M&A ACADEMY

ANATOMY OF AN ACQUISITION AGREEMENT

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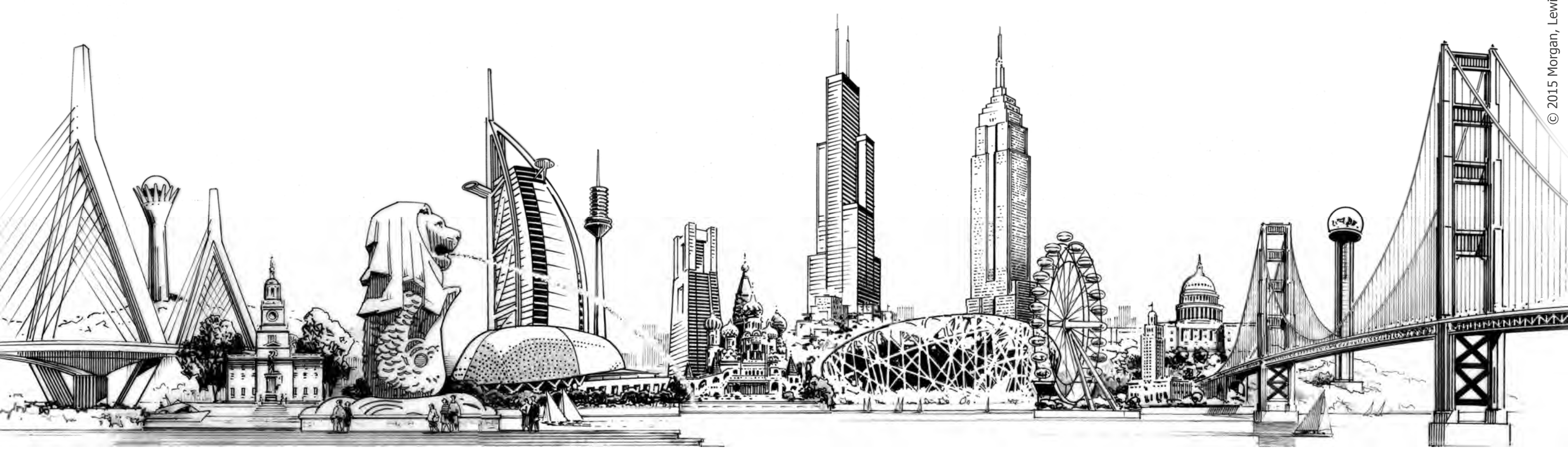

Agenda

- Overview of Acquisition Methods
- Anatomy of the Acquisition Agreement
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  - III. "Commercial Provisions"
  - IV. Representations & Warranties
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Overview of Acquisition Methods

3 principal methods to acquire a business:

- **Asset Acquisition** (purchasing the assets of target business)
- **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 structure 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:
  - Structure typical in the acquisition of an entity that is operating as an ongoing business
  - Target company becomes wholly owned subsidiary of Buyer (in some cases subject to post-closing merger)
  - Buyer acquires target company subject to all of its assets and liabilities
  - Typically more tax beneficial to Sellers
  - 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 acquisition methods, most acquisition agreements contain certain basic provisions:

- Preamble
- Recitals
- Definitions
- "Commercial Provisions"
- Representations & Warranties
- Covenants – Preclosing
- Closing Conditions
- Covenants – Post-Closing
- Indemnification
- Miscellaneous

Preamble, Recitals, & Definitions

I. Preamble & Recitals

- All agreements describe who the parties are to the agreement

- 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 they 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. Definitions

- Specific meanings to particular words used in the agreement to avoid ambiguity. Some terms are defined in the body of the document; these are included in the definitions section with a cross-reference to the section where the term is defined.

Commercial Provisions

III. Commercial Provisions

- Purchase Price/Form of Consideration
  - Cash
  - Stock
  - Promissory Note
  - Combination
- Timing/Closing
  - Simultaneous sign & close
  - Sign, with subsequent closing
- 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 at the "effective time," 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
  - Buyers often require that a portion of the purchase price be placed in escrow to secure post-closing obligations of the sellers (such as purchase price adjustments and indemnification obligations)
  - A separate agreement sets up separate escrow account(s) to be held by the escrow agent (usually a bank/financial institution) and the terms and conditions under which the escrow agent should distribute the escrow funds or other escrowed property
  - Depending on the type of consideration, consider a different form of escrow (i.e., holdback of stock to be issued as consideration)

- Purchase Price Adjustments
  - Mechanisms used to ensure that all value is captured and allocated between Buyer and Seller, to protect against changes in value between signing and closing, and to resolve disagreements in value post-closing
  - Can be based on a number of factors – net worth, net working capital, revenue, value of specific assets/targets
  - Parties need to ensure appropriate "comparison" between Buyer's and Sellers' financial accounting systems and methodologies

- 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 nonfinancial

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
    - Typically designed to compensate Buyer if Sellers receive superior offer prior to closing

Representations & Warranties

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

- Statements of fact and assurances made by the parties
  - Sellers and/or the company are providing a description of the property being sold, and 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 between the parties
- Indemnification
- Closing/Termination
  - Applicable with a signing and subsequent closing – risk that the representations and warranties provided by Sellers/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 not true as of closing, then Buyer does not have to close

Representations & Warranties (cont'd)

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

- "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; Real Property
  - Condition/Sufficiency of Assets
  - 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 Sellers/company
- Sellers want 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 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 Sellers 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 – Preclosing

- 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 – Preclosing

- 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, or 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:
  - Certain capital expenditures over a certain dollar threshold
  - Acquire or dispose of businesses, material assets, or equipment
  - Change accounting practices, procedures, or methodologies
  - Amend, modify, or enter into any material agreements
  - Declare dividends or distributions
  - Confidentiality and publicity
  - "No-Shop" and "Go Shop" clauses (public company/fiduciary duties)

Closing Conditions

VI. Closing Conditions

- Applicable to agreements with signing and subsequent closings
  - Mutual conditions to parties' obligations to close
  - One-way conditions
    - Buyer's obligation to close
    - Sellers' 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
- Sellers seek certainty of deal closing so they will resist conditions that are not within their 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 (cont'd)

VI. Closing Conditions

- 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 Sellers' 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 Sellers are most concerned with receiving purchase price payment

Other Covenants

VII. Covenants – Post-Closing

- 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 Sellers 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
    - Sellers seek to have narrow definition to minimize indemnification obligations; seek to exclude incidental, consequential, special, or indirect damages, including lost profits

Indemnification (cont'd)

VIII. Indemnification

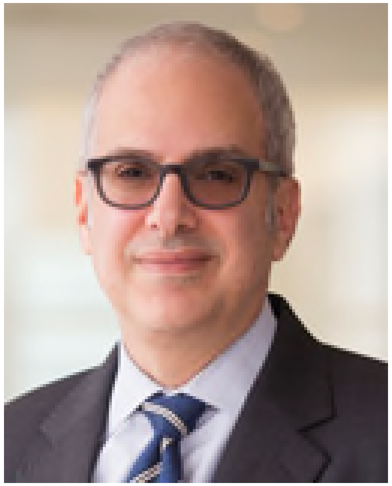
- Key Points (cont'd):
  - Limitations on Indemnification
    - Baskets, mini-baskets, deductibles
    - Caps
    - Materiality scrapes
  - Other Limitations/Remedies
    - Impact of insurance/tax benefits
    - Indemnification escrow
    - Exclusive remedies
    - Multiple sellers – joint and several liability vs. several and not joint (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

Questions?

Biography



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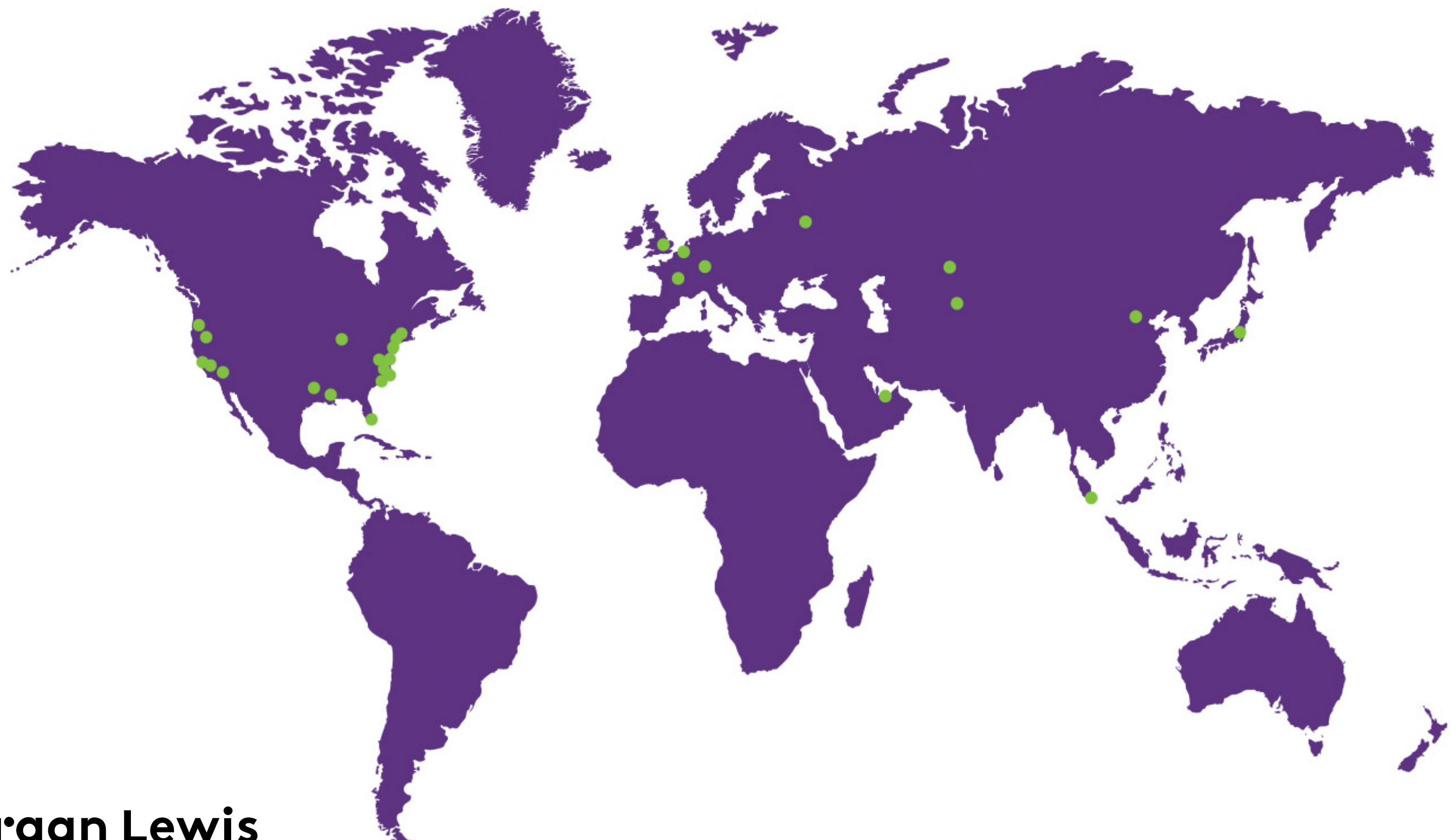

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