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M&A ACADEMY

Getting to the Heart of It: The Anatomy of an M&A Transaction

Rebekah Raber & Andrew Rocks

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Overview of M&A Structures

Three principal methods to acquire a business:

- **Asset Acquisition** (purchasing the assets of target entity)
- **Stock Acquisition** (purchasing the stock of target entity)
- **Merger** (direct or indirect merger with target entity)

Factors to consider in deciding which structure is best:

- Tax considerations
- Commercial issues
- Third-party and corporate consents
- Deal process and timing

Overview of Asset Acquisitions

Buyer acquires specific assets and liabilities of target company

Considerations:

- Corporate structures of Buyer and Seller do not change
- Commercially more flexibility – Buyer has ability to pick and choose specific assets and liabilities
- Typically more tax-beneficial to Buyer
- Risk that Buyer fails to purchase important assets
- More time consuming and can be more complicated depending on third-party consents and transfer mechanics
- Seller retains excluded assets, excluded liabilities

Overview of Stock Acquisitions

Buyer acquires the stock of target company from selling stockholders

Considerations:

- Target company becomes owned directly by Buyer
- Buyer acquires target company subject to all of its assets and liabilities
- Typically more tax-beneficial to Seller
- Depending on number of shareholders, may be time-consuming

Overview of Mergers

Target company's outstanding equity is converted into right to receive consideration by operation of law

Considerations:

- Governed by state statute
- Merger structures:
  - Forward Merger — target company merges with and into Buyer; Buyer assumes all of target company's assets, rights, and liabilities by operation of law. Target company ceases to exist as a separate entity.
  - Forward Triangular Merger — target company merges with and into Buyer subsidiary; Buyer subsidiary assumes all of the target company's assets, rights, and liabilities by operation of law. Target company ceases to exist as a separate entity.
  - Reverse Triangular Merger — Buyer subsidiary merges with and into target company. Target company is surviving corporation.

Anatomy of the Acquisition Agreement

Although there are various M&A structures, most acquisition agreements contain certain basic provisions:

- Preamble
- Recitals
- Definitions
- “Commercial Provisions”
- Representations & Warranties
- Covenants – Pre-Closing
- Closing Conditions
- Covenants – Post-Closing
- Indemnification
- Miscellaneous

Preamble, Recitals & Definitions

I. <u>Preamble & Recitals</u>

- Preambles describe who the parties are to the agreements
- Recitals refer to the "whereas" clauses that precede the main text of a contract
  - They provide a general idea about the contract to its reader, such as what the contract is about, who the parties are, and why the parties are signing the contract.
  - The recitals do not contain rights or obligations of the parties, but merely explain or introduce the nature of or background to the contractual relationship.

II. <u>Definitions</u>

- Specific meanings to particular words used in an agreement to avoid ambiguity in a separate definitions section. Some terms are defined in the body of the document rather than in the definitions section.

Commercial Provisions

III. Commercial Provisions

- Purchase Price/Form of Consideration
  - Cash
  - Stock
  - Promissory Note
  - Combination
- Timing/Closing
  - Simultaneous sign & close
  - Sign, with subsequent closing after satisfying closing conditions
- Depending on the structure of the deal, this section will describe what is being purchased, transferred, etc., and mechanics/instruments of transfer
  - **Asset Acquisition** - lists purchased assets, excluded assets, assumed liabilities, excluded liabilities, mechanics/instruments of transfer (bill of sale, assignment and assumption agreement, IP filings)
  - **Stock Acquisition** - describes the capital stock being purchased, mechanics/instruments of transfer (stock certificates, stock powers, lost securities/affidavits), and treatment of outstanding stock options, warrants, and other equity-linked arrangements
  - **Merger** - mechanics of the merger, describing the effect of the merger, what entity survives the merger and assumes assets/liabilities, mechanics/instruments of transfer (merger certificate, letters of transmittal/role of transfer/payment agent), and treatment of outstanding stock options, warrants, and other equity-linked arrangements

Commercial Provisions (cont'd)

III. Commercial Provisions

- Escrows/Holdbacks
  - Buyers often require that a portion of the purchase price be held back or placed in escrow to secure post-closing obligations of the Sellers (such as purchase price adjustments and indemnification obligations)
  - Where one or more third party escrow accounts are to be utilized, a separate escrow agreement will govern the terms and conditions on which such escrowed property are to be held and distributed by the escrow agent (usually a bank/financial institution)
  - Depending on the type of consideration, think about a different form of escrow/holdback (i.e., holdback of stock to be issued as consideration)
- Purchase Price Adjustments
  - Mechanisms used to ensure that the purchase price paid at closing accurately reflects the equity value of the target business as of the time of closing
  - Can be based on a number of factors –net working capital, revenue, net worth, value of specific assets
  - Parties need to ensure an agreed upon financial accounting methodology to properly measure the specific adjustment metric
- Earn-Outs
  - Typically one or more contingent payments after closing based on certain targets to be met within a certain period
  - Targets may be financial or non-financial
  - Highly negotiated

Commercial Provisions (cont'd)

III. Commercial Provisions

- Deal Protections
  - Exclusivity/No-Shop (see Covenants)
  - Voting/Support Agreements
  - Break-Up/Termination Fees
    - Less common in private transactions, unless there is significant financing or antitrust risk
    - In the public company context these fees are typically designed to compensate Buyer if Seller receives superior offer prior to closing

Representations & Warranties

IV. <u>Representations & Warranties</u>

- Statements of fact and assurances made by the parties
  - Seller and/or the target are providing a description of the property being sold, the underlying business, and the company's financial condition; also serves as additional diligence/comfort for Buyer
  - Buyer is basically providing comfort that it can consummate the transaction
- Allocates risk related to the condition of the target business
- Indemnification
- Closing/Termination
  - Applicable with a signing and subsequent closing – risk that the representations and warranties provided by Seller/company at signing will not continue to be true as of closing
  - Buyer will typically want a "bring-down" that the representations and warranties are still true as of closing
  - If the representations and warranties are generally not true as of closing, then Buyer does not have to close

Representations & Warranties (cont'd)

IV. Representations & Warranties

- "Typical" Seller/Company Representations:
  - Organization and Good Standing
  - Authorization of Agreement
  - Ownership and Transfer of Shares/Assets
  - Capitalization
  - No Conflicts; Third-Party Consents
  - Financial Statements
  - Undisclosed Liabilities
  - Absence of Certain Changes
  - Material Contracts
  - Environmental
  - Title to Assets
  - Condition/Sufficiency of Assets
  - Real Property
  - Compliance with Laws
  - Employee Matters/Employee Benefit Matters
  - Intellectual Property
  - Taxes
  - Insurance
  - Litigation
  - Related Party Transactions
  - FCPA
  - Brokers
  - Full Disclosure

Representations & Warranties (cont'd)

IV. Representations & Warranties

- Buyer's representations and warranties serve different purpose than the ones provided by Seller/company
- Seller wants comfort that Buyer can enter into the transaction and can close the deal and pay the purchase price
- Some reciprocal representations; depending on form of consideration (i.e., Buyer stock or promissory note), Buyer may be required to provide additional core representations such as:
  - Capitalization
  - Financial Statements
  - Solvency
  - Undisclosed Liabilities
  - Litigation
  - Taxes

Representations & Warranties (cont'd)

IV. <u>Representations & Warranties</u>

- Scope and Limitations of Representations and Warranties – allocates risk between Seller and Buyer:
  - Materiality Qualifiers
    - "Material Adverse Effect" or "MAE" – defined term in agreement; forward-looking in nature; very substantial change for the worse
    - "Material" – more broad; rarely defined
  - "Knowledge" Qualifiers
    - "Actual" vs. "constructive knowledge"
    - "Reasonable inquiry" vs. "Due inquiry"
  - Time Limitations/Survival
  - Disclosure Schedules – Purposes:
    - Affirmative disclosure: to provide information about the target business
    - Negative disclosure: to provide exceptions to the representations and warranties
  - R&W Insurance (see Indemnification)

Covenants

V. Covenants – Pre-closing

- Applicable to agreements with signing and subsequent closings
  - Imposes obligations to get deal closed
  - Provides assurances that the target company will be operated in the ordinary course of business and will be in "same condition" at closing as it was at signing
  - Provides protection that certain actions will not be taken prior to closing
- Level of obligation - "best efforts" vs. "commercially reasonable efforts"
- Risks that could prevent deal from closing
  - Government injunction/lawsuit
  - Regulatory approvals
  - Third-party consents
  - MAE

Covenants (cont'd)

V. Covenants – Pre-closing

- Affirmative covenants: promises to perform – typical covenants include:
  - Provide access to Buyer to books and records to allow Buyer to learn more about the business, to prepare to own
  - Operate the target company in the ordinary course of business
  - Maintain good relationships with customers and suppliers
  - Maintain assets and properties of target company owned/used by target company in current condition, subject to reasonable wear and tear
  - Perform all obligations under contracts relating to properties, assets, and business
  - Comply with applicable laws
  - Make HSR/other governmental filings
  - Provide access to information
  - Seek third-party consents
  - Seek stockholder approval
- Negative covenants: refrain from performing – typical covenants include:
  - Not to make capital expenditures over a certain dollar threshold
  - Not to acquire or dispose of businesses, material assets, or equipment
  - Not to change accounting practices, procedures, or methodologies
  - Not to amend, modify, or enter into any material agreements
  - Not to declare dividends or distributions
  - Confidentiality and publicity
  - Implement "No-Shop" and "Go Shop" clauses (public company/fiduciary duties)

Closing Conditions/Termination Rights

VI. <u>Closing Conditions/Termination Rights</u>

- Applicable to agreements with signing and subsequent closings
  - Mutual conditions to parties' obligations to close
  - One-way conditions
    - Buyer's obligation to close
    - Seller's obligation to close
- Failure to satisfy closing conditions provides other party with a right to "walk away" from the deal and not close; does not provide a separate cause of action
- Seller seeks certainty of deal closing so it will resist conditions that are not within its control, such as third-party consents
- Buyer seeks conditions to protect it from buying a business that has materially changed or that cannot be operated post-closing because of required third-party consents or other restrictions that have not been obtained or cleared

Closing Conditions/Termination Rights (cont'd)

VI. Closing Conditions/Termination Rights

- Typical Mutual Conditions:
  - HSR Act filings
  - No governmental orders that make the transaction illegal
  - Other applicable governmental approvals
- Typical Conditions to Obligations of Buyer:
  - "Bring-down" of representations and warranties
  - Compliance with acquisition agreement/performance of Seller's covenants
  - No MAE
  - No litigation
  - Third-party consents
  - Deliverables of closing certificates (compliance, secretary, FIRPTA)
- Conditions to Obligations of Sellers – typically same as Buyer, but Seller is most concerned with receiving purchase price payment

Closing Conditions/Termination Rights (cont'd)

VI. Closing Conditions/Termination Rights

- Typical Termination Rights:
  - Transaction is enjoined by law or a regulator
  - Either party materially breaches
  - Failure to close by "outside date"
  - Failure to close when all conditions have been satisfied (less standard; more common when outside financing involved)
- Public company deals often entail additional termination triggers, including breaches no shop covenants
- Termination triggers often tied to specific avenues of recourse

Other Covenants

VII. <u>Covenants – Post-Closing</u>

- Restrictive covenants
  - Confidentiality, noncompetition, nonsolicitation
- Other covenants
  - Tax matters
    - Filings, elections, contests
    - Cooperation and exchange of information
    - Tax treatment/indemnification payments
  - Employment matters
    - Benefit plan transitions
    - Severance obligations
    - Parachute payments
    - WARN Act
  - Books and records
  - Indemnification/D&O insurance
  - Litigation assistance/further assurances
- Transition services

Indemnification

VIII. Indemnification

- Post-closing remedy for losses incurred – resulting from breaches of representations, warranties, covenants, specific liabilities, or other agreements in the acquisition agreement
- Allocates risk of loss between Seller and Buyer
- Key Points:
  - Time Limitations/Survival Post-Closing
    - Survival period for representations and warranties ranges – from 6 months to 2 years (buyers typically want the survival period to last at least through the completion of one audit cycle of financial statements)
    - Certain representations last longer – surviving indefinitely or until the expiration of the applicable statute of limitations (organization/authority, capitalization, title, taxes, environmental matters, ERISA)
    - Survival of Covenants – preclosing covenants typically expire at closing; post-closing covenants typically survive indefinitely or until performance is fulfilled
  - Definition of "Losses"
    - Buyer seeks to have broader definition; third-party claims
    - Seller seeks to have narrow definition to minimize indemnification obligations; seeks to exclude incidental, consequential, special, or indirect damages, including lost profits

Indemnification (cont'd)

VIII. Indemnification

- Key Points (cont'd):
  - Limitations on Indemnification
    - Baskets, mini-baskets, deductibles
    - Caps
    - Materiality scrapes
  - Anti-Sandbagging/Effect of Knowledge
    - Knowledge by Buyer that a Seller representation and warranty is inaccurate
    - Seller's ability to update disclosure schedules and effect on indemnification
  - Other Limitations/Remedies
    - Impact of insurance/tax benefits
    - Indemnification escrow
    - Exclusive remedies
    - Multiple sellers – joint and several liability vs. several and not joint liability (pro rata)
  - Mechanics of Claims/Indemnification Procedure
  - R&W Insurance
    - Current practice
    - Impact on negotiating representations and warranties, indemnification
    - Diligence undertaking by insurance company
    - Role of broker

Miscellaneous Provisions

- Termination
- Merger/Integration Clause - Entire Agreement; No Other Terms
- Expenses
- Notices
- Severability
- Governing Law/Jurisdiction; Waiver of Jury Trial
- Successors and Assigns
- Amendment
- Construction of Agreement – Construed as Jointly Drafted
- No Third-Party Beneficiaries

Key Takeaways from This Session

- Understanding the tax implications, commercial issues and process of a particular deal will be important in deciding what structure is best (get tax experts involved early).
- Although there are various structures to a deal, the definitive agreement usually contains certain basic provisions.
- Market practice is currently trending toward limited indemnification or “public style” recourse regimes due to the use of R&W insurance.
- Tune into our future sessions for more detail on deal structuring and other topics discussed today!

QUESTIONS?

Biography

Rebekah Raber
New York, NY
rebekah.raber@morganlewis.com
T +1.212.309.6771

Rebekah Raber advises a diverse range of clients from Fortune 500 companies to emerging businesses on corporate matters including mergers and acquisitions, private equity, venture capital, and joint ventures in both domestic and cross-border transactions. She represents public and private companies through strategic acquisitions and divestiture transactions. Rebekah has experience in a broad range of industries, including financial services, media, energy, natural resources, retail, life sciences, and technology.

Biography

Andrew P. Rocks counsels clients on a wide variety of business law matters, focusing on public and private mergers and acquisitions (M&A) (including spin-offs and other divestitures, joint ventures, strategic investments, and recapitalizations), private equity, venture capital investments, and general corporate and securities law matters

Andrew Rocks
Philadelphia, PA
andrew.rocks@morganlewis.com
T +1.215.963.5255

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