Top 10 Issues in Mergers and Acquisitions Transactions

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When negotiating the terms of an M&A transaction that spans over several months, the parties should address many issues up front (preferably at the letter of intent stage or as soon as possible after the execution of a letter of intent). The target company and the acquiring company should consider the following issues when contemplating a transaction.

1. Deal Structure

Three alternatives exist for structuring an acquisition: (i) stock purchase, (ii) asset sale, and (iii) merger. The acquirer and target often have competing legal interests and considerations within each option. It is important to recognize and address material issues when negotiating a specific deal structure. Primary considerations relating to deal structure include: (i) transferring liability, (ii) third party contractual consent requirements, (iii) stockholder approval, and (iv) tax consequences.

Transferring Liability. Unless contractually negotiated to the contrary, upon the consummation of an equity sale, the target's liabilities are transferred to the acquirer by operation of law. Similarly, the surviving entity in a merger will assume by operation of law all liabilities of the selling entity. However, in an asset sale, with limited exceptions, only those liabilities that are designated as assumed liabilities are assigned to the acquirer while the non-designated liabilities remain obligations of the target.

Third Party Consents. To the extent that the target's existing contracts prohibit the assignment of contractual rights and obligations to an acquirer without the consent of the other party to the contract, a pre-closing consent to assignment may be required. No such consent requirement exists for an equity purchase or merger unless the relevant contracts contain specific prohibitions against assignment upon a change of control or by operation of law, respectively.

Stockholder Approval. In most circumstances, the target's board of directors can grant approval of an asset sale at the corporate level without obtaining individual stockholder approval. However, all selling stockholders are required to grant approval pursuant to a stock sale. When unanimity is otherwise unachievable in the stock sale context, a merger structure may be appropriate as an alternative pursuant to which the acquirer and target negotiate a mutually acceptable stockholder approval threshold sufficient to consummate the deal. Note, however, that under Delaware law (and most other jurisdictions that follow a similar corporate doctrine), non-consenting stockholders to an asset sale or merger are entitled to exercise appraisal rights, legal rights of a company's shareholders to demand a judicial proceeding or independent valuation of the company's shares to determine a fair value of the stock price, when they dispute the adequacy of the deal consideration.

Tax Consequences. A transaction can be taxable or tax-free depending upon structure. Asset sales and equity purchases have immediate tax consequences for both parties. However, certain mergers and/or reorganizations/recapitalizations can be structured such that at least a portion of the sale proceeds (in the form of acquirer's stock a/k/a "boot") can receive tax deferred treatment. From an acquirer's perspective, an asset sale may be most desirable because a "step up" in basis occurs such that the acquirer's tax basis in the assets is equal to the purchase price, which is usually the fair market value. This approach enables the acquirer to significantly depreciate the assets and improve profitability post-closing. With a stock purchase structure, the selling shareholders pay long term capital gains provided they owned the stock for at least a year. However, the acquirer would only obtain a cost basis in the stock purchased and not the assets, which would remain unchanged and may cause an unfavorable result if the fair market value is higher. A third possibility would be to defer at least some of the tax liability via a merger/recapitalization pursuant to which the boot remains tax free until its eventual future sale. Compromises are possible including, by way of example, a "338(h)(10) election" pursuant to which the parties consummate a stock purchase with all the aforementioned results being the same except, for tax purposes, the deal is deemed an asset deal and the acquirer obtains the desired basis step-up in the assets.

2. Consideration: Cash versus Equity

The type of consideration for a transaction may be a decisive factor for both parties. Deal financing centers on the following:

Cash. Cash is the most liquid and least risky method from the target's perspective as there is no doubt as to the true market value of the transaction and cash consideration removes uncertainty on the value which may effectively pre-empt rival bids that include equity components. From the acquirer's perspective, cash can be sourced from working capital/excess cash or untapped credit lines but doing so may decrease the acquirer's debt rating and/or affect its capital structure and/or control on a going-forward basis.

Equity. This structure involves the payment of the acquiring company's equity, issued to the stockholders of the target, at a determined ratio relative to the target's value. The issuance of equity may improve the acquirer's debt rating thereby reducing future cost of debt financings. There are transaction costs associated with equity consideration and risks related to stockholders meeting (potential rejection of the deal), registration (if the acquirer is public) and brokerage fees. That said, the issuance of equity may provide more flexible deal structures.

The ultimate payment method may be determinative of what value the acquirer places on itself. An acquirer tends to offer equity when it believes its equity is overvalued and cash when the equity is perceived as undervalued.

3. Working Capital Adjustments

M&A transactions often include a working capital adjustment as a component of the purchase price. The acquirer wants to ensure that it acquires a target with adequate working capital to meet the requirements of the business post-closing, including obligations to customers and trade creditors. The target wants to receive consideration for the asset infrastructure that enabled the business to operate and generate the profits that triggered the acquirer's desire to buy the business in the first place. An effective working capital adjustment protects the acquirer against the target initiating (i) accelerated collection of debt, or (ii) delayed purchase of inventory/selling inventory for cash or payment of creditors. The typical working capital adjustment includes the difference between the sum of cash, inventory, accounts receivable, and prepaid items excluding accounts payable and accrued expenses. In terms of measuring the working capital, the definitive agreement will include a mechanism that compares the actual working capital at the closing against a target level, typically required for normal business operations based on a historical review of the target's operations over a defined period of time. Certain unusual or atypical factors, "one-offs", add-backs, and cyclical items will also be considered as part of the working capital calculation. The final determination for the post-closing working capital adjustment will usually occur within a few months of the closing and, to the extent that disagreements between the parties arise concerning the calculation, dispute procedures are set forth in the definitive agreement.

4. Escrows and Earn-Outs

The letter of intent should clearly indicate any contingency to the payment of the purchase price in a transaction, including any escrow and any contingent consideration based upon future performance (commonly referred to as an "earn-out"). The purpose of an indemnification escrow is to provide recourse for an acquirer in the event there are breaches of the representations and warranties made by the target (or upon the occurrence of certain other events). Although escrows are standard in M&A transactions, the terms of an escrow can vary significantly. Typical terms include an escrow dollar amount in the range of 10% to 15% of the overall consideration with an escrow period ranging from 12 to 24 months from the date of the closing and a requirement of the use of a third-party escrow agent. Depending on the target's business and the acquirer's ability to negotiate, occasionally, special escrows can be set up to address particular issues that arise in due diligence, such as sales tax or data privacy issues.

Earn-out provisions are less common and provide contingent additional payments from an acquirer to the target or its shareholders. Earn-out provisions are most often used to bridge the gap on valuation that may exist between the target and the acquirer, and are typically tied to the future performance of the business such that the business acquired meets certain financial or other economic milestones after the transaction is closed. Typical milestones include future revenue and other financial metrics. When drafting earn-out terms, it is important to have the milestones be as objective as possible and include a dispute mechanism. From the target's perspective, the concern with earn-outs is that post-closing the target loses control over the company and decisions made by the acquirer post-closing can dramatically impact the ability to achieve the milestones that were established.

5. Representations and Warranties

The acquirer will expect the definitive agreement to include detailed representations and warranties by the target with respect to such matters as authority, capitalization, intellectual property, tax, financial statements, compliance with law, employment, data privacy, ERISA, and material contracts. It is critical for the target and its counsel to review these representations carefully because breaches can quickly result in indemnification claims from the acquirer. The disclosure schedules (which describe exceptions to the representations) should be considered the target's "insurance policy" and should be as detailed as possible. One of the more debated representations is the "10b-5" representation, which requires the target to make a general statement that no rep or warranty contains any untrue statement or omits to state a material fact necessary to make any of them not misleading. Target companies are typically uncomfortable with such a broad statement, but without such a representation an acquirer often will question whether the target is withholding certain information. Acquirers and targets also struggle with the appropriateness of knowledge qualifiers referenced in the representations, which limit the scope of a contractual provision. The target typically tries to narrow the scope of indemnification as much as possible by inserting knowledge qualifiers in many of the material representations (for example, with respect to whether the target's intellectual property has infringed the rights of any other third party), but the acquirer will want these types of risk to lie with the target.

6. Target Indemnification

Target indemnification provisions are always highly negotiated in any M&A transaction. One of the initial issues to be determined is what types of indemnification claims will be capped at the escrow amount. In some instances, all claims may be capped at the escrow. It is common to have a few exceptions to this cap – any claims resulting from fraud and/or intentional misrepresentation usually are capped at the overall purchase price. In addition, caps for breaches of "fundamental reps" (such as capitalization or tax) usually exceed the escrow as well. Another business term related to indemnification to negotiate relates to whether there will be a "basket" for indemnification purposes. In order to avoid the nuisance of disputes over small amounts, there is typically a minimum claim amount that must be reached before the acquirer may seek indemnification. Once this minimum threshold is met, the provision could include a true deductible (such that the acquirer is only permitted to recover any amounts in excess of the minimum threshold) or a "first dollar" approach (such that once the minimum threshold is met, the acquirer is permitted to recover all amounts, including the deductible amount).

7. Joint and Several Liability

Related to the concept of indemnification is the issue of joint and several liability. As most transactions involve multiple target stockholders, one of the primary issues to consider regarding indemnification, from the acquirer's perspective, is to what extent each of the target's stockholders will participate in any indemnification obligations post-closing (i.e., whether joint and several, or several but not joint, liability will be appropriate). Under joint liability, each of the target's stockholder is individually liable to the acquirer for 100% of the future potential damages. However, if the liability is several, each stockholder pays only a relative contribution to the damages. It goes without saying that the acquirer will almost always desire to make each target stockholder responsible for the full amount of any future potential claims. However, target stockholders will generally resist this approach but, even more so, where there are controlling stockholders and/or financial investors (both of which traditionally resist joint and several liability in every situation).

8. Closing Conditions

A section of the definitive agreement will include a list of closing conditions which must be met for the parties to close the transaction. These conditions are often negotiated at the time of the definitive agreement (although sometimes a detailed list will be included in the letter of intent) and may include such items as appropriate board approval, the absence of any material adverse change in the target's business or financial conditions, the absence of litigation and requisite stockholder approval. One of the more heavily negotiated closing conditions is the stockholder voting threshold which must be achieved for approval of the transaction. Although the target's operative documents and state law may require a lower threshold, acquirers typically request a very high threshold of approval (90% – 100%) out of concern that stockholders who have not approved the transaction might exercise appraisal rights. To minimize the risk that a closing condition is not met which would give the acquirer leverage to walk away from the transaction, the target should review its stockholder structure carefully before committing to such a high threshold (although from a target perspective, the more stockholders approve the transaction, the better).

9. HSR/Timing Issues

In connection with any transaction, the parties should review long-term lead items as soon as possible. For example, the parties should complete an analysis to determine whether a Hart-Scott-Rodino filing, aimed to notify the FTC and the Department of Justice of large mergers and acquisitions before they occur, will be required to be made and, if so, at what point such filing will be completed (occasionally it is filed after the letter of intent is executed but more often is filed upon the execution of definitive agreement). Although the 30-day waiting period can be waived, the necessity of making an HSR filing can significantly delay the closing of a transaction. A second potential lead items is determining if any third-party notices or consents (as further described above) are required and the process by which such notices or consents shall be made.

10. Non-competes & Non-solicits

Within the context of an M&A transaction, a covenant not to compete or solicit is a promise by the selling shareholder(s) of the target to not, for a certain post-closing time frame or after termination of employment with the target/acquirer, (i) engage in a defined business activity that is competitive with the target's/acquirer's business, or (ii) attempt to lure away customers or employees of the target/acquirer. Enforceability of such restrictions requires that the restrictions be (A) reasonable in time and scope, and (B) supported by consideration. Because the M&A context involves the sale of a business and considerable financial benefit to the selling shareholders, courts generally have deemed such exchange of benefits or consideration adequate for purposes of enforceability both in terms of scope (i.e., any material business competitive with that of the target /acquirer) and multiple years of duration. Non-compete covenants are usually not applicable to institutional investors.

For more information on merger and acquisition issues, please contact **Mary Beth Kerrigan**.