisition of stock

- buyer gets cost basis in stock, no step-up in underlying assets
- seller likely has less gain – assuming a higher basis in stock
- target entity retains historic (tax and non-tax) liabilities
- Seller will generally prefer to sell stock

Acquisition of assets

- buyer gets cost basis in assets which can be amortized
- seller likely has more gain – assuming a higher basis in stock
 - in case of corporate seller, may have two levels of tax
- buyer generally does not take historic (tax and non-tax) liabilities
- buyer will general prefer to acquire assets



Structuring the deal

Deemed asset sales

- taxable forward merger
- Section 338(h)(10) and section 336(e) election
- purchase of equity in a pass-through entity

Impact of tax reform

- corporate rate reduced from 35% to 21%
- bonus depreciation
- interest limitation



Structuring the deal: to auction?

- **in most disposals, the seller will face two main routes to sale:**
 - holding an auction
 - negotiating a transaction with a single interested buyer
- **decision usually driven by the circumstances of the transaction:**
 - auction sales where there is a strategic, planned disposal and target company is anticipated to be highly sought after with multiple strong bidders
 - direct sales often responsive to opportunistic buyers, or following direct introduction via intermediaries
- **benefits of an auction sale process can include:**
 - creating competitive tension and maximizing price
 - giving seller control of the process
 - perfect scenario for R&W insurance to mitigate tail liabilities and other more seller-friendly terms (such as no survival, no indemnity, and locked box)
 - private equity bidders?
- **downsides of the auction sale process can include:**
 - transaction costs can be higher
 - opening the cupboard to multiple bidders - some bidders may not be serious and may be on 'fishing expeditions'
 - if the auction process does not result in a sale, this could have a negative effect of the target company's market perception
 - managing internal stakeholders
 - front-loading work streams (i.e. vendor due diligence)

Internal alignment



Aligning key stakeholders and your internal deal team

- **who will be working on the sale within the business, and how will confidentiality be managed?**
 - senior management team or a delegated committee
 - HR
 - internal tax and finance
 - commercial teams
- **who will be working on the sale outside the business as external advisors?**
 - likely that conversations with your bank/key investors will be undertaken relatively early
 - leverage trusted legal advisors/long standing relationships to build competitive tension in investment banks/financial advisors early in the process
- **communications protocol:**
 - who is the project manager?
 - who is ultimately responsible for delivering the transaction?
 - how will external advisors interact?
 - how will conflicting internal requirements be managed?
 - who will filter from external advisors to internal stakeholders?

Facilitating a smooth sale, minimizing risk and preserving value



Preparatory due diligence

Common issues and transaction 'threats' and how to disarm them

- **confirm your corporate records are complete and up to date**
 - confirm latest copies of bylaws and operating agreements
 - confirm location of all stock certificates
 - confirm target company(ies) are in good standing in their State of organization/formation and have good standings in each "foreign qualified" State
- **encumbrances and the processes to deal with them**
 - identify all outstanding indebtedness and liens on the target and assets. Buyer may likely expect all amounts be paid off at closing and all liens released
- **employee obstacles**
 - were benefits set up correctly (was 401K testing done as required)?
 - are there FLSA / employee categorization issues?
 - are there any employment claims outstanding including any EEOC claims?
- works councils and European consultation requirements triggered?
- **third party consents and impact on deal structure**
 - identify landlords, key customers, key suppliers, regulatory/licences (including governmental filings)
- **antitrust filings**
 - weaponization of antitrust and impact on transactions
- **litigation and claims**
 - current statuses, quanta, counsel opinions if significant?
 - covered by insurance?
- **joint ventures and strategic alliances**
 - do you need to get your partner on board?
- **approvals**
 - determine which internal corporate approvals (board and shareholder approvals) will be necessary and lead times for each

Vendor due diligence

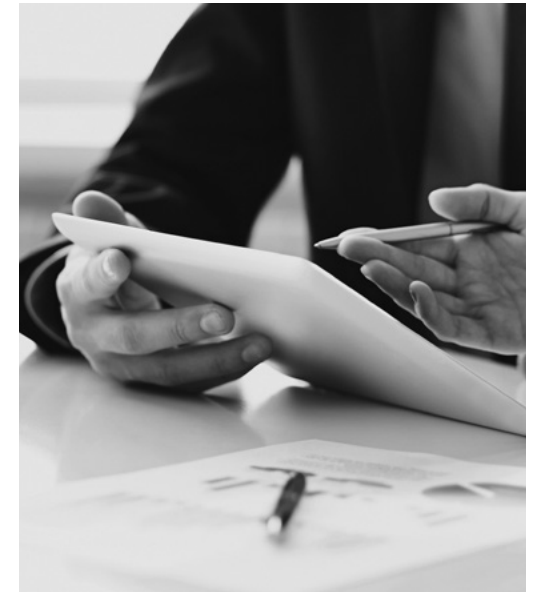
- Legal VDD uncommon in the US, but increasingly common in Europe
- Key benefits:
 - identifying and addressing potential issues or areas requiring improvement
 - identifying and consents or approvals required for sale
 - assisting in the preparation of any IM or other sale materials that will be provided to potential buyers
 - assisting with the eventual disclosure letter
 - familiarizing your advisors with your business, which may take work off your hands once the process is fully up and running
 - speed – facilitates auctions in particular
 - rep and warranty insurance



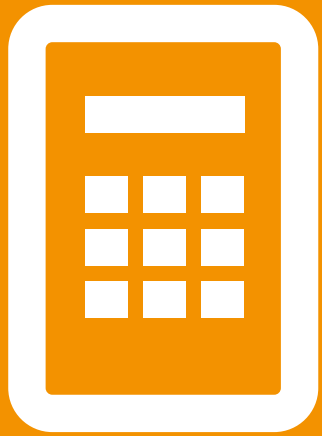
Separation anxiety

Consider and identify any separation issues that will need to be addressed before or at Closing if selling part of a Group

- often, non-sale assets and sale assets will be mixed between the sale perimeter and the retained group
- common examples of assets are IP rights and IT infrastructure, comingled/shared contracts, insurances and people
- where shared assets exist, you may need to put appropriate arrangements in place as part of a pre-sale restructure or as part of the transaction to ensure that:
 - the sale group will be able to operate both before and after Closing
 - your retained group will continue to own or have rights to use any assets required
- it is important to consult with tax advisors to ensure that any reorganization is tax efficient
- group-level services, such as legal, accounting, insurance or HR functions may also be in place. If so, the seller will need to consider whether or not a transition services agreement should be in place



A sellers' market?



Impact of a seller's market on transaction terms

Our Market Monitor is an annual review of Global M&A trends in the US, UK/Europe and Asia, based on a review of the 500+ deals we close each year, interviews with our global M&A Partners and an analysis of market trends and publically available information.

Key findings:



The continued rise of the locked box and other developments related to purchase price



Rep and warranty insurance has changed the M&A landscape



Convergence of European practices (but less so US)



Buyer's market has become a seller's market (in some sectors and for some targets)

Focus on the R&W insurance market



Zero recourse for the seller (ie buy-side policy)



\$1 liability cap



Policy enhancements extend the survival period for rep claims beyond those in the purchase agreement



Underwriting premium – generally 0.65% to 1.65% of the policy limit (which tends to be around 30% of consideration)



Excess/ retention/ deductible – 0.5% - 1% of EV (commonly lower) – generally excess only



R&W insurance deductible will generally drive the amount of the basket in a R&W insurance deal

Key terms comparison at a glance

	US	Europe	Asia
Purchase price adjustments	Purchase price adjustments are the norm, locked box is much less common	A more even split of purchase price adjustments and locked box deals, with locked box becoming more popular in the last decade	Purchase price adjustments are the norm. Locked box is much less common. Note: rare in Vietnam.
Deal conditionality	Risk only passes to the buyer on closing: <ul style="list-style-type: none"> – MAC – purchase price adjustment – reps and warranties materiality accurate at completion 	Negotiable (split signing and closing seen in only 43% of European deals, compared to 85% in the US)	The majority of deals in Asia Pacific are conditional (84%)
De minimis	Much less common in the US (35%)	Used in 72% of deals in the UK	Fairly common in Asia (74%), albeit rate in China (but becoming more common)
Basket/threshold	Occurs in almost all US deals (98%) 70% operate as “excess only” Tend to be lower than Europe (95% were 1% or less as % of consideration)	Basket/threshold limitation occurs in 68% of European deals First dollar recovery/tipping baskets are more common in Europe Less consistency in Europe re size of basket	Fairly common (rate in China and Vietnam but becoming more common) Tend to be higher than in US/Europe (about 1.0% of purchase price) First dollar recovery is more common than excess
Seller liability cap	95% have a cap of 25% or less of purchase price Cash escrow or hold back of 10%-15% of purchase price as security, which is often the same as the cap	40% of deals in Europe have cap of 25% or less; Escrows/hold backs less common	Usually negotiated down from 100% and ranges from 10-100%. Commonly 100% in Vietnam and Thailand, albeit in Thailand key warranties are often unlimited. In most countries, 20-50% is common for business and operational warranties.

Key terms comparison at a glance, continued

	US	Europe	Asia
Disclosure	Specific disclosure schedules Vendor due diligence is uncommon	General disclosure has become common Vendor due diligence reports often prepared, particularly for auction processes	General disclosure is increasingly common. Specific disclosure schedules is common. Vendor due diligence is becoming more popular. No consistency across countries in Asia.
Buyer's knowledge	Buyer knowledge limitations are not common Neither are reverse warranties "Sand-bagging" is negotiated	Buyer knowledge qualifies the warranties Buyers commonly give reverse warranties	Buyer knowledge limitations are rare in China, Japan, Thailand, Vietnam and Philippines, but fairly common in Hong Kong, Taiwan, Indonesia, Malaysia and Singapore. In Indonesia, buyer knowledge qualifies the warranties (but not the indemnities).
Materiality scrape	Buyer is entitled to disregard materiality qualifications in the reps for the purpose of establishing whether the de Minimis or basket thresholds have been met and calculating damages	Extremely rare in European deals	Commonly seen in deals across Asia, but often not quantified. Quantified amounts only in Thailand and Vietnam. Only specific warranties are quantified in Singapore (e.g. contract value).
Tax	Coverage for tax indemnity? New exclusions?	Synthetic tax indemnity?	Other than Singapore, China, Hong Kong and Japan, it is fairly common to have tax indemnity, which is usually included in the purchase agreement.

Preparing for third party due diligence



The data site and potential pitfalls

- often time consuming and potentially disruptive exercise
- general disclosure of data room?
- two main approaches that can be taken to structuring the due diligence process:
 - seller provides due diligence information in response to buyer-initiated information request
 - seller pre-determines at the outset of the sale process the due diligence material that will be made available to the buyer (i.e., auctions)
- be aware of and consider restrictions on sharing information with the buyer, for example:
 - confidentiality obligations owed to a third party?
 - personal data (i.e., GDPR)
- antitrust considerations where trader buyers are concerned – antitrust law may restrict the disclosure of commercially sensitive information – clean teams?
- disclosure of litigation - avoid waiving privilege!
- consider how to treat commercially sensitive information:
 - phased approach to due diligence exercise?
 - redacting?
 - summaries (rather than copies) of commercially sensitive documents
 - restricting the user's ability to copy, download or print any commercially sensitive documents in the data site
 - data site rules?

Alternative exit strategies



IPOs

- not all companies suitable for taking public - given the cost (both of the IPO process and ongoing compliance costs) and increased regulatory and reporting burdens
- advantages of an IPO as a form of exit/investment:
 - ability to fully exit, or potentially retain some equity as an active (or passive?) investor
 - enhanced ability to raise capital via access to investors
 - increased public awareness/prestige
 - ability to (part) fund acquisitions with stock
 - ability to incentivise employees with stock options
- disadvantages of going public:
 - level of regulation and degree of disclosure
 - cost
 - subject to market confidence to an extent
 - potential lock-in if you retain any shares
 - volatile markets
- the process
 - many elements similar to a straight sale: possibility of a “dual-track” process
 - still required internal due diligence and ‘problem solving’
 - restructuring both the business and potentially share capital to be suitable to float
 - appointment of advisors (more than in a sale)
 - putting appropriate management in place on appropriate terms
 - choosing a market and building a book

Private equity

- private equity 'dry powder' at record levels, often very competitive bidders in auction processes
- similar to other sale transactions, but there are key differences:
 - PE buyers are more familiar R&W insurance and PE sellers likely to insist on it
 - management likely to receive equity in buyer vehicle to align incentives (i.e., share in the upside at exit)
 - more likely to be a seller 'roll over' or reinvestment in the buyer vehicle which will require separate legal and tax advice
 - an "investment agreement" will be required setting out the rights of the investors and management;
 - while it is likely that management will retain everyday 'ordinary course of business' control, the PE firm will appoint an investor director to the board (who typically has relevant sector expertise and experience) and will (assuming a majority investment) have the final say on key business and strategic decisions
- certain PE firms may have a reputation for replacing original management more readily than others in their investments
- PE firms often have a differing risk profile to trade buyers, and may be more pragmatic on certain matters (or less on others!)
- likely to be a greater element of tax planning and structuring (typically) in a private equity led transaction
- the PE firm will inevitably be seeking an exit of its own in 3-5 years time, leading to a different growth dynamic post-Closing

Spin-offs

- what is a spin-off?
- why spin?
 - some companies want to get rid of a weak or low-margin division that is detracting attention from the parent
 - some companies seeking buyers for parts of their business are not getting good offers from other firms, or from private equity, and so choose to Spin (i.e. Foster's Group spinoff of Treasury Wine Estates)
 - shareholder activism and the concept of the "Conglomerate discount" (the Economist) - "stockmarkets value a diversified group at less than the sum of its parts"
- how do spin-offs perform?
 - since 2003, the Bloomberg spin-off Index has generated a total return of 1,030%, versus 194% for the S&P 500 Index
 - for the 10-year period, the Bloomberg spin-off Index has appreciated 342% (versus 154% for the S&P 500 Index)
 - over the three years to 2018 the spin index is up 60% versus 35% for the S&P 500
- tax is central
 - a spin-off may be tax-free, but if the applicable requirements are not satisfied, a spin-off will be taxable to both the distributing corporation and the shareholders receiving the distributed corporation



Conclusion



Conclusion

- Preparing for sale requires a potentially significant time investment (on top of the day job!)
- Internal alignment of key stakeholders early in the process is fundamental
- Various ways to achieve a disposal – consider what works best for you in terms of structure, the market and likely demand for the target
- Do not underestimate the data site and due diligence process
- Be alive to curveballs
- Consider potential alternative exit structures: a straight stock sale may not always be your best route



Deal or no deal

May the Force Be with You: practical advice for the legal department preparing a company for sale

Questions



eversheds-sutherland.com

© Eversheds Sutherland 2019. All rights reserved.
Eversheds Sutherland (International) LLP and Eversheds Sutherland (US) LLP
are part of a global legal practice, operating through various separate and
distinct legal entities, under Eversheds Sutherland. For a full description of
the structure and a list of offices, please visit www.eversheds-sutherland.com
DTUK002871_10/19

