M&A Deals: Key Issues, Tips and Tactics

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This presentation outlines key issues investment bankers have identified as generating frequent client requests for banker input in negotiating M&A deals.

A. Issues Arising Prior to Definitive Agreements.

Is it better to use a letter of intent or an unsigned deal summary or to move directly to negotiate definitive agreements?

When parties first engage in merger talks, there is invariably an NDA exchanged, sometimes including a restriction against further shopping the target ("no shop") (which typically contains a "fiduciary out" clause permitting the target to engage in discussions with unsolicited superior offers).

The question then becomes whether the parties should

- prepare a signed letter of intent (LOI) or
- an unsigned summary of key deal terms or
- move directly to definitive agreements.

Public-private deals typically have a formal non-binding term sheet (including a binding no shop) that is signed prior to preparation of definitive documents. This gives the acquiror a limited period of time to conduct diligence (and thus the ability to walk away if not satisfied) while reducing the risk of a third party bidder. This also gives both parties sufficient certainty as to economics and key deal terms to be able to conclude they will reach agreement on definitive documents and thus that the expense of moving forward (and the risk to the target of taking itself off the market) is justified. A term sheet that is reasonably detailed on key economic points (exchange ratio, price adjustment and collar provisions, indemnity provisions) and walk-away rights (MAE out, no shop fiduciary out, key closing conditions and termination provisions) will also make it more likely that these tough issues will not derail the deal at the definitive agreement stage.

In *public-public deals*, normally the scope of representations and the need for due diligence are less critical, indemnity provisions are rare, and the main issues are economics, deal certainty and break up fees, so there is less benefit from a term sheet and it is more typical to move directly to the definitive agreement. The need to sign before a press leak and before any movement of the parties' relative trading prices that derails the deal also drives the parties directly to definitive documents. Finally, the execution of a term sheet, or even the preparation of a deal term summary or definitive agreement draft reflecting complete agreement on all key deal terms, can compel public disclosure of pending negotiations. For this reason, executed term sheets are rare in material deals involving public companies and the parties normally proceed directly to definitive agreements (often preceded by an unsigned deal summary). However, key economic terms are intentionally omitted from any such summary and early drafts of the definitive agreement to reduce the risk of being forced to disclose the deal negotiations.

Are buyer-friendly or target-friendly term sheets a better starting point?

Whether the buyer elects to serve up a one-sided or a "down-the-middle" term sheet or deal summary will often depend on negotiating style, perceived deal leverage (which often relates to the risk of other bidders) and the intensity of the desire of the CEOs to "get the deal done."

Examples of terms slanted in favor of the buyer:

- "Customary representations" (i.e., long for target, short for buyer, limited knowledge/materiality/MAE qualifiers)
- target indemnity provisions; no cap or basket

- escrow to secure indemnity; possible remedy beyond escrow amount/period
- survival of representations at least through escrow period, possibly longer
- voting agreements from target affiliates holding up to 35-45% of target; more if private?
- one-way "lock up" option to buy 19.9% of target at deal price if target supports other bid
- MAE walk away, with no or limited exceptions
- due diligence closing condition (maybe unfair--gives buyer an option to buy)
- minimum target net worth closing condition
- no shop with no (or very limited) fiduciary out
- mandated vote on deal, even if other bidder
- right to top other bidder
- one way break up fee (2% per se reasonable--4% aggressive)
- "all necessary consents" closing condition
- termination right upon commencement of third party bid
- restrictive pre-closing covenants
- noncompetes from founders
- employment agreements from key employees

Examples of terms slanted in favor of target:

- Mutual Representations (that is, identical for target and buyer)
  - this naturally makes buyer moderate the scope of representations
  - favors the target—buyer advisors should never concede unless merger of equals
- representations expire at closing
- contemplate use of knowledge, materiality and MAE qualifiers for the representations
- No indemnity, escrow or survival of representations
  - or if so, then a 1 year survival and escrow period, 10% indemnity cap and escrow, 1%+ basket, and cross-indemnity from buyer
- No "MAE out", or extensive exceptions for predictable risks (customer cancellations/employee attrition) and industry-wide factors
- Very limited closing conditions: regulatory approvals and absence of litigation
- Broad No Shop fiduciary out exception and ability to provided information, negotiated and terminate deal w/o vote on first deal upon receipt of a possibly superior offer
- Collar/Walk away right if price declines
- Interim funding arrangement

What are the tactical implications of including vs. excluding key terms from a term sheet?

- Advantage of including:
  - lowers risk that parties will fail to reach agreement on definitive agreements
  - forces executives to focus on key points up front while you have their attention
- Disadvantage:
  - if term sheet is too detailed, may force public disclosure of negotiations
  - may bog down deal momentum by stalling CEOs' "handshake" on the deal

B. Definitive Agreement Issues

Discuss how to define and negotiate a "MAC out". How does the Tyson *case impact these provisions? What are some of the most effective arguments to use in this regard?*

Buyer will almost always have the right to walk from the deal if the target has experienced a material adverse change (MAC) or material adverse effect (MAE). A buyer unhappy with the negotiated price will often hope to declare a MAC before closing and seek to re-negotiate the price or even terminate the deal, so the definition is critical.

Issues are:

- if CEOs really want the deal, why have such a "MAC out"?—(because it may be a breach of buyer board's fiduciary duty to close an acquisition where the value has evaporated)
- does target have a similar condition to its obligation to close? (usually yes)
- must the MAC have occurred or only be reasonably likely to occur—many subtle variations here
- as target advisor, always delete "prospects" from the list of what aspects of target have suffered a MAC
- when is the MAC "material"?—target may be inclined not to specify—the case law in this context is relatively favorable for target—one case implying that for a revenue shortfall to be material it must be on the order of a 50% shortfall and the *Tyson* case suggesting that if the buyer could reasonably anticipate the adverse effect (in that case a restatement of target's financials pre-closing) it cannot claim that such event is a MAC thereby effectively giving the buyer an option to buy the target;

these cases suggest that buyer should not rely on a "general" MAC closing condition as a way out of the deal

So, buyer advisors may try to have target stipulate that certain factors are a MAC (or a breach of a stand alone closing condition, or a basis for adjusting the exchange ratio by a specified amount)—such as specified employee or customer attrition levels or more than a X% shortfall from projected revenue or net worth--arguing that the agreed valuation, or the buyer's basis for doing the deal, is dependent on these factors

Conversely, the target advisors should try to anticipate the MACs likely to occur to the target pre-closing, and exclude those from the definition (so buyer must close despite the occurrence of such specified exceptions); examples are adverse changes caused by factors such as:

Standard MAC Out Exclusions

- movement in a party's stock price (buyer will want this too) [collar may limit this]
- performance of the merger agreement (e.g., agreed layoffs)
- failure of buyer to agree to requested actions or covenant waivers
- events affecting target's industry generally (but not affecting target disproportionately)
- events caused by "general economic conditions" (but not affecting target disproportionately)

Heavily Negotiated MAC Out Exclusions

- shortfall from analysts' or disclosed projections (target will argue this is fair if valuation already reflects that target will miss street estimates, or because customers will understandably be concerned about integration of the combined company's products; buyer will argue this negates the basis for the deal valuation and should be deleted or "capped" at a de minimus shortfall)
- customer or employee attrition, at least below a certain level or due to deal announcement
  - buyer will argue that customers and employees are the key value elements in the purchase; target will argue that such attrition is entirely predictable; compromise may be to:
    - allow, but cap, the level of attrition deemed included within the exception, and make clear that the attrition was directly attributable to announcement of the deal or to customer concerns about the buyer's announced product integration plans, and
    - add a separate closing condition that either specified key employees accept employment or that other steps be taken to limit employee attrition risk.

Discuss customary vs. non-customary conditions. What are some of the most effective arguments to use in this regard?

The analysis here is similar to the MAE stipulation/exception analysis set out above.

Buyer argues that the financial or strategic basis for the deal and the valuation is that certain factors be true at closing, and a key goal of the financial and legal diligence process is to identify such factors. Conversely, target will argue that it needs deal certainty to agree to a no shop and that it will only agree to closing conditions that are both clear and certain to occur. Both parties will argue that their respective Board's fiduciary duties hinge on the closing conditions being included, excluded or clarified.

Customary Closing Conditions

- Representations true [in all material respects (typical in private deals) vs. except to such an extent as would result in an MAE (typical in public deals)]—argue for the latter on basis of the target's need for certainty of closure and that buyer should not walk away where the breach of representations do not rise to the MAE level in the aggregate, and that such a carve out will lessen arguments about exceptions in the representations; argue for the former on the basis that target should not be misrepresenting anything, and that acquiror would not have agreed to the deal if representations were at all false, and that the negotiated materiality, knowledge and MAE qualifiers in the representations give target all the deal certainty it needs]
- Performance of all covenants [in all material respects?]
- Absence of MAE [refer to earlier discussion]
- All consents obtained [if material?; if failure to obtain would have a MAE?; best efforts rather than absolute covenant?] [target will argue this gives the party from whom a consent (e.g., as to contract assignment) is sought a veto on the deal and too much economic leverage, and that this makes deal too uncertain]
- Absence of litigation/HSR issues [shareholder litigation opposing transactions is predictable—target will want buyer to proceed anyway, buyer will not want to "buy

a lawsuit", and will not want to close if DOJ or FTC mandates disposition of assets]

- Absence of dissenters above a set percentage, say 2%-5% [buyer with stock argues it wants to limit cash paid and that Delaware cases often rule that the per share value in an dissenters' appraisal proceeding is higher than the negotiated deal value; target argues this condition is not required by either accounting or tax rules and effectively gives minority holders a veto on the deal]
- In a tender offer for a California corporation, achievement of 90% tender (so can ensure that buyer can cash out minority holders in a back-end short-form merger)
- Obtaining required shareholder approvals

Non-Customary Closing Conditions

- The absence of excessive employee or customer attrition levels or the meeting of projected (or agreed) target interim revenue or net worth thresholds at closing (buyer argues that the agreed valuation, or the buyer's basis for doing the deal, is dependent on these factors)
- Waiver by target officers of option acceleration or severance (target argues that this is pre-agreed and that this gives officers a "veto" on the deal, buyer argues that acceleration adversely impacts retention and adds unnecessarily to deal costs)
- Release by all employees of any equity or employment related claims
- Elimination of certain risks or cost exposures identified in due diligence (such as settlement of a pending claim or lawsuit) (buyer will argue that the deal is too risky or that the contingency is too hard to value until eliminated so it must be settled or resolved; target will argue this gives the adverse party from whom a release is sought a veto on the deal and too much leverage; compromise may be to have no such closing condition but instead include an adjustment to deal value based on estimated range of risk or cost, or have an indemnity by target shareholders for the identified risk, perhaps subject to an agreed basket and cap)
- Satisfactory completion of buyer's diligence investigation [not advisable for target; effectively gives buyer an option to buy]

What is the range of most likely outcomes for a "typical" public/private merger as to survival of representations and warranties, indemnity and escrow?

The elimination of the limits fixed by pooling rules gives buyers more flexibility on indemnity, escrow and survival provisions, but targets still push for the old pooling rule limits (escrow (and generally the indemnity cap) not exceeding 10% of deal value and generally no general indemnities (or survival of representations) beyond the first anniversary of closing). Buyers will instead typically demand survival for at least two years on most claims, but three to six years on matters such as due authorization, title, capitalization, tax, environmental, ERISA, intellectual property/patent infringement, litigation and intentional misrepresentation. Indemnity escrows rarely exceed 15%-20% (and if they do, they frequently decline during the escrow period), and they usually last 1 year (or 2 years for specified risks) (although in deals with an earnout, the buyer will usually reserve the right to set off some or all types of indemnity claims against earnout payments, perhaps subject to a cap). Indemnity caps are often tied to the escrow amount (say 20%), as specified above, but will often be higher for breaches of representations such as due authorization, title, capitalization, tax, environmental, ERISA, intellectual property/patent infringement, and litigation matters. Baskets are far more typical than deductibles and baskets range from ¼ of 1% to 1% of the deal value. The target shareholders' exposure on identified risk contingencies is often not subject to either the basket or the cap (which is why such claims are often taken into account as a price adjustment based on estimated exposure instead). Other issues include exclusivity of indemnification remedy, exclusivity of escrow as source of remedy, the definition of damages to include interest and consequential damages, ability to credit tax deductions or insurance proceeds received by buyer and control of litigation over third party claims.

Representations and warranties: Which ones really matter?

The most critical representations are generally those that bear on:

1. the most material potential liabilities or other financial exposures of the target; and
2 the key value elements of the target from the buyer's prospective.

The materiality and probability of potential liabilities and other financial exposures will often depend on the nature and size of the target and its business model. For technology companies, the sufficiency and protection of the target's intellectual property and the absence of

infringement or claims of infringement will often be the most critical representations and warranties. Clearly, representations as to financial statements, absence of contractual conflicts, absence of changes from the balance sheet date and litigation will be critical to identifying potential liabilities. But others may also be helpful in a particular context, such as disclosure as to material customer complaints and order cancellations in the last 12 months, customer indemnity obligations and material warranty claims. Also helpful can be representations as to the ability to collect receivables, usability of inventory and burdensome development obligations. The diligence process will help identify these potential areas of concern and representations should be tailored to induce full disclosure as to such matters. There is often heated negotiation about the existence and scope of a 10b-5 representation: that all of the other representations are true and correct in all material respects and do not contain material omissions; or that there is no fact, event or condition (known to target) that would (or could) make the representations untrue.

CEOs and investment bankers are perhaps best suited to identifying the key elements of value in the target, and in particular those facts or assumptions critical to justifying the deal valuation. The most critical representations bear on those key value elements. For technology companies, disclosure as to intellectual property, progress against development milestones, customer and employee attrition risks, projections and sufficiency of assets can often be the most critical. Representations regarding cash position and burn rate may be critical where buyer's cash position is not strong and the time to cash break even is critical to survival of the combined company.

Discuss the typical arguments as to including or excluding materiality, knowledge and MAE qualifiers in or from representations and warranties.

Buyers typically argue that no materiality, knowledge or MAE qualifiers are appropriate in the representations since the buyer simply wants complete disclosure to manage the post-closing business and legal risks and because:

(a) the buyer has agreed to a "basket" for indemnity claims, so "No double dipping!", and
(b) the closing condition that there are no breaches of target representations already has a materiality or MAE qualifier.

Targets will argue:

(a) if the target is public, that the size of the deal and the availability of public information about the target (and securities laws liabilities) make representations without these qualifiers unnecessary.
(b) that these qualifiers are necessary to simplify preparation of the disclosure schedule and to ensure that the disclosure sought is truly material.
(c) that the target should not be asked to warrant something it cannot know for certain, such as the absence of any risk of patent infringement (counter: this is all about risk allocation).

Discuss the importance of disclosure schedules and provide tips on how to read them.

Buyers will want to ensure that the disclosure schedule does not contain language that negates or modifies the representation or shifts the risk of breach, or that is so ambiguous as to lead to a dispute whether an exception was actually disclosed. Careful review of the disclosure schedule is the best form of due diligence and it can confirm the results of buyer's own diligence efforts.

Where a buyer requires a target to indemnify for breach of representations, as is the case in most public-private deals, the disclosure schedule is the most critical means for the target shareholders to minimize indemnity liability, so target bankers, counsel and management must scrutinize the disclosure schedule to ensure that all material risks are fully disclosed.

Where there is no indemnity provision, and the closing condition on representations is subject to an overall MAE exception, as is the case in most public-public deals, there is less precision needed in the disclosure schedule.

Earn-outs: What are the key issues and pitfalls?

Tough issues include:

- lack of alignment of goals post deal
- employee morale issues if earn out not paid
- frequent source of disputes
- hard to anticipate all interpretation issues that will arise later
- slows deal negotiations and drafting
- payment milestones can become outdated
  - development milestone may become outmoded due to:
    - changing customer demands

    - need to integrate products
  - revenue milestone may cease to be achievable due to cost cuts
  - milestones can be impacted by employee attrition
  - milestones can be impacted by consolidation or sale of buyer's divisions
- difficult to anticipate all ways in which buyer can "game" the milestone, e.g.,
  - revenue milestone:
    - change in revenue recognition methodology
    - buyer's sales force not incentivized to cross-sell
  - earnings milestone—change in reserves or effective tax rate
  - development milestone—change in available resources

When do enhanced scrutiny and Revlon *apply?*

In certain circumstances, including a change of control (generally not a stock-for-stock merger of equals), an active bidding process/auction, a sale of a subsidiary with minority shareholders, a break-up of the company or the adoption of defensive measures, courts will review directors' decisions to ensure that the decision making process was adequate and that the action was reasonable. (While this seems like a low standard, it allows the judges to look at the result and not just the process.) In the "defensive" context, "reasonableness" requires that (i) a potential superior competing bid and meaningful stockholder vote not be precluded (such as by excessive voting lock-ups or process constraints) and that stockholders are no coerced (such as by excessive break-up fees).

In such cases, the duty of the Board is to get "the best value reasonably available to the stockholders."

No single blueprint to get the best value: conduct pre-signing auction or "market check" (limited shopping to most likely bidders) and/or permit subsequent superior offers an opportunity to prevail.

What are the Board's duties in negotiating "no shop" and "lock up" arrangements? What are the different flavors of no shop provisions? What are the legal limits on deal protections?

- The board cannot contract away its fiduciary duty.
- A "No Shop" clause cannot prevent the Board from carrying out its duty in considering unsolicited bids or negotiating the best value reasonably available.
  - A properly drafted no shop provides a "road map" for a third-party bidder to make a superior offer.
  - Board must show that lock-up measures were reasonable and necessary to get the deal (and premium).
  - The differences among (flavors of) no shops generally relate to the following:
  - What must be received from the third party bidder? Must the offer be firm, fully financed, superior on its face and in writing (and must a banker so advise?), or merely be an inquiry that the target board in good faith believes could result in a superior offer? Must that offer be made up front or can it result from the target providing information or engaging in discussions after receipt of an unsolicited inquiry?
  - What can the target do with the unsolicited inquiry or offer? Provide information? Negotiate? Terminate the agreement prior to a shareholder vote? Do any of the above only where counsel advises that same is "required" by or "consistent with" the target board's fiduciary duty?
  - As a general rule, the more heavily shopped a deal is pre-signing, and the higher the premium, and the more clear it is that "Revlon" does not apply, the more stringent the no shop can be and the more limited the "fiduciary out" can be.
  - At a minimum, the target board generally must remain free to "consider" any unsolicited bid it receives, to change its recommendation and to communicate the terms of the alternative deal to its shareholders.

What are the Board's duties in evaluating break up fees and what are the usual triggers?

- Break-up fees must be reasonable (2% per se reasonable - 4% more aggressive).
  - Break up fees usually triggered by:
    - Primary acquiror's decision to abandon deal in response to voluntary actions by target board adverse to the primary deal, such as changes in recommendation to stockholders, endorsing rival bid, etc.
    - Target's termination of primary deal in response to a superior rival bid (often after primary buyer fails to match superior offer)

   - Rejection of deal by stockholders (and sometimes, for breach of representations, time-out, or even regulatory terminations), following a rival public bid (not a "naked" no vote) and entry into (and sometimes closing of) a rival bid (theory is primary bid "teed-up" the better offer and that successful acquiror, rather than target stockholders, will bear the cost).
- Break-up fees are usually not liquidated damages for a breach of the merger agreement—they are part of the legitimate road map to leave the first deal.

Voting/tender agreements: Can a deal be "locked up" (with no fiduciary out) by obtaining voting agreements for a majority of the outstanding shares?

- *Omnicare* holding: "No, absent a fiduciary out." In Omnicare, Inc. v. NCS Healthcare, Inc., Nos. 605, 2002 and 649, 2002, Holland, J. (Del. April 4, 2003), the Supreme Court of Delaware held that when a deal is fully locked up (i.e., it is "mathematically impossible" or "realistically unattainable" for another bidder to succeed), making closing a fait accompli, through a combination of deal protection devices, in that case consisting of (1) specifically enforceable voting agreements committing stockholders with a majority of the voting power to vote for the deal, (2) a "force the vote" provision, and (3) the absence of an effective "fiduciary out", so as to prevent the board from being able to effectively exercise its fiduciary duties, then such deal protection devices are unenforceable. The Court warned target boards that entering into a fully locked deal without an effective "fiduciary out" may be an abdication of the board's responsibility to retain the ability to exercise its fiduciary duties in that context. Nevertheless, in the closely held, private target context (i) parties sometimes agree to use a target majority stockholder written consent to approve and "lock" an acquisition immediately after execution of the merger agreement; and (ii) buyers may argue that Omnicare is limited to its facts.

- *Orman v. Cullman,* 794 A.2d 5 (Del. Ch. 2002), distinguished Omnicare and upheld a voting agreement that prohibited the controlling shareholders from voting in favor of a rival bid for 18 months, where minority holders were given a veto right on the current deal, so they could force the company to remain independent.

Are there any other creative ways to protect transactions from interlopers?

Deals are normally protected with the features discussed above:

- no shop
- voting agreements
- lock up option for 19.9% of target at deal price if it accepts a competing bid
- break up fees
- right to top third party bid

There is some variability in the terms of these features, but collectively they remain subject to the overall limitations discussed earlier, including that in general they cannot, considered as a whole, be preclusive or coerce shareholders into voting for the first deal.

Other possible arrangements may include the following, subject to the limitation noted above:

- *Refusal Rights* — A right of refusal or right of first offer will often deter potential buyers; it is rarely given easily.
- *Crown Jewel Option* — structuring a crown jewel option to give the first buyer access to assets or rights that a known competing bidder will find objectionable.
- *Nominally Non-Preclusive Voting Agreements* — obtaining voting agreements covering a non-preclusive number of shares, from parties collectively owning a preclusive number of shares.
- *Oenerous Business Arrangements* — irrevocable business arrangements that are reasonable but that a potential bidder would find objectionable, such as foreign distribution rights, discounted volume purchase agreements, joint development arrangements, or technology licenses and the like, but such arrangements may be inconsistent with the target board's fiduciary duties.
- *Investments* — a strategic investment in the form of warrants, convertible debt or preferred stock with significant liquidation preferences will at least give the holder a place at the negotiating table, since the buyer will often not want such securities to remain outstanding, and may insist that the holder waive certain liquidation preferences in a thin deal to give employees holding common stock sufficient incentive to remain with the combined company.

- *10% Interest:* Since pooling rules have now been terminated, mere holding of a 10% interest in a company (and thus ability to dissent and preclude pooling) is no longer an absolute obstacle to a deal. However, since a back end merger following a tender offer for a California corporation cannot be done as a short form merger without achieving a 90% tender, a 10% interest in such entity may be a deterrent.

What is the HSR filing threshold? What are the different levels of "effort" that buyer/seller must put forth to achieve antitrust and other regulatory clearance?

I. Domestic Antitrust Filings (HSR)
HSR Filing is required where:

(a) The acquiring person will hold more than $59.8 million worth of voting securities and assets of the acquired person and the parties meet the "size-of-person" requirements below; or

(b) Regardless of the parties' sizes, the acquiring person will hold more than $239.2 million worth of voting securities and assets of the acquired person.

Meeting any one of the following three subtests satisfies the "size-of-person" test:

(1) A person with $119.6 million or more of total assets (on its most recent regularly-prepared balance sheet) or annual net sales (from its most recently completed fiscal year) proposes to acquire voting securities or assets of a person engaged in manufacturing (note that software is not considered manufacturing) with $12.0 million or more of annual net sales or total assets;

(2) A person with $119.6 million or more of total assets or annual net sales proposes to acquire voting securities or assets of a person not engaged in manufacturing with $12.0 million or more of total assets (net sales test does not apply); or

(3) A person with $12.0 million or more of total assets or annual net sales proposes to acquire voting securities or assets of a person with $119.6 million or more of annual net sales or total assets.

Note that "person" means ultimate parent. Note also if the transaction involves the formation of a joint venture or LLC, or involves the acquisition of stock or assets of a foreign company, then certain additional tests must be met to require notification.

II. Different Levels of Effort Required to Achieve HSR Clearance

- *None*-buyer can terminate where
  - HSR "second request" or foreign equivalent
  - Government seeks injunction or institutes litigation
  - Government requires any divestiture or limitation on business conduct
- *Some*-buyer can only terminate if
  - regulatory delay exceeds 3-6 months,
  - Requested divestiture or limitation on business conduct is "material"
- *Extensive*-buyer can only terminate if
  - regulatory delay exceeds 9 months
  - fight injunction and file an appeal
- Requested divestiture or limitation on business conduct will have MAE
  - buyer must agree to non-MAE divestitures; and
  - buyer may not agree to acquire any third parties until HSR clearance
- Drop Dead Date-extend 3-6 months automatically if HSR 2nd request?

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