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M&A The Right Way: The Process and its Tricks and Traps

AN ACA-FOLEY HOAG WEBINAR ON EXECUTING SUCCESSFUL SALES

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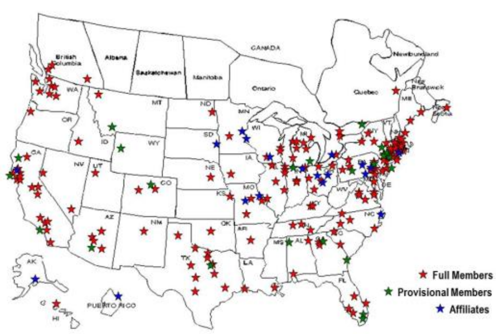

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- We do expect the content will more than fill our time

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Three Basic Rules For Sellers

- THE GOAL: Money in your pocket at the end of the process after taxes and payment of deal liabilities.
- THE DEAL MINIMUM: Always walk away from the closing with the minimum amount you would accept for the entire company.
- PREPARATION: If you anticipate a transaction in the reasonably foreseeable future, start preparation for it as soon as possible.

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Phases Of The Deal: A Brief Overview

- Pre-deal preparation
- Starting out
- Locating prospective buyer/buyers
- Interactions with prospective buyers: their information gathering and due diligence
- Negotiation of deal terms
- Reaching agreement on price and terms with a buyer
- The preliminary agreement (letter of intent)
- Definitive documents
- Closing

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Phases Of The Deal: A Brief Overview (continued)

- How long does this take?
  - Time for actual deal phase is highly variable.
  - Due diligence and negotiation of definitive documents can require considerable time.
  - Most buyers request at least 45-60 days of exclusivity after letter of intent/preliminary agreement. Time period is negotiable.
  - This may only be time period to negotiate definitive purchase agreement: a subsequent period to close may be built into definitive purchase agreement.
  - An auction process will require more time if pursued.
  - Rushed sellers usual receive suboptimal terms.
  - Private deals can be more complex than big public deals: they have more variability and moving parts.
  - Timing may be significantly affected by need for government approvals/filings. Problem is not restricted to large deals.

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Preparation for an M&A Transaction

- In best case, consideration is given to a potential transaction as company operates.
- Preparation affects all phases of operation/planning. These materials contain only examples.
- It is unrealistic to think a pre-sale company is always run appropriately for a transaction. Thus, there will need to be a "corporate clean-up" when the company starts a deal.
- Avoid large "unforced errors."
  - Examples:
    - Distribution agreements that preclude access to markets for long period.
    - In competitive markets with many potential buyers, agreements that tie the company to one competitor for a long time or which orient fully a product line to that competitor.
    - Material agreements with non-assignment provisions where change of control equals assignment.
    - Rights of first refusal.
    - Licenses of rights to third parties that larger buyers may want.

Preparation for an M&A Transaction (continued)

- Advisable activities in anticipation of sale.
  - Examples:
    - The simplest: assure that everything that should be signed has been signed.
    - Very basic: have a minute book and keep it up to date.
    - In company's agreements, consider termination provisions strategically before their execution.
    - In company's agreements, focus on clauses in "boilerplate" that might affect sale indirectly: e.g., assignment; amendment; waiver.
    - Avoid contractual commitments that will burden a buyer.
    - Include drag along right in company documents: no one should be able to interfere with transaction approved by the Board and a majority of the stockholders.
    - Consider relationship with key management: Are they motivated to help/hurt transaction?
      - Different executives have different positions.
      - Carve out/bonus plans
      - Accelerated vesting--two very different views

Preparation for an M&A Transaction (continued)

- Don't do it
- It is a good idea

- Focus on agreements with management generally.
  - Intellectual property assignments
  - Non-solicitation provisions
  - Non-competition provisions
  - Assignability of agreements
  - Agreements on departure before the deal: e.g., releases

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Starting The Deal

- The decision to sell
- How is the decision reached?
  - Is there only one decision?
- Who makes the decision?
  - Initially and thereafter
  - What is the role of the Board of Directors?
  - Of management?
  - What is a "special committee"? Do you need one?
- What happens if there is a disagreement about selling?
  - The reluctant founder

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Selecting The Deal Team

- Who speaks for the Company?
  - Another key rule: Always speak with one voice. Multiple voices cause losses in negotiations.
  - Can management do it?
  - Alignment of interest
    - What must you do to align the interests?
  - Should/can a Board representative do it?
  - Should/can an investment banker do it?
- Who else is on the team?
  - Other members of management: There is a lot to do.
  - Lawyers
  - Accountants
- Investment bankers
  - A BIG question: Do we need one?
    - Selecting one in a segmented investment banking market
      - Size
      - Industry specialty
    - What do they add?
    - What do they cost?
- Stockholder representative for post-closing claims

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How Do You Find A Buyer?

- Sometimes the buyer is "obvious."
  - Is that true?
- Unsolicited offers.
  - What should you do with them?
- If an M&A transaction is desired in the short term, the company is always selling. This is sale of another product: only the company is the product.
  - Importance of commercial relationships
  - The trade show/industry conference
- Running "a process".
  - What is "a process"?
  - Do you need an offering memorandum?
  - Can you run the process yourself?
  - What does this mean?
  - Again: should you use an investment banker?

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How Do You Find A Buyer? (continued)

- Auctions in the process
  - Are they a good thing?
  - Maximizing price
  - How does management feel about them?
    - When is management's "deal" determined?
  - What effect will an auction have on the business being sold?
  - Confidentiality and leaks
  - The role of an auction as protection to corporate fiduciaries

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Buyers

- Types of buyers.
  - Strategic
    - Experienced/occasional
    - Large/small
    - From the industry/conglomerates
  - Financial
    - Style
  - Others/hybrids
    - Roll ups and platform companies
- Do sellers care who is the buyer?
  - Management sellers certainly do.
  - But others should as well.
    - Re-trading
    - A desire to "win points"
    - Deal patterns

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Buyers (continued)

  - Likelihood/ease of closing
    - Remember that the buyers will want an exclusive right to deal during negotiations
    - Do they "write checks"?
    - Are they "just fishing"?
      - Information gathering
      - Recruiting
- Due diligence as to prospective buyers
  - Track record
  - True precedent transactions
  - Reports from prior target managements
  - How did other targets fare after acquisition?

Confidentiality

- The sale process and all of its stages must be confidential
  - Avoid unnecessary staff disruptions
  - Avoid disruption of customer relationships
  - Avoid advantages to competitors
- How do you maintain confidentiality in an active deal process?
  - Limit participants: the more people who know, the less likely it will be confidential
  - Organize and plan interactions
  - Use of a "blind" introduction
  - Use offsite opportunities for negotiations/diligence
  - Obtain confidentiality agreements (a/k/a non-disclosure agreements) from all prospective buyers before engaging.
    - Even that activity can require some planning
- What do we do when word starts to leak out?
  - Damage control: internal/external
  - Some rumors are inevitable
    - "We do not comment on rumors."
- When should you disclose and to whom?

Confidentiality Agreements

- Aren't all confidentiality agreements alike? No. Like any other agreements they vary widely.
- The basics
  - Broad definition of confidential information: Do not limit it to marked documents
  - Agreement not to disclose
    - Disclosure may be made by prospective buyer to its representatives - - but only with limitations
  - Agreement not to use confidential information
    - Sometimes omitted: a mistake
    - Recent case has focused attention on helpful (to sellers) applications of non-use provisions
  - Agreement not to solicit employees: essential in sale process.
  - Acknowledgement of no obligation to undertake transaction and no transfer of rights in information.
  - Obligation to return/destroy information.
- Beware the "residual rights" clause: a staple of some large buyers
- Consider a relatively long term for the agreement

Fiduciary Duties

- Who has a fiduciary duty in this situation?
  - Directors
  - Officers
  - Controlling stockholders
- Laws differ from state to state. Duty is determined by state in which target corporation (or other entity) is organized (not state of principal place of business).
- Duties may be different if you have a limited liability company or limited partnership.
- The basic duty in Delaware under the Revlon case: once the corporation is "for sale", obtain the best price reasonably available.
- But recent decisions support negotiated transactions with a single buyer in situations approved by disinterested directors after appropriate process.
- How do you handle conflicts of interest?
  - Recusal
  - Special committees
  - Isn't management always conflicted?

Written Indications Of Interest

- Do you need them?
  - Essential in an auction. That is how it proceeds. They are used to decide negotiating partner.
  - Useful in other contexts. Focuses the buyer and sorts out whether there might be a deal.
- What will the indication of interest say?
  - Outline of price, structure and other key terms.
  - Non-binding on either party
  - Often a precursor to letter of intent or in the form of a letter of intent

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Price: How Do We Determine It?

- How eager is the buyer? How useful is the company to the buyer? A game changer?
- Keep in mind that the company may be far more valuable to a large buyer than to the company's stockholders: operating leverage; the need for the team; saving time.
- Auction dynamics
- Metrics for particular industries
- Comparable transactions
  - Are they really comparable?
  - How do you know their real terms?
  - Can be very helpful: but be wary.
- The difference between enterprise value and price to the stockholders
  - Obligations to pay at closing
  - Distinctive issues with consulting businesses, investment advisers and other professional services businesses

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Letters Of Intent

- Basic: Consider the letter of intent to be the key "terms oriented" document in the transaction. Spend the time and effort to negotiate it carefully.
  - Non-binding except as specifically stated
  - Describes terms of the transaction
  - More money made (or lost) here than at any other time in sale process. Focus on terms here and bring lawyers into negotiation process fully.
  - With "honorable buyer", sellers can use it to prevent re-trading of terms.
- What is in a letter of intent?
  - Broad statement that it is non-binding on either party except as stated
    - Avoid binding requirement to negotiate in good faith. This is a trap for the unwary.
  - Deal description: price and structure
  - Basis on which there could be purchase price adjustments
  - Anticipated timing of deal
  - Key "non-customary" conditions to closing
    - Management contracts

Letters Of Intent (continued)

- Distinctive issues with consulting businesses, investment managers and other professional services businesses
- Specialized consents

● For sellers, the following terms are essential: limits on liability post-closing; description of escrows or holdbacks; baskets; deal “statutes of limitations”

- Remember the first basic rule above and apply it.
- This is the time to limit liability.
- The price is not a useful indicator of deal economics without knowledge of post-deal liability
- Can the sellers really limit liability?

● Exclusivity/No Shop

- Prospective buyer wants it as a binding term: do they get it? Need for preemptive bid.
- Duration
- Exceptions to exclusivity

● Break-up fees? Reverse break-up fees? Deposits?

- Not customary at this stage

Due Diligence And Related Activities

- What is due diligence?
  - What is the origin of the term?
  - Broad review of target company, its business and documents
  - Activity often follows a written diligence review list.
- When does due diligence take place?
  - Some must occur before indication of interest/letter of intent. Enough so that a prospective buyer can craft an offer.
  - After letter of intent/before definitive agreement there will be further diligence.
  - Should sellers permit diligence after execution of definitive agreement? Only bring down/confirmatory due diligence. Should sellers agree to a “diligence out” or “diligence condition” to closing?
    - Ordinarily, no. This is a trap for the unwary.
- Who participates in the due diligence process and what do sellers and target company do?
  - Diligence teams typically are led by CFO and chief scientific officer (if there is one).
  - Documentary diligence
    - Modern style involves posting to an electronic data room
    - Lawyers should review documents before posting to disclosure side of data room

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Due Diligence And Related Activities (continued)

- Interviews with key personnel
  - Need to manage carefully
- Intellectual property due diligence. Can be very extensive and expensive
- A specialized problem: Documents and information which are confidential, themselves. How to disclose them?
- The problem of sensitive information and a prospective buyer that is a competitor. Remedies:
  - Delayed disclosure
  - Third party review of technical or other sensitive information

- How does due diligence affect the deal?
  - Effect on liability limits - - special items
  - Prospective buyer resistance to negotiation of liability limits before diligence - - usually a pretext
  - Effect on representations and warranties
  - Provides information for disclosure schedules in purchase agreement
- How should the sellers and target company prepare for due diligence?
  - Assembly and review of documents

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Due Diligence And Related Activities (continued)

- The "corporate clean-up": dotting i's and crossing t's
  - The myth of the "clean little company"

- How much due diligence is enough?
  - Setting limits on due diligence – if possible
  - What to do about never-ending requests:
    - Control diligence timing
    - Different phases of diligence apply to different phases of deal
    - Buyer "pays" for diligence with progress on other deal points
  - Don't the lawyers/business people/accountants on the other side have anything else to do?
  - Is this really about the deal or do they have another agenda?
  - The "big" company problem. Also a private equity problem.
- Remember: due diligence can be <u>very</u> expensive for the target.
- What do sellers do when the prospective buyer tries to re-trade the deal "as a result of" due diligence?

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Deal Structures – A Very Brief Introduction

- What are typical deal structures for sales?
  - Stock purchase
  - Stock purchase structured as a reverse merger: A reverse cash out merger if consideration is for cash.
    - Why is it reverse?
  - Asset sales
  - Redemption/recapitalization
- How is the deal structure chosen?
  - Deal structure is negotiated. For corporations with numerous stockholders/option holders, parties will assume a reverse cash out merger or other stock merger.
  - Tax considerations often drive choice of structure.
  - Sellers or buyer may have liability or insurance concerns that dictate approach
  - Asset sale form can be more difficult to execute because of need for consents to transfer and transfer documents. Can be very time consuming and expensive.
  - However, in appropriate circumstances, asset sale form can be used to generate tax benefits that raise price. Tax attributes of asset sale approach can sometimes be applied in a stock purchase format with a tax election.

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Purchase Price Adjustments And Deferred Payment

- Purchase price adjustment provisions are common
  - Most typical, is a price adjustment concerning net working capital of the target company as of the closing time.
    - Parties set target working capital.
    - The purchase price increases or decreases on the basis of determination of net working capital.
    - If determination is "as of closing", buyer makes first calculation. A danger to sellers.
    - Need review/dispute resolution mechanisms.
    - This is an opportunity for post-transaction conflict.
  - Adjustments are also sometimes made on the basis of net worth metrics or cash/debt amounts of the target company.
  - Debt free/cash free variation.
- Earn-Outs or Milestone Payments: Additional price payments based on subsequent events
  - Often tied to a formula related to revenues or earnings or specific events
  - Revenue approach more closely aligns interests of buyer and sellers

Purchase Price Adjustment And Deferred Payment (continued)

- How do sellers influence (guarantee) results/payments?
  - They cannot. They have lost control of the business.
  - Do they have any security? Usually not.
- Thus, earn-out/milestone payments should not be accepted by sellers as resolution of basic price disagreements.
- See the second basic rule above.

The Definitive Documents

- Purchase agreement: whether in purchase or merger agreement form, contains:
  - Specific price and terms of payment
  - List of other basic closing documents
  - Representations and warranties about the target company and transaction
    - Lengthy (often very lengthy) description of different aspects of the target company in legalese
    - Modified by a disclosure schedule prepared by the target company and sellers--but negotiated with buyer
    - Important and time consuming; liability is created for false heavily-negotiated representations and warranties
    - Information obtained by buyer in due diligence usually does not help: "sandbagging."
  - Indemnification provisions
    - For what?
    - Who is liable?
    - Buyer is searching to expand the scope of coverage. "Market" practices may be changing.
    - What particular items found in diligence are covered by indemnification?

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The Definitive Documents (continued)

- Liability limitations and escrows -- follow letter of intent
  - Limit on liability – percentage of purchase price
  - Basket -- minimum amount of claims to trigger liability
    - Deductible
    - Tipping basket
  - Time limit on claims – internal statute of limitation
  - How should the "fraud" exception work?
  - Other "customary exceptions" to limitations of liability
  - Specific exceptions driven by due diligence
  - Escrow or holdback against liability
    - Can be a good thing -- believe it or not!
- Closing conditions
  - Important first decision: is there a simultaneous signing and closing?
- Provisions for representative of sellers
  - Administers post-closing liability and claims
  - Need to provide authority, liability limitations and fund for expenses of representative

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The Definitive Documents (continued)

- Termination provisions
  - Sellers need ability to terminate the agreement after some period of time if no closing.

- Employment/Consulting Agreements/Non-Competition Agreements
  - Key for management, of course
  - Maintenance of alignment of interests
  - Treatment of existing agreements
  - New employment agreements/consulting agreements/non-competition agreements
    - Regular buyers and large companies have "problems" that can be anticipated.
    - Beware waves of documents.
  - When are they negotiated? Can be tricky.
  - Remember that payments to management can affect net purchase price to sellers. Buyers focus on enterprise value.
- Closing documents. Examples:
  - Consents and approvals. Defined by the deal and the target company's business.

The Definitive Documents (continued)

- Licensors, customers, suppliers, lessors, etc.
- Government
  - Note: for larger deals, Hart-Scott-Rodino or other clearance may be necessary pre-closing
  - Specialized issues: for example, CFIUS review of acquisitions by non-United States buyers
- Certifications as to compliance with representations and warranties and covenants
- Secretary's certificate as to resolutions of directors and stockholders
- Legal opinions
  - What more do lawyers have to say?
- Documents of transfer in stock sale or asset sale
- Certificate of merger

- Post-closing Documents
  - Transmittal documents from stockholders in merger
  - Documents related to purchase price adjustments
  - Resale registration statement under the Securities Act of 1933 (hopefully on Form S-3) if consideration is stock

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THANK YOU

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