



# Exit Strategy Options for Chemical Companies in 2011-2012 – Legal Aspects of Transaction

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# About the Webinar Speaker

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About Steven M. Cohen, Partner, Morgan Lewis

- Steve has represented companies and investors in venture capital financings; issuers in IPOs and secondary public offerings, acquisitions, divestitures and mergers, joint ventures, and international strategic partnerships.
- Morgan Lewis is a top-15 mergers and acquisitions transactional firm according the league tables from *Thomson Reuters*, *Mergermarket*, *Bloomberg* and *Buyouts*.
- Morgan Lewis has advised on more than 550 M&A transactions in the last five years.
- With 22 office throughout the United States, Europe and Asia, Morgan Lewis is well positioned to assist clients with cross-border transactions.

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# Overview

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- Large conglomerate chemical companies are selling non-strategic assets, many of which have been neglected and are potentially profitable.
- Profitable specialty chemical niche opportunities are available for sale by small business sellers
- Billions of dollars of private equity money must be invested by end of 2014
- Debt financing is again available to leverage equity for acquisitions.

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# Key Areas to Consider

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- Deal structure matters—tax, accounting, legal and business issues
- Comprehensive due diligence is critical
- Sometimes more profitable to assume liabilities with a price reduction than to exclude them
- Understand differences in global markets

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# Type of Consideration

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## Cash Consideration:

- Pay entire amount at closing;
- Escrowed payment to cover indemnification liability; and/or
- Installment payments or promissory note.

## Equity Consideration (particularly if sale is to a public company):

- Class of equity (preferred or common) to be issued (whether or not it will be convertible);
- Fixed exchange ratio vs. fixed value;
- Floor, cap or collar;

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# Type of Consideration

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Equity Consideration (particularly if sale is to a public company) *continued*:

- Walk-away right if outside collar;
- Put/call restrictions on transfer or termination of employment;
- Contingent value rights and other post-closing price protection mechanisms;
- Federal and state securities law issues;
- Registration rights for securities received or registering publicly traded securities on Form S-4;
- Market risk of buyer's stock.

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# Type of Consideration

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## Earn-Out:

- Define measurement standard for earn-out (revenue, profits, etc.);
- The measurement standard can be applied pre-tax or post-tax;
- Provide for what happens if Buyer combines with a different business or wants to sell an acquired business unit;
- Exclusion of any matters from the computation of measurement standard;
- Provide for method of determining calculations and resolving disputed relating to calculation; and
- Be careful not to tie earn-out to employment.

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# Structure of Transaction

<u>Purchase of Stock</u>	<u>Purchase of Assets</u>
Seller generally prefers	Buyer generally prefers
Relatively simple	Somewhat more complicated because need transfer and assignment documents for all assets purchased
Contracts and business can often be transferred without third party consents	Third party consents to transfer contracts may be required
Seller avoids future liability for occurrences prior to sale, except to the extent Seller indemnifies Buyer	Buyer generally able to limit liability to those expressly assumed; Seller retains future liability for occurrence prior to sale, except to the extent Buyer indemnifies seller.

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# Structure of Transaction

<u>Purchase of Stock</u>	<u>Purchase of Assets</u>
Seller avoids possible double taxation, and may have even more favorable taxation if the stock is “qualified small business stock”	Seller might be subject to double taxation; favorable capital gains rates are available only if Seller is an LLC or an S corporation
Seller must convince all shareholders to sell their stock (or consider merger)	Unanimous agreement of Seller’s shareholders not required
Buyer assumes Seller’s tax basis for assets, even if paid more for the assets than the tax basis; if step up election if filed, Buyer pays tax on step up amount unless Seller is an S corporation	Significant potential for Buyer to obtain step up in tax basis of assets

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# Structure of Transaction

<u>Purchase of Stock</u>	<u>Purchase of Assets</u>
Buyer cannot write off amount paid for stock (although may be able to write off reasonable amount paid for individual shareholder non-competes)	Significant potential for Buyer to be able to obtain eventual write-off for all or most of purchase price
Buyer takes all assets	Buyer can exclude undesired assets
Buyer may be able to make use of tax loss carryforwards, but there are strict limitations	Third party consents to transfer contracts may be required
	Buyer and Seller may agree on advantageous allocation of purchase price

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# Special Issues to Consider when Selling to Private Equity Buyer

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- Cash can be paid up front or over time (i.e., Seller debt);
- Often have earn-out component of purchase price;
- Often, at least one existing stockholder is required to retain a sufficient minority interest to achieve recap accounting treatment;
- May have limit (i.e., 19.9%) on amount that can be retained by existing stockholders in order to achieve asset basis step-up.
- Must allocate consideration to existing stockholders based upon existing liquidation preference rights, but “roll over equity” can be *pari-passu* with private equity firm.

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# Special Issues to Consider when Selling to Private Equity Buyer

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## Management:

- Post-transaction Board
- Post-transaction management;
- Veto rights to equity holders;
- Restrictive covenants to debt holder.
- Employment Agreements, including equity compensation for management going forward in addition to any rollover equity.

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## Sale to Strategic *versus* Private Equity Buyer

<u>Strategic Buyer</u>	<u>Private Equity Buyer</u>
Sale of all equity or assets	Sale of partial equity interest
Complete divestiture and cash out of founder	Some cash out, some ongoing equity interest
Founder relinquishes control	Private Equity firm generally controls Board
Adversarial negotiations	Some adversarial negotiations
Terms may be public	Terms generally confidential

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## Sale to Strategic *versus* Private Equity Buyer

<u>Strategic Buyer</u>	<u>Private Equity Buyer</u>
Seller generally responsible for indemnities in Purchase Agreement	Seller generally responsible for indemnities in Purchase Agreement
6-20 week process	12-20 week process
Valuation may include premium for future synergies	Valuation based on market multiple of EBITDA

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# Material Diligence Issues

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- ☑ Environmental
- ☑ Pension
- ☑ Health, Welfare and other Benefits (any retiree obligations)
- ☑ Union Contracts
- ☑ Accounting, with particular emphasis on inventory
- ☑ Tax
- ☑ Corporate—minutes, stock ownership and corporate governance.

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# Material Diligence Issues

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- ☑ Customer and Supplier Contracts
- ☑ Real Property – owned and leased (co-location issues)
- ☑ Insurance
- ☑ Outstanding and Recently Resolved Disputes
- ☑ Patents and Trade Secrets
- ☑ Trademarks and Trade Names
- ☑ Regulatory and Permit Compliance.

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# Other Issues to Consider in Letter of Intent

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- ☑ Confidentiality Agreement and Standstill (if public)
- ☑ No shop, limited shop or go-shop clause
- ☑ HSR/regulatory approvals
- ☑ Pre-closing audit obligation
- ☑ Purchase Price Adjustment based upon Closing Balance Sheet or other financial criteria
- ☑ Access for Phase I environmental audit.

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# Other Issues to Consider in Letter of Intent

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- ☑ Covenants not to compete or solicit customers or employees
- ☑ Employment/Consulting Agreements for key executives of Seller
- ☑ Escrow/Holdback of portion of purchase price to cover purchase price adjustment and indemnification claims
- ☑ Financing contingency or other issues relating to financing of transaction by Buyer
- ☑ Responsibility to pay brokers or finders and other deal expenses

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# Be Prepared

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## Top 10 Issues For Potential Seller To Consider One Year Prior To A Proposed Liquidity Event

- What are your primary business goals (i.e., near term cash, long-term value, ongoing control of business) and relative priorities of those goals.
- Upgrade management, if needed, particularly focusing on the CFO and internal controls and integrity of financial statements.
- Choose experienced deal counsel and, if necessary, transition counsel to be primary corporate counsel so there are no surprises upon commencement of proposed liquidity event transaction.

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# Be Prepared

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- Choose an experienced accounting firm to conduct an audit for at least the full year preceding the transaction and to analyze revenue recognition and depreciation and amortization policy.
- Protect key intellectual property assets – obtain license to use any key IP that is not owned, assign any rights owned by affiliates that were not previously assigned to the company, and register trade names as trademarks.
- Check material commercial and investment agreements to determine required consents or amendments for possible liquidity transaction.

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# Be Prepared

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- Check material commercial and investment agreements to determine required consents or amendments for possible liquidity transaction.
- Assess sufficiency of minute books, stock books and other corporate records prior to due diligence being convened with respect to the liquidity event transaction. Poor corporate records can turn a “stock” transaction into an “asset” transaction, with potentially adverse tax consequences.

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# Be Prepared

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- Consider adding independent directors to Board of Directors, particularly if potential liquidity event is an IPO. Consider directors and officers insurance prior to commencing process.
- Engage in personal estate planning prior to commencing liquidity event activity and resulting “step-up” in valuation.

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# Case Studies

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- Case Study # 1 – Mergers of Companies with Disparate Chemical Businesses – Dupont/Danisco and Solvay/Rhodia
- Case Study #2 – Private Equity Needs to Invest Committed Capital – SK Capital acquisitions of Aristech from Mitsubishi, Ascend Performance Materials from Solutia and Calabrian from founders.
- Case Study # 3 – Private Equity Needs Exits – Apollo (Hexion) Carlyle (PA) and Court Square (MacDermid) – 10 year fund life requires exits and will take advantage of favorable M&A market conditions.

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# Choosing Counsel

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- ☑ Relevant Experience
- ☑ Excellent Reputation for Quality Service
- ☑ Efficient Price
  - Fixed fee or fee range
  - Understand fee assumptions to avoid unexpected increase

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# Conclusions

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Three most important points Chemical executives should take away from this webinar:

- Great time for Chemical industry M&A – money will be made
- Be prepared
- Be opportunistic with respect to deal structure and terms to achieve best long-term financial result.

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