



# M&A TRANSACTIONS AND RELATED HOT TOPICS

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# AGENDA

- Tax
- SPACS/IPOs
- Delaware Update
- Specific Issues in M&A Transactions



TAX

# CURRENT TAX REFORM/BUDGET STATUS

- Bipartisan infrastructure package potentially coming up for a vote this week, although no draft is yet available.
- Dems' reconciliation package – starting to converge on \$3.5T of spending, with \$2.2T of tax increases.
- May soon see a budget resolution providing high-level direction on spending and taxing levels, to be followed in the Fall with specific tax and spending legislation within the parameters of the budget resolution.

# KEY TAX REFORM PROPOSALS

- Corporate rate
  - Biden: Increase to 28%
  - Likely compromise (Manchin): Increase to 25%
- GILTI (Biden and Wyden)
  - Eliminate QBAI/NDTIR
  - Increase effective rate (Biden says to 21%; Wyden less specific)
- FDII
  - Biden: Repeal, replace with unspecified R&D incentives
  - Wyden: Consider modifying FDII to gear FDII benefit to proportion of worldwide R&D performed in the US; also eliminate QBAI and equalize rate with GILTI rate

# KEY PROPOSALS, CONT'D

- BEAT
  - Biden: Repeal, replace with OECD undertaxed payments rule (would not apply to US-based MNCs)
  - Wyden: Increase BEAT rate, restore domestic business tax credits, possibly amenable to restoring value of FTCs
- Other (Biden)
  - Anti-inversion measures (50% inversion line, additional inversion test in Greenbook based on management and control, decoupled from shareholder continuity, where US company was >50% of pre-deal FMV)
  - 15% minimum tax on book income (those with earnings of at least \$100m)

# BIDEN ADMINISTRATION'S CAPITAL GAINS PROPOSAL

- Long-term capital gains and qualified dividends of taxpayers with adjusted gross income of more than \$1 million would be taxed at ordinary income tax rates, with 39.6% generally being the new top marginal rate (43.4% including the net investment income tax).
  - Sen. Joe Manchin pushing to cap increase at 28%.
- Effective for gains required to be recognized after the “date of announcement,” meaning April 28, 2021 (tied to an earlier administration release, a month prior to the Greenbook release).
- Doubtful that such a large and retroactive tax increase will make it through a closely divided Congress, but some increase seems realistic to expect, and some retroactivity (whether back to April 28, 2021 or to some other legislative milestone date yet to occur) cannot be ruled out.
- Biden also has proposed generally eliminating tax-free step-up in basis at death.



# IMPACT ON STRATEGIC M&A DEALS

- General push for quick transaction timelines to attempt to lock in current LTCG rates before any increase (assuming not retroactive).
- Some instances where Sellers have sought explicit tax-protection/gross-ups from Buyers to hedge against rate changes mid-transaction that impact Seller's expected tax burden from a transaction.
- If rate changes end up being effective starting Jan. 1, anticipate year end planning/bespoke structures (e.g., "busted" Section 351 contributions) to trigger gains in 2021.
- Some Sellers have begun seeking explicit payment for tax attributes/transaction tax deductions/NOLs again to increase transaction value.
  - Tax Indemnity Offset
  - Upfront purchase price adjustment
  - As and when realized

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# SPACS/IPO'S

# WHAT IS A SPAC?

- “Special purpose acquisition company” formed to acquire a business.
- Formed by “sponsor teams” with target industry experience demonstrating success in identifying, acquiring and operating growth businesses in that industry.
- SPAC raises money through an initial public offering (IPO) with the proceeds placed in trust only to be used for an acquisition.
- SPAC has generally up to 2 years to complete business combination, which allows SPACs time to identify targets.
- Shareholders of SPAC generally required to approve acquisition of target company.
- If public investors don’t like an acquisition target, public investor shares in SPAC are redeemed from the trust.

# ADVANTAGES OF SELLING TO A SPAC

- Allows for alternative exit opportunity for target companies, in addition to outright sale or IPO.
- Access to public markets and the ability to go public during periods of market instability.
- Accelerated timeline to go public compared to traditional IPO.
- Enjoy benefits of public company status.
  - Access to capital to fund operations and growth.
  - Stock to be used as currency for future acquisitions.
  - Broader use of equity compensation to align incentives.
- Unlike IPO, valuation negotiated and agreed at time of deal announcement.
- Ability for existing owners of company to share meaningfully in future growth with stock rollover that may not be available in a traditional exit.

# DISADVANTAGES OF SELLING TO A SPAC

- Dilution to target shareholders due to sponsor promote.
- Unlike an outright sale, target shareholders do not realize proceeds on 100% of equity, though generally greater proceeds to target shareholders than available to selling shareholders in traditional IPO.
- Target must be IPO ready.
- Market risk to closing the deal since shareholders of SPAC generally required to approve transaction.
- Limited recourse against SPAC whether or not the deal closes.
- Public disclosures regarding target financial results in proxy statement and post-closing as a public company.

# LEGAL AND REGULATORY CLIMATE

- Increased regulatory scrutiny and enforcement activity by the SEC.
- Recent SEC guidance on accounting for SPAC warrants caused a slowdown in SPAC IPO activity and temporary delay in deSPAC transactions that were subject to SEC review.
- Litigation risks have increased for SPACs and deSPAC companies:
  - Focus on target's projections in proxy statement.
  - Greater emphasis on due diligence process.
  - Further sensitivity with conflicts of interest or the appearance of conflicts of interest.
- D&O insurance costs for SPACs increasing.

# PARTING THOUGHTS ON THE SPAC MARKET

- SPAC IPOs have increased in size, as have deSPAC transactions.
- Continuing innovation in deal structures and terms.
- PIPE market will continue to be an important component of deSPAC transactions.
- Notwithstanding recent volatility and slowdown in SPAC IPO activity, deSPAC transactions will likely be a key driver to overall transaction volume in 2021.



# DELAWARE UPDATE



# M&A CONTRACT TERMS

- **Material Adverse Effect**

- Allocates risk of events between signing and closing that would have a substantial impact on the target—with company-specific risks allocated to target and general risks allocated to buyer.
- E.g.: *Any fact, event, etc. that is or would reasonably be expected to be material and adverse to the business, assets, . . . of the target, taken as whole, or that would or would reasonably be expected to prevent, materially delay, . . . the ability of target to close . . . .*
- Exceptions/carve-outs are included to shift risk to buyer, e.g., systemic events that do not have a disproportionate effect on target.

# M&A CONTRACT TERMS

- **Material Adverse Effect**
- Heavy burden of proof:
  - “significant” adverse effect on the business (qualitatively and quantitatively, e.g., >40% earnings decline may qualify, but there are cases where MAE not found with even greater losses); **and**
  - extending, or expected to extend, for a “durationally significant” period (measured in years, not months, i.e., not a short-term hiccup).
- MAE remains exceedingly difficult to prove, with only one successful case in Delaware (*Akorn Inc. v. Fresenius Kabi AG*)

# M&A CONTRACT TERMS

- *Snow Phipps Group, LLC v. KCAKE Acquisition, Inc.*
  - Following signing, target had precipitous revenue decline (40-60%) due to COVID-19, but ultimately ended the year with a 14% decline in revenue and 25% decline in EDITDA.
  - *Ruling:*
    - Absent specific agreement by the parties, adverse event must be consequential to the long-term earnings of the company, not a short-term hiccup.
    - Majority of revenue decline was due to countrywide government orders, which fell under the MAE exceptions for government orders, and such orders did not disproportionately affect target compared to others in its industry — important to this determination was the classification of target as being in the cake-decorating industry and not the grocery store industry.

# M&A CONTRACT TERMS

- *Bardy Diagnostics, Inc. v. Hill-Rom, Inc.*
  - Target's largest revenue source was selling and servicing its ambulatory electrocardiogram device to Medicare patients (29% of revenues). Following the signing, Medicare's reimbursement rate was reduced by 86%.
  - *Ruling:*
    - Decline in revenue constituted a significant adverse effect on the business — satisfying the first prong of the MAE test — but buyer failed to prove a reasonable expectation it would continue for a durationally significant period since the process of Medicare rate-setting was shown to be unpredictable and could increase in a commercially reasonable time.
    - MAE had an exception (broadly written in a way that captured changes to Medicare rate), which only applied if it did not have a materially disproportionate impact on target compared to other “similarly situated companies operating in the same industries or locations” — only one such company existed, and the court found that the new Medicare rate did not disproportionately impact target by comparison.

# M&A CONTRACT TERMS

- **Ordinary Course Covenant**
- Affirmative obligation to operate target, between signing and closing, in the ordinary course of business.
  - “Ordinary course” has been defined as “normal and ordinary routine of conducting business.”
  - Extraordinary events highlight what it means to operate in the ordinary course, i.e., ordinary course on a clear day or ordinary course in response to extraordinary events?
  - As with any contractual provision, the language will dictate interpretation, such as whether the obligation is flat or qualified by an “efforts” standard, or whether ordinary course is exclusively of target (i.e., past practice) or of comparable companies.

# M&A CONTRACT TERMS

- *AB Stable VIII LLC v. MAPS Hotels and Resorts One LLC*
  - Target, which had agreed to sell 15 hotels to buyer, sought specific performance to close when buyer indicated it was not willing to close. Buyer claimed target breached its covenant to only operate in the ordinary course of business consistent with past practice due to actions taken in response to COVID-19, such as closing 2 hotels and limiting operations at others.
  - *Ruling:*
    - Since there was no efforts-based qualification to the covenant, target was obligated to operate as it had in the past, as if there were no pandemic, even if its response to COVID-19 was reasonable.
    - Court cautioned that parties will be held to their contractual obligation, for better or worse, and if target wants flexibility in operations it should negotiate for that in the agreement, such as through an “efforts” standard or other modification.

# M&A CONTRACT TERMS

- *Snow Phipps Group, LLC v. KCAKE Acquisition, Inc.*
  - Following market uncertainty and revenue decline due to COVID-19, target borrowed from its revolving credit facility and cut costs, which buyer claimed was a breach of target's covenant to operate its business in a manner consistent with past custom and practice.
  - *Ruling:*
    - No breach of the covenant since (i) target had drawn on the facility five times in recent years, and target had notified buyer of the draw (buyer did not give target the opportunity to cure the alleged breach, as the agreement required) and because target never spent the funds (could have cured any breach), and (ii) target had a historic practice of cutting costs when sales declined.

# CONTROLLING STOCKHOLDER TRANSACTIONS

- **Standards of Review**

- *Business Judgment Rule*: Presumption that in making business decisions, corporate fiduciaries have acted without conflict, on a reasonably informed basis and in good-faith pursuit of the corporation's best interests.
- *Enhanced Scrutiny*: Intermediate standard of review that applies to specific situations like final-stage transactions, hostile takeovers, director-entrenching actions, or interfering with stockholder franchise; requires that defendant fiduciaries show that their motivations were proper and not selfish or in bad faith, and that their actions were reasonable.
- *Entire Fairness*: Highest standard; applies when fiduciaries have conflict of interest; requires defendants to demonstrate that the challenged transaction is both procedurally and substantively fair (fair process and fair price).



# CONTROLLING STOCKHOLDER TRANSACTIONS

- **Returning to Business Judgment Rule**
- Transactions that would otherwise be subject to entire fairness review may be returned to business judgment rule in certain circumstances.
- *Kahn v. M&F Worldwide Corp.*
  - Business judgment rule applies when a controlling stockholder transaction has *ab initio* been subject to (i) negotiation and approval by a special committee of independent directors and (ii) approval by an uncoerced, fully informed vote of a majority of the minority stockholders.
- *Corwin v. KKR Financial Holdings LLC*
  - In the absence of a controlling stockholder, the business judgment rule applies when a fully informed, uncoerced majority of the disinterested stockholders voted in favor of the challenged transaction.

# CONTROLLING STOCKHOLDER TRANSACTIONS

- Stockholders do not owe fiduciary duties, but “controlling stockholders” owe fiduciary duties in certain circumstances.
- *Controlling Stockholder* = (i) owns more than 50% of the voting power or (ii) owns less than 50% of the voting power (typically not an insignificant percentage) but exercises control over the business affairs of the corporation, either generally or with respect to a particular transaction.
  - When not a majority stockholder, control is a holistic inquiry: power to designate/remove directors, contractual consent rights, relationships with directors and officers, commercial relationships with customers or vendors of the company, influence over the board, etc.
- Minority stockholders can form a “control group,” with each having fiduciary duties.
  - Must be connected in legally significant way, e.g., contract, common ownership, agreement, etc., to work together toward shared goal.
  - More than a mere concurrence of self-interest among certain stockholders.

# CONTROLLING STOCKHOLDER TRANSACTIONS

- Recent noteworthy controlling stockholder cases:
  - *In re Tesla Motors Inc. Stockholder Litig.*
  - *In re Pattern Energy Grp. Inc. Stockholders Litig.*
  - *In re Tilray, Inc. Reorg. Litig.*
  - *In re GGP, Inc. Stockholder Litig.*



# SPECIFIC ISSUES IN M&A TRANSACTIONS

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- Antitrust environment
- Retention of key target employees
  - Consideration paid in the form of equity or cash that vests over time
  - Specific retention payments tied to remaining employed and/or acquired business hitting certain thresholds
  - PE buyer approach to retention/roll-over equity
- Non-solicits and Non-competes
  - Different views: VC-backed and PE-backed targets

# SPECIFIC ISSUES IN M&A TRANSACTIONS

- Earn-outs
  - A potential approach to bridge the valuation gap
- Representation and Warranty Insurance
  - Accepted and very standard indemnity approach; lag times for underwriting
  - No indemnity escrow becoming more common
- Transition Services
  - Non-solicit regarding seller's employees may be of importance depending on types of services being provided to buyer

# THANK YOU / QUESTIONS?

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