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Starting a Deal

February 2016

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Confidentiality Agreements

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Getting the Deal Started

- Confidentiality Agreements (sometimes referred to as non-disclosure agreements or "NDAs") help kick-off the deal by permitting the parties to exchange information and materials for defined purposes
- Landscape of NDAs
  - Unilateral vs. mutual (one-way flow of information from Seller to Buyer or two-way flow of information for add-on acquisitions)
  - Private target vs. public target (public targets will require standstills)
  - Joinders to NDAs (*i.e.*, wrap letters) for financing sources and other advisors
- Buy-side vs. Sell-side
  - Buyers concerned with limiting the scope of the NDA as much as possible
  - Sellers concerned with protecting information and employees as broadly as possible

Most Important Issues

- What is considered Confidential Information?
- What restrictions are placed on parties?
- Who has access to the Confidential Information?
- How long do restrictions last?
- What occurs upon a misuse?
- What happens upon termination of negotiations?

"Confidential Information"

- Typically, the Seller will seek to protect both written and verbal information provided by the Seller or any of its Representatives to the Buyer or any of its Representatives
  - Includes notes, analyses, compilations, studies, interpretations, documents or records relating thereto
  - Seller seeks to cover materials/information provided **before** or after the date of the NDA
- The Buyer seeks to limit what is confidential in several ways
  - Only include information expressly marked "confidential"
  - Only include information received in respect of the transaction
  - Only include information delivered **after** execution of NDA

Excluded from "Confidential Information"

- Buyer seeks to add exceptions to what is confidential:
  - Information that is, or becomes available, in the public domain
  - Information received from a third party who is not known to be bound by an NDA or obligation of confidentiality with Seller
  - Information already in the Buyer’s possession
  - Information developed by the Buyer without violating the terms of the NDA

Sample "Confidential Information" Markup

"Confidential Information" shall not include information that: (i) is **or becomes** generally available to the public other than as a result of a disclosure by you or your Representatives **in violation of this Agreement**; (ii) is or becomes available to you ~~on a non-confidential basis~~ from a source other than the Company or its representatives; provided that such source is not **known by you to be** bound by a confidentiality agreement with or other contractual, legal or fiduciary obligation of confidentiality to the Company ~~or any other person~~ **with respect to such information**; (iii) was known to you or **your Representatives** ~~on a non-confidential basis~~ prior to its disclosure to you by the Company or its representatives; **or (iv) is or was independently developed by you or your Representatives without violating the terms of this Agreement**.

Keeping the Negotiations Confidential

- NDAs typically restrict the parties from disclosing not only the Confidential Information but also "Discussion Information" or "Deal Information" – *i.e.*, the existence of the negotiations and the terms and conditions of any potential offers
- Potential buyers generally want to restrict disclosure of negotiations to limit competition from other potential buyers
- Seller generally wants to restrict disclosure of negotiations to avoid disruption to the business by being "in play." Seller also wants to avoid parties knowing exactly who is (and who is not) involved in an auction process so that the Seller can create the appearance of maximum competition

Restrictions Regarding Confidential Information

- Use Restrictions (in Addition to Non-Disclosure Restrictions)
  - The Confidential Information can be used "*solely for the purpose of evaluating a Possible Transaction and for no other purpose*."
  - Buyer may seek **not** to allow additional use restrictions (*e.g.*, *"… and shall not be used in any manner detrimental or adverse to the Company*.")
- Particularly important when trade secrets or other competitively sensitive information are being disclosed (may implicate antitrust issues)

Who Receives the Confidential Information?

- Seller seeks to limit the universe of parties who are permitted to see the Confidential Information
- Buyer seeks to ensure that all parties that will assist in the evaluation of a potential transaction (*i.e.*, "Representatives") will have access to the Confidential Information, including:
  - Directors, officers and employees
  - Advisors (including attorneys, accountants, consultants, bankers, financial advisors and any representatives of such advisors)
  - Affiliates (portfolio companies and affiliated funds)
  - Potential financing sources (debt and equity)

Binding the "Representatives"

- Typical options to bind the Representatives to the terms of the NDA
  - Buyer is required to make its Representatives aware of the confidential nature of the Confidential Information and obtain their agreement to keep the information confidential in accordance with the terms of the NDA
  - Each Representative must execute a written agreement acknowledging its familiarity with the NDA and agrees to act in accordance with the NDA as if it were a party thereto
  - Each Representative executes an NDA in "substantially the same form" as the Master NDA or a counterpart thereto
  - Buyer must keep a schedule of all of its Representatives
- Buyer is typically liable for breaches of the agreement by any of its Representatives
  - Buyer may seek certain exclusions

Required Disclosure

- Parties must be permitted to disclose Confidential Information when required by law, regulation, court order or exchange rules
  - Ensure exception applies to you **and your Representatives**
  - Ensure exception also applies to Transaction Information (existence of process, status of negotiations, etc.)
- Common limitations on disclosure
  - An opinion (sometimes written) of counsel that disclosure is required
  - Notice prior to any disclosure (ensure that notice only provided if not prohibited by law)
  - Cooperation to resist/limit any required disclosure

Returning/Destroying Confidential Information

- The NDA will contain a provision to deal with Confidential Information if discussions are terminated
- Generally the materials must either be (i) returned or (ii) destroyed (and the Buyer must certify to its destruction) upon the Seller's request therefor
- Buyer typically seeks carve-outs to allow it to retain certain copies of the materials, including:
  - As required by law/regulations
  - Electronic copies of the Confidential Information retained in an archived computer backup system
  - To defend against claims under the NDA

Non-Solicitation of Employees

- The Seller may have concerns about the Buyer "raiding" employees – particularly at a time when employees, may be concerned about the stability of their position
- Key Issues
  - How long do the restrictions last?
  - Which Buyer entities are bound?
  - Which employees are covered?
  - What exceptions apply?

Non-Solicitation of Employees (cont'd)

- Term
  - Periods range from six months to two years
- Covered Buyer Entities
  - If affiliates must be included, ensure they are limited to controlled affiliates/subsidiaries who have been provided Confidential Information
- Covered Employees
  - Employees above a certain level (*e.g.*, executive officers, employees with a title of vice president or above, management-level employees, etc.)
  - Only employees who become known as part of process or employees to whom the Buyer was first introduced as part of process
- Exceptions
  - Employees responding to general advertisements
  - Employees placed by a placement agency
  - Unsolicited inquiries from employees (this is often the most contentious point as difficult for Seller to prove violation of this exception)

Sample Non-Solicit Markup

"**For a period of [●], after the date hereof**, neither you nor any of your **controlled** affiliates **to whom you have provided Confidential Information** will solicit any **management-level** employee of the Company to whom you have ~~been made aware of~~ **first been introduced** in connection with your evaluation of the Possible Transaction to terminate his or her employment with the Company; provided that neither you nor your affiliates shall be prohibited from making general solicitations of employment **(whether through the use of placement agencies or otherwise) or from further soliciting or hiring any such person who responds to such general solicitation or who first contacts you or such affiliate on his or her own initiative without any solicitation or who first contacts you or such affiliate on his or her own initiative without any solicitation or encouragement by you or such affiliate**."

Standstills

- Public company NDAs contain standstill provisions restricting the recipient's ability to acquire, vote or dispose of stock of the disclosing party
- Sometimes these restrictions are keyed off of avoiding transactions that would trigger Exchange Act disclosure requirements
- Typically, standstill provisions also prohibit conduct relating to a proxy solicitation and restrict the recipient from requesting amendments of the standstill provision
- Subject to numerous negotiated exceptions

Standstills – Certain Exceptions

- Periods range from six months to two years depending on the circumstances
- Limit scope to Buyer (and affiliates that receive Confidential Information), not also to Representatives or affiliates in general
- Permit passive acquisitions of securities of the Seller (thresholds vary from 1% to 5%)
- Permit acquisition of non-voting securities of the Seller
- Preserve ability to submit private offer
- If a third party commences an offer or otherwise announces an intention to seek control of the Seller, Buyer is often released from the standstill provisions so that it can either participate in the offer or make its own proposal
- Consider most favored nation clause

"Doing Business" Acknowledgments & "Developing Technology"

- Increasingly recipients are adding general disclosures about their participation in industries generally and activities of portfolio companies
- Technology-focused companies seek acknowledgements that they may be investing in a particular field
- Recipients seek to disclaim imputed receipt of Confidential Information by their Affiliates

Remedies for Breach

- Parties can agree contractually on the existence of requisite elements of a compulsory remedy
  - Acknowledgement that disclosing party may or will suffer irreparable damage if the Confidential Information are disclosed
  - Acknowledgement that disclosing party is entitled to equitable relief upon a breach without the posting of a bond or proof of actual damages
  - Acknowledgement that monetary damages would be difficult to establish
- The recipient of the Confidential Information will often try to limit consequential, special and punitive damages

Remedies for Breach (cont'd)

- General Term
  - Periods range from 1 year to 7 years
  - Sellers will often omit a termination or expiration date, meaning that obligations would last indefinitely
  - Strategic buyers typically will be required to agree to longer terms than financial buyers
  - Trade secrets, if disclosed, will often have an extended term

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Letters of Intent

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Letters of Intent

- Generally non-binding business understanding between a potential buyer and seller expressing their interest in doing a deal and the general terms and conditions on which they are interested in doing such a deal
- Even though non-binding, there could be disclosure obligations in a public company sale

Letters of Intent (cont'd)

- Typically covers major terms only
  - Purchase price (and adjustments)
  - Structure
  - Contingencies
  - Timing
  - Apportionment of major known liabilities
- Often based on limited understanding of business by Buyer

Letters of Intent (cont'd)

- Letters of intent may contain binding provisions
  - Non-solicitation/No-shop
  - Confidentiality
  - Access to management and/or diligence materials
  - Exclusivity
  - Expense reimbursement
  - Break-up fees
- Critical issue – be very precise as to which provisions are and are not binding

Letters of Intent – Purposes

- Regulatory
  - HSR
- Financing
  - Can be used to secure financing
  - Covenant relief – easier to talk to the bank with evidence of contemplated deal
- Exclusivity
  - Seller wants a clear picture of Buyer’s proposed terms before committing to going exclusive

Letters of Intent – Purposes (cont'd)

- Roadmap for Deal Process and Diligence
- Negotiations
  - Sets the foundation
  - Even though generally non-binding, creates a baseline for negotiations
- Timing and Efficiency
  - Dive right into full documentation vs. focus first on key deal terms
  - Letter of intent lends itself to negotiation of a binding term sheet

Letters of Intent – Level of Detail

- Appropriate level of detail is a delicate balance
- Too much detail – might as well go straight to full documentation
- Too little detail – may not provide enough information to serve any purpose
- Strategy – different for Seller and Buyer
  - Seller wants as much detail as possible in order to decide whether to take the next step
  - Buyer wants to put its best foot forward
    - Access and exclusivity
    - Build in flexibility
    - Spin – particularly in an auction

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Investment Banker Engagement Letters

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Investment Banker Engagement Letters

- Scope of the Engagement
  - M&A engagement
  - Securities offering or IPO
  - Other investment banking services
  - Exclusive financial advisor
- Definition of Acquisition
  - More than 50% of stock or assets
  - Substantial portion
  - What happens on a partial sale?

Investment Banker Engagement Letters (cont'd)

- Compensation
  - Percentage of "Consideration"
  - Fixed fee
  - Incentive fee structure based on purchase price
  - Exceptions (*e.g.*, identified Buyers)
  - Tax withholding
- Definition of "Consideration"
  - Cash
  - Debt and other liabilities
  - Dividends and share repurchases

Investment Banker Engagement Letters (cont’d)

- Contingent Payments – Escrow, Earnout, etc.
  - Timing
  - Amount
- Tail
  - Fee payable if a transaction is entered into or consummated within X months after termination of engagement letter

Investment Banker Engagement Letters (cont’d)

- Termination
  - Fixed term
  - At any time? With minimum notice?
  - "Cause" exception to tail – willful misconduct or bad faith
  - Banker quits
- Expenses
  - Limited to a dollar amount without consent
  - In addition to fee
- Opinion

Investment Banker Engagement Letters (cont'd)

- Indemnification
  - Gross negligence exception
  - Bad faith and willful misconduct
  - Control of defense
- Confidentiality
- Non-Reliance by Stockholders

Investment Banker Engagement Letters (cont'd)

- Conflict of Interest
  - Relationship with Seller
  - Financing for Seller
  - Ordinary course trading, hedging, commercial banking and other financial advisory services
  - Confidentiality and ethical walls

Investment Banking Relationships in M&A Transactions

- Recent focus on financial advisor conflicts (*e.g.*, *Del Monte Foods, El Paso Corp.* and *In re Rural Metro*)
- Relationships should be disclosed to the Board early, including:
  - Engagements of financial advisor and its affiliates during a certain time period by the counterparty and its affiliates
  - Aggregate fees received by financial advisor and its affiliates during a certain time period from the counterparty and its affiliates
  - Equity ownership by, or other material interests of, the financial advisor's employees proposed to work on the matter for their own account in the counterparty or its affiliates
- Update disclosures as additional relationships materialize and/or additional potential counterparties identified

Investment Banking Relationships in M&A Transactions (cont'd)

- In sell-side transaction, financial advisor generally should represent the company exclusively with respect to the transaction, including agreement:
  - Not to provide investment banking services to any other party with respect to the transaction
  - Not to provide equity or debt financing to any party with respect to the transaction
- Disclosures and exclusivity provisions often exclude ordinary course trading, hedging and commercial banking matters

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Process and Structural Considerations

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Key Milestones in the Process

- Business Understanding
- Assembling the Deal Team
  - Business team
  - Financial advisors
  - Legal advisors
  - Accountants
  - Consultants
  - Coordination and communication between all parties is critical
- Preliminary Documentation
  - Indication of Interest
  - Letter of Intent
  - NDA
  - Exclusivity

Key Milestones in the Process (cont'd)

- Due Diligence
- Signing of Definitive Agreement and Subsequent Public Announcement (8-K)
- Post-Signing Activities
    - Consents
    - Regulatory Approvals
    - Stockholder Approval
- Closing
- Post-Closing Activities

Structural Considerations: What is Being Sold?

- Entire Enterprise
- Subsidiary
- Division
- Specific Assets (*i.e.*, a product line or factory)

Structural Considerations: Consent Requirements

- Third-party consents may be required for asset acquisition and forward subsidiary merger agreements
  - Careful review of assignment provisions in contracts and indentures is necessary
- Third-party consents are greatly reduced (or eliminated) in reverse subsidiary mergers
  - Reason: No change in entity
  - Third-party consent triggered by change of control provisions in contracts
- Stock acquisitions are the same as reverse subsidiary merger
  - Reason: No change in entity

Structural Considerations: Tax and Accounting Factors

- Tax treatment to Buyer
- Tax treatment to Seller
  - May permit combinations that are tax-free to Seller's stockholders who receive Buyer's (or Parent's) common stock. Use of some cash or other property ("boot") may result in capital gains tax for these stockholders
  - Requires compliance with highly defined/formal statutory regime and less predictable judicial doctrines
- Accounting Considerations
  - Impact of transaction on pro forma balance sheet
  - Impact on GAAP earnings

Structural Considerations: Securities Laws

- Securities laws are an issue especially when securities are used as part of the consideration
- In purely private deals, stock consideration may be impractical unless all parties receiving newly-issued securities qualify as "accredited investors"
  - Who is accredited (Regulation D / Rule 506)?
    - Big institutions and entities
    - Directors, officers and general partners of the issuer
    - Any natural person with net worth in excess of $1.0MM (excluding their primary residence) or who has had more than $200,000 of income in each of the two years prior to the deal or $300,000 if married
    - Up to 35 "non-accredited investors" may participate in a Regulation D offering as long as they are otherwise "sophisticated"
- In case of these unaccredited investors, the company must provide an offering document similar to a registration statement

Structural Considerations: Other Factors

- Nature of Ownership of Seller
  - Public company or private company (widely- or closely-held)
  - Stockholder approval requirements
- Stockholder Vote by the Buyer
  - Typically not required by state statute for subsidiary mergers, stock deals or asset acquisitions
  - Required by stock exchange rules if 20% or more of Buyer's common stock is issued as consideration in the deal
  - Can also be required by the charter

Structural Considerations: Other Factors (cont’d)

- Liability Management
  - Avoidance of liability
  - Insulate Buyer against liability
    - Use of subsidiary structures
    - Asset acquisitions (with some caveats)
- Timing
- Antitrust Considerations

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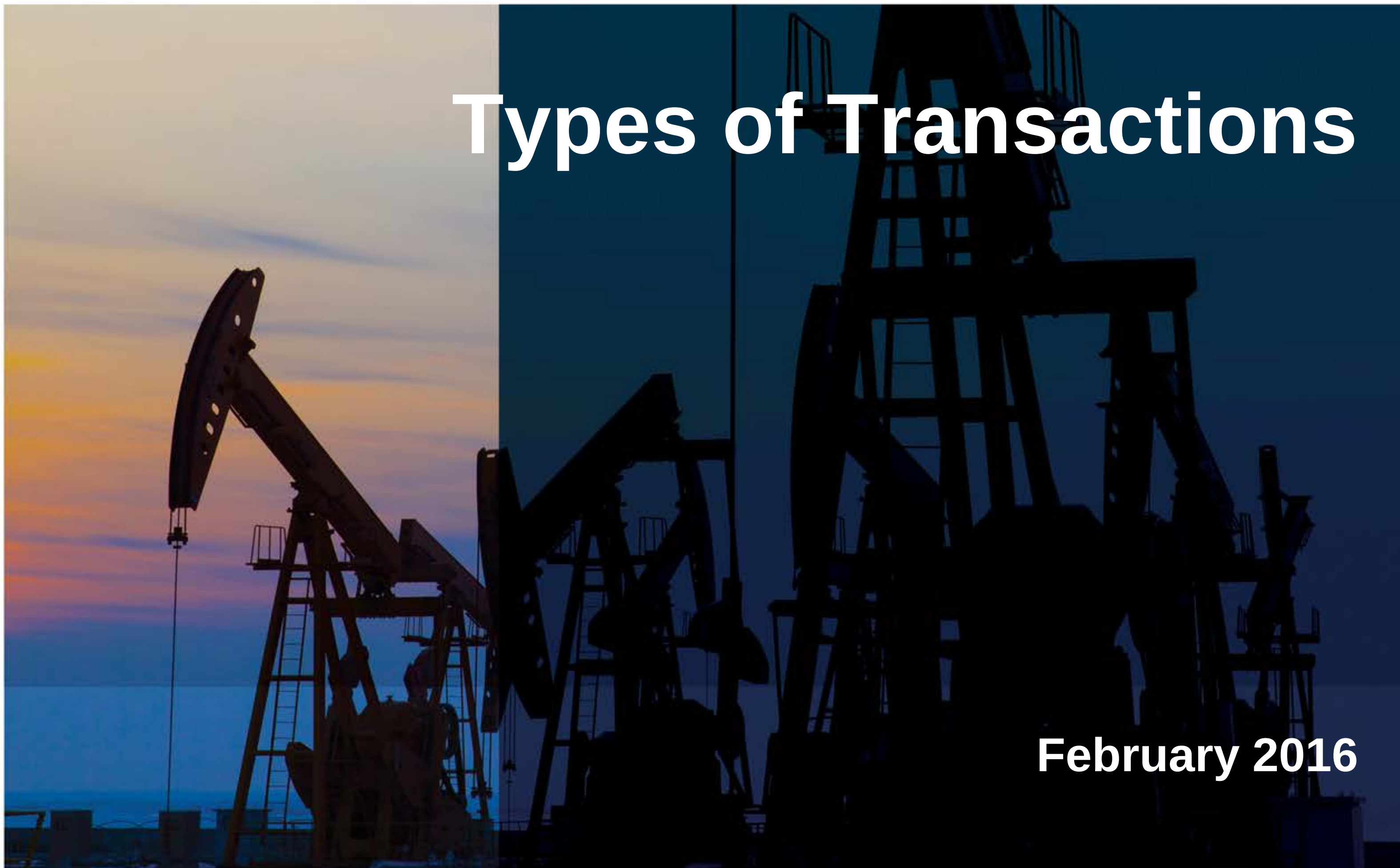

Types of Transactions

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Negotiated Stock Purchase

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Negotiated Stock Purchase

- Consensual transaction between Buyer and all Sellers
- Not feasible for public companies (or some private companies)
- May be treated as an asset purchase for tax purposes (§338(h)(10) election)
- Buyer Approvals
  - Board approval generally required
  - Stockholder approval requirements depend on type of consideration
- Seller Approvals
  - Each Selling Stockholder must approve
  - Generally receive board approval

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Negotiated Asset Purchase

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Negotiated Asset Purchase

- Consensual transaction between Buyer and selling company, not selling stockholders
- Transaction usually limited to specific assets and liabilities and requires assignment of each and every asset, and assumption of each and every liability involved in the transaction
- Assets can include stock of subsidiaries
- May result in entity and stockholder level taxation
- Buyer Approvals
  - Board approval generally required
  - Stockholder approval requirements depend on type of consideration
- Seller Approvals
  - If "all or substantially all" of assets, board and stockholders must approve
  - Otherwise, board approval is sufficient

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Mergers

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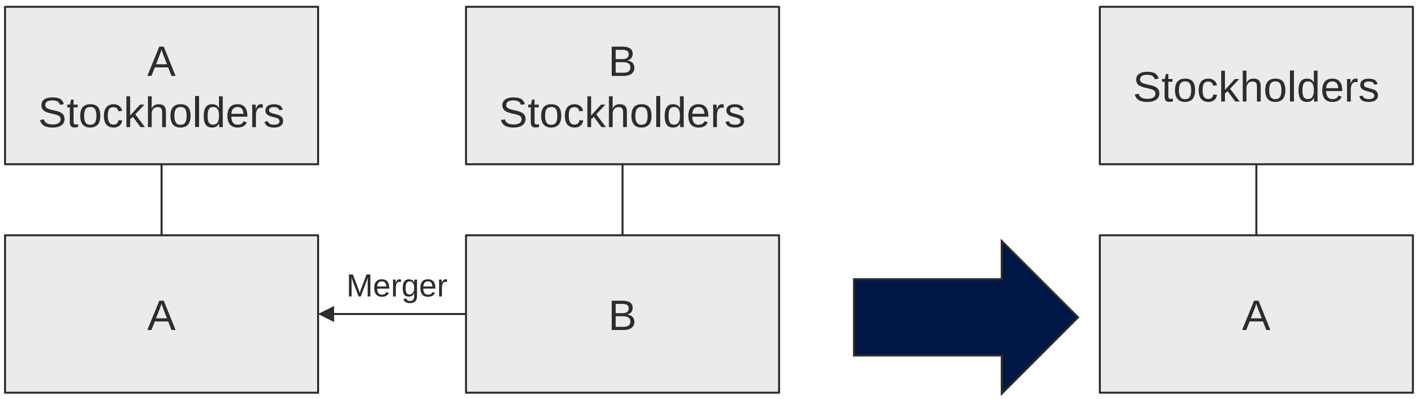
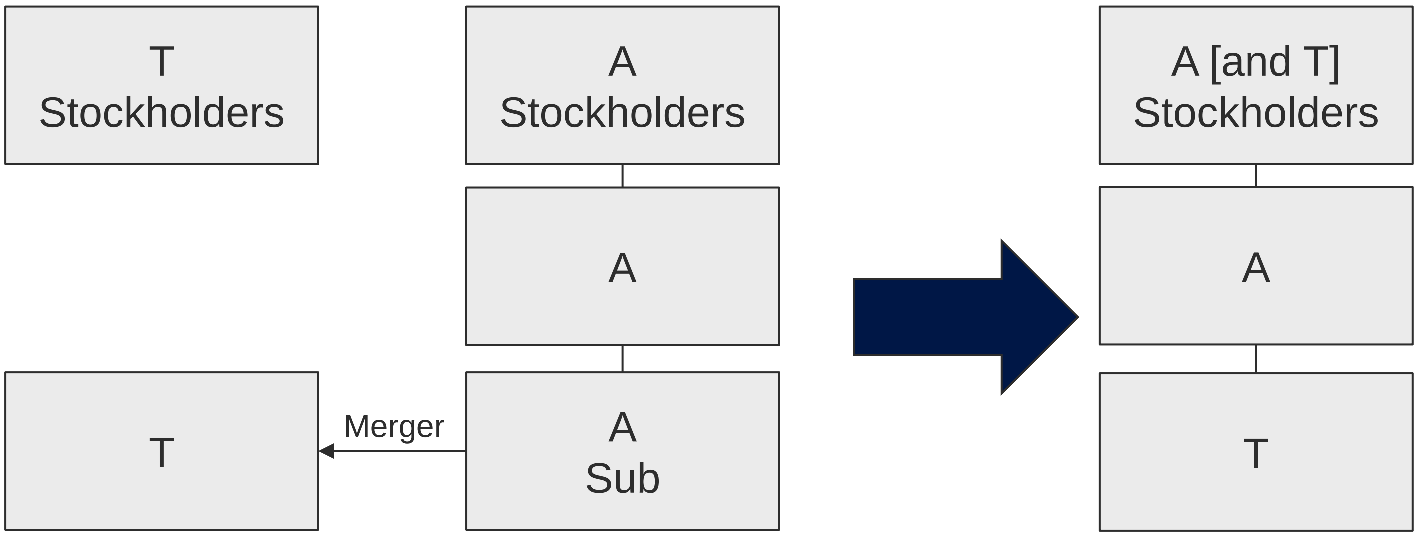
Direct Merger



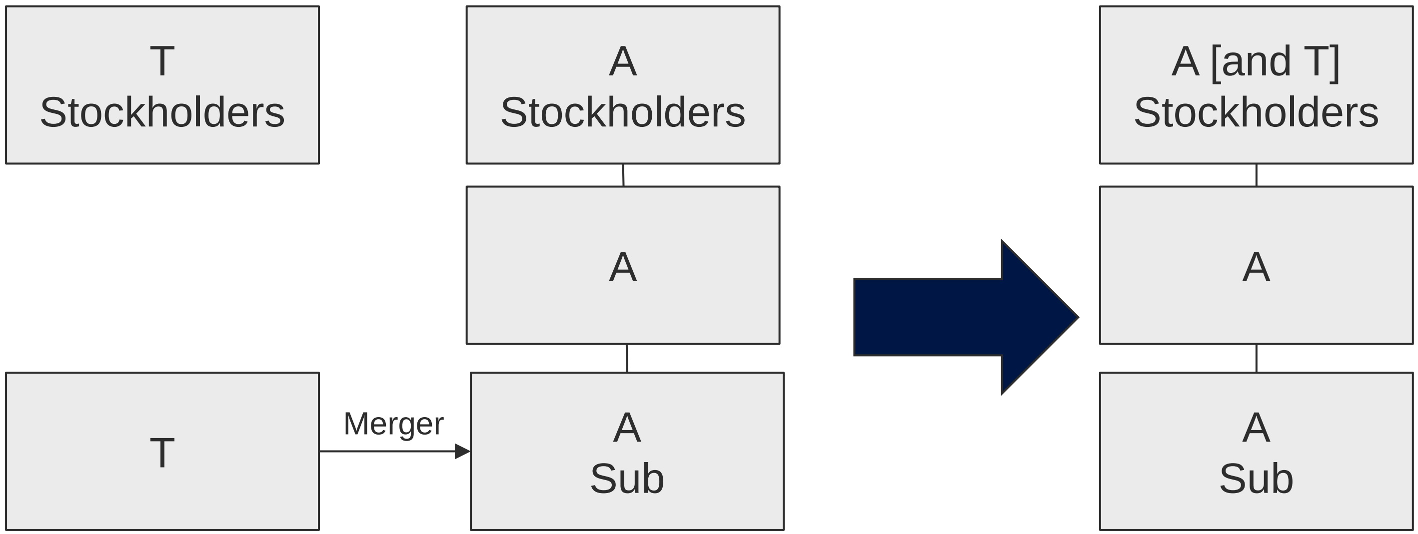
- Company A merges with Company B
  - Either Company A (or Company B) is the “surviving company”
- Surviving company retains its own assets and liabilities and succeeds to assets and liabilities of other company
- Surviving company can change name
- Both sets of stockholders can become stockholders of survivor, tax free; “acquired company” stockholders can instead receive cash or other securities
- Required Approvals
  - Board and stockholders of both companies must approve
  - Possible appraisal rights

Reverse Subsidiary (aka Reverse Triangular) Merger



- Company A creates a subsidiary ("A Sub") which merges into Company T, with Company T designated as the surviving company
- Generally preferred structure versus a forward merger due to fewer consents required
- Buyer Approvals: (1) Board approval generally required, (2) Stockholder approval requirements depend on type of consideration (20% Rule under NYSE/Nasdaq)
- Target Approvals: (1) Board approval, (2) Majority (or supermajority) approval of outstanding shares and (3) Possible appraisal rights

Forward Subsidiary Merger



- Same as reverse subsidiary merger, except that A Sub would be designated as the surviving company
- Impact on T stockholders is the same
- More flexible tax treatment
- More issues with respect to consents

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Tender Offers

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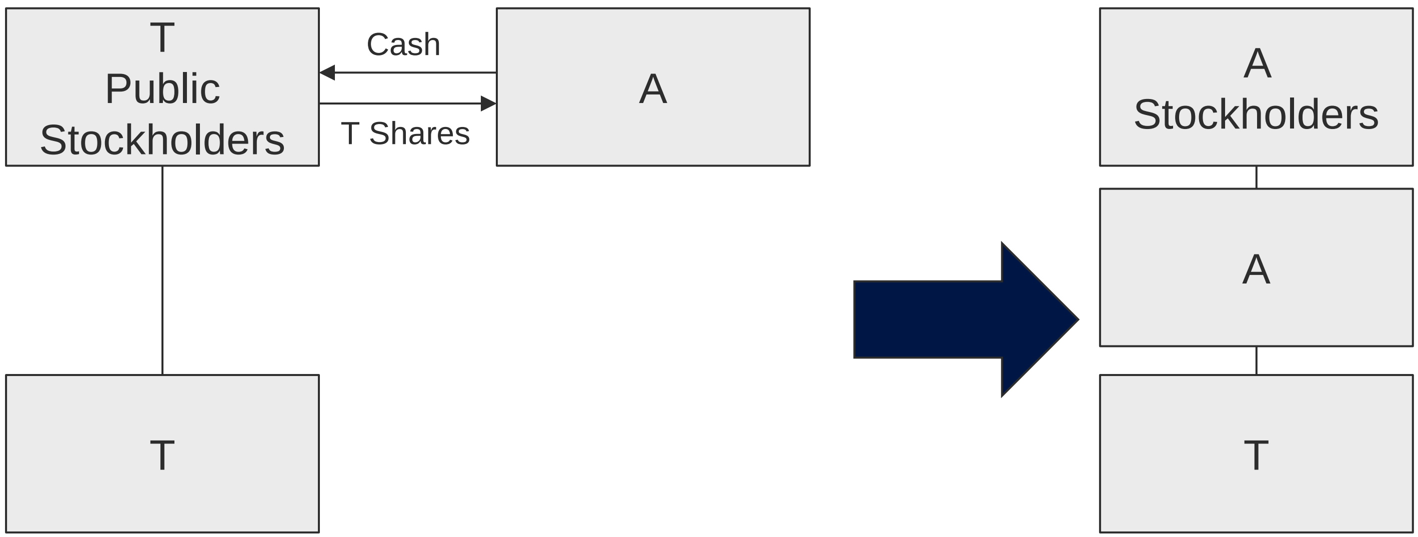
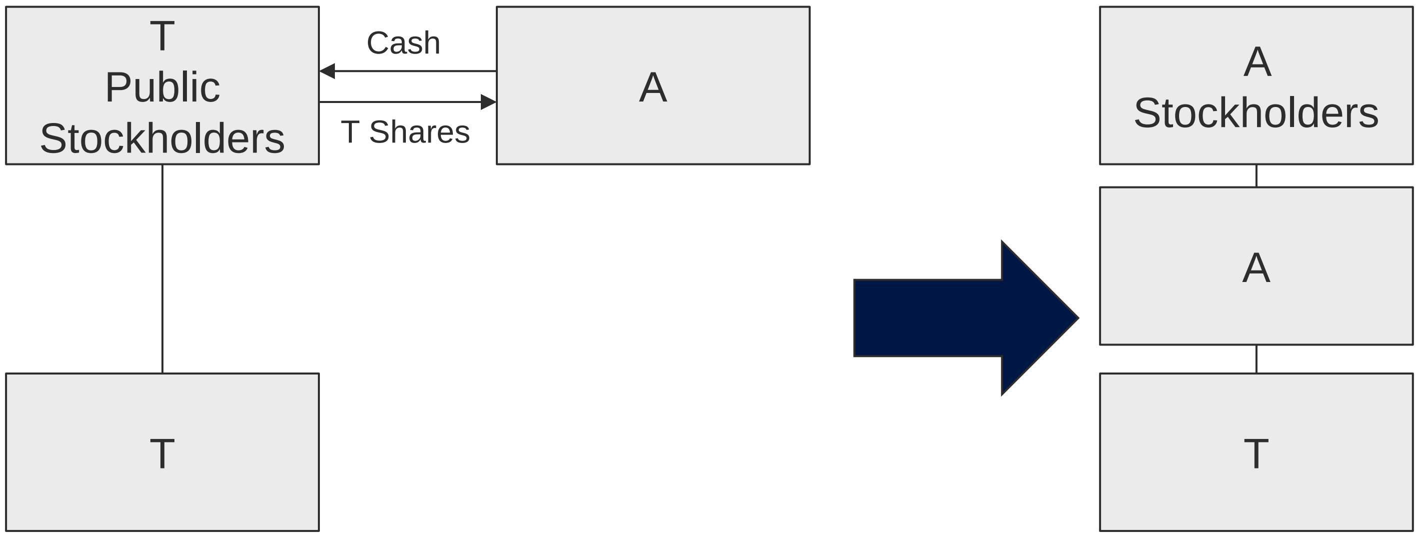
Tender/Exchange Offer



- Object of the tender or exchange offer is to acquire shares representing the voting power necessary to approve a “second step” merger
  - Public company tender offer virtually never results in 100% ownership
  - Tender offer is usually conditioned on the tender by public stockholders of at least 50% of the fully diluted shares
  - If 90% (or a simple majority if DGCL §251(h) is used) of the shares are obtained, Buyer may be permitted to do a “short-form” merger without a stockholder vote in the second step

Tender/Exchange Offer (cont'd)



- Target Approvals
  - Target board approval generally not required for Buyer to make the offer (hostile offers)
  - Majority (or supermajority) stockholder tender needed
  - Schedule 14D-9 stating the Board's recommendation of the offer
- Buyer Approvals
  - Depends on consideration and structure
  - Board approval generally required

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An Overview of DGCL 251(h)

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DGCL 251(h)

- Section 251(h) of the DGCL reduces the threshold necessary to effect a short-form merger immediately after the closing of the tender offer (in most cases to a simple majority), eliminating the need for tender offer bridge financing, if all of the following conditions are met:
  - The target is a Delaware corporation whose shares are listed on a national securities exchange or held of record by more than 2,000 holders
  - The certificate of incorporation of the target does not expressly require a stockholder vote
  - The merger agreement expressly provides that the merger will or may be effected under Section 251(h) and will be effected as soon as practicable after consummation of the tender offer

DGCL 251(h) (cont'd)

- The Buyer consummates a tender offer for any and all of the Target's outstanding shares that would otherwise be entitled to vote on the adoption of the merger agreement
- Following consummation of the tender offer, the Buyer owns at least the percentage of shares (typically, a majority) that otherwise would be required to adopt the merger agreement
- The Buyer entity consummating the offer merges with or into the Target pursuant to the merger agreement
- The outstanding shares of the Target not purchased in the tender offer (or otherwise cancelled in the merger) are converted in the merger into the same amount and kind of consideration paid for shares accepted in the tender offer

DGCL 251(h) (cont'd)

- The Buyer may choose to permit or require the merger agreement to be governed by this section
  - Permitting rather than requiring the use of 251(h) can provide the Buyer with flexibility to choose the most optimal acquisition strategy

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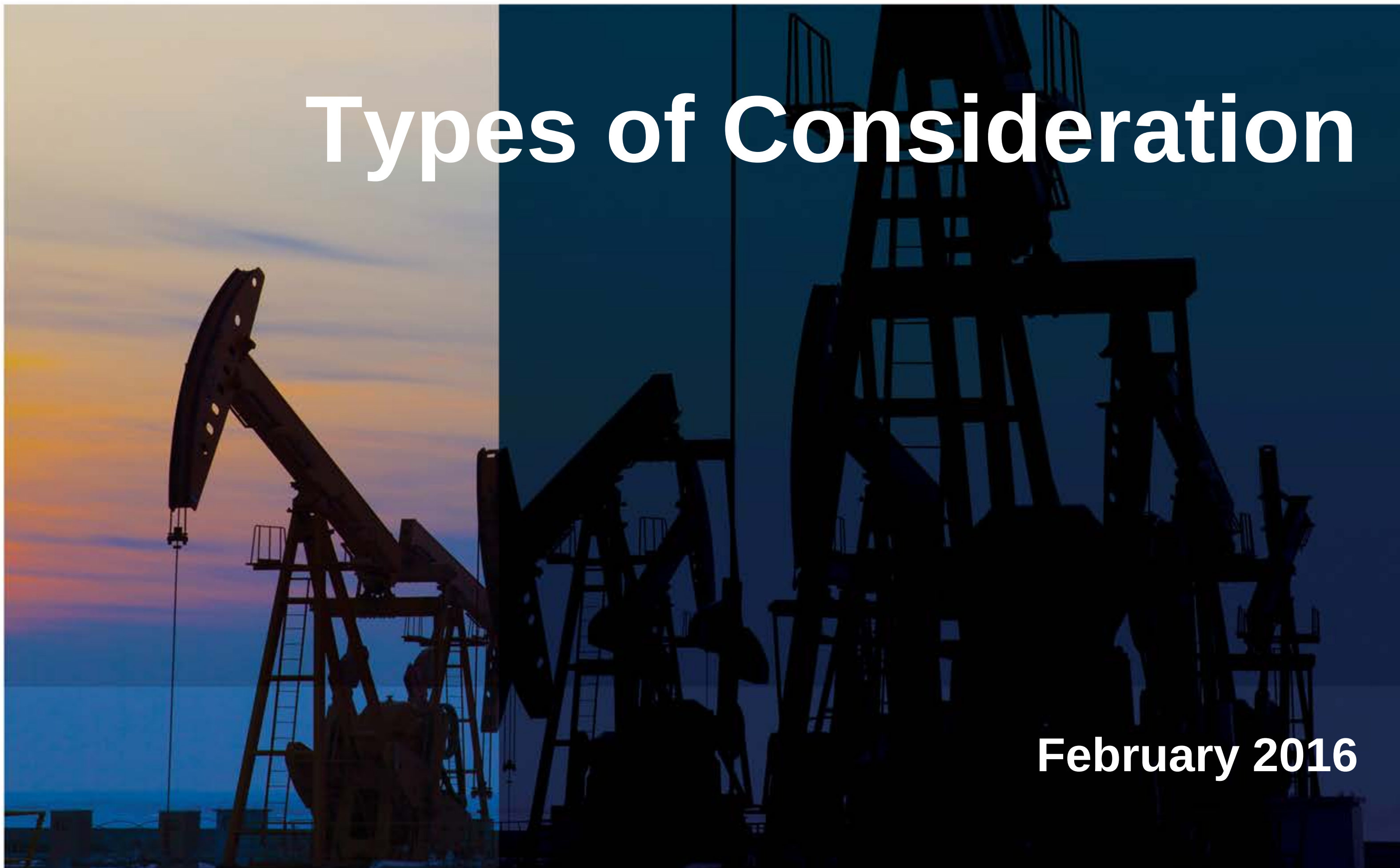
Types of Consideration



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The Basics – Public Deals – All Cash

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The Basics – Public Deals

- The Basics – Public Deals
  - All Cash
    - Simple to value and can result in quickest time to completion of the transaction
    - Issues relate to funding the cash consideration if not on hand
    - Transaction typically includes a debt commitment letter at time of signing
    - Transaction agreement includes:
      - Cooperation covenant on part of Seller and its management
      - Protective language in favor of lenders

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The Basics – Public Deals – All Stock

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The Basics – Public Deals

- The Basics – Public Deals
  - All Stock
    - More difficult to arrive at a purchase price due to the floating nature of the consideration
      - The difficulty is exacerbated by (a) the inherent volatility of the underlying stock, and (b) the time between signing and closing of the transaction
    - There are four common pricing approaches for all stock deals:
      - Fixed exchange ratio
      - Fixed value with floating exchange ratio; collars
      - Fixed exchange ratio within a price collar
      - Price floors

The Basics – Public Deals (cont'd)

- The Basics – Public Deals
  - All Stock
    - Fixed exchange ratio
      - At the time of the transaction agreement, the parties agree on a fixed ratio of the Buyer's stock for each share of the Seller's stock
      - Advantages
        - Simple and easy to understand
        - Risk of price volatility is shared to maximum extent between Buyer and Seller
        - Buyer knows exactly how many shares it will have to issue at the time of signing and can evaluate the impact of that issuance on its financial metrics

The Basics – Public Deals (cont'd)

- The Basics – Public Deals
  - All Stock
    - Fixed exchange ratio
      - Disadvantages
        - Post-signing decline in Buyer's stock price (and the associated decrease in the value of the consideration to be received by the Seller's stockholders) can:
        - Jeopardize stockholder approval
        - Encourage competing proposals
          - Buyer can always modify the consideration, if needed

The Basics – Public Deals (cont’d)

- The Basics – Public Deals
  - All Stock
    - Fixed value with floating exchange ratio
      - At the time of the transaction agreement, the Buyer agrees to deliver a fixed value to the Seller’s stockholders and, accordingly, the number of shares of Buyer’s stock to be issued will float with its stock price
        - The value of Buyer’s stock is typically determined using a volume-weighted average over a pre-determined period of time prior to closing (*e.g.*, 10 days or 30 days)

The Basics – Public Deals (cont'd)

- The Basics – Public Deals
  - All Stock
    - Fixed value with floating exchange ratio
      - Advantages
        - Seller gets some protection against stock price volatility
        - Buyer can benefit from increases in its stock price between signing and closing (because a higher price results in fewer shares being issued)
      - Disadvantages
        - Significant price declines in Buyer's stock can result in massive dilution

The Basics – Public Deals (cont'd)

- The Basics – Public Deals
  - All Stock
    - Fixed value with floating exchange ratio
      - Collars
        - A collar around the exchange ratio (1) limits the maximum number of shares to be issued by Buyer (protecting the Buyer) and (2) sets a floor on the minimum number of shares to be issued by Buyer (protecting the Seller)
        - No further adjustment if the exchange ratio, as determined by the formula, goes outside of the range of the collar
        - The collar range is typically symmetrical (X% below the Buyer's stock price baseline and X% above the Buyer 's stock price baseline)
        - Arbitrage trading impact should be considered

The Basics – Public Deals (cont'd)

- The Basics – Public Deals
  - All Stock
    - Fixed exchange ratio with a price collar
      - At the time of the transaction agreement, the Buyer agrees to deliver a fixed number of shares of its stock, provided that if the value of the Buyer's stock falls outside of a specified range (*e.g.*, 15% above or below an agreed price at the time of the transaction agreement), then the Buyer will provide additional or fewer shares to the Seller's stockholders to compensate for a price decline or increase
        - The value of Buyer's stock is typically determined using a volume-weighted average over a pre-determined period of time prior to closing (*e.g.*, 10 days or 30 days)

The Basics – Public Deals (cont'd)

- The Basics – Public Deals
  - All Stock
    - Fixed exchange ratio with a price collar
      - Advantages
        - No adjustment for stock price movement between the specified range
        - Seller and Buyer stockholders get some protection against Buyer's stock price volatility
      - Disadvantages
        - Buyer may need to issue additional shares in the event of declines in its stock price, which would result in additional dilution

The Basics – Public Deals (cont'd)

- The Basics – Public Deals
  - All Stock
    - Price floors
      - At the time of the transaction agreement, the Buyer and Seller agree that the agreement can be terminated if the Buyer's stock price falls below a specified level over an agreed-upon period
      - Single trigger
        - Simple price decline in Buyer's stock below a specified threshold
      - Double trigger
        - Requires both (1) a decline in Buyer's stock below a specified threshold and (2) a decline in Buyer's stock below a specified threshold when measured against an agreed-upon peer group
      - Stockholder approval requirements give a *de facto* termination right to the Seller

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The Basics – Public Deals – Part Cash and Part Stock

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The Basics – Public Deals

- The Basics – Public Deals
  - Part Stock and Part Cash
    - At the time of the transaction agreement, the Buyer agrees to pay the Seller's stockholders a portion of the consideration in stock and a portion of the consideration in cash
      - Significant tax planning is required to generate optimal results
    - Considerations
      - Should the value of the stock and cash consideration remain the same (*e.g.*, 50/50) between signing and closing, or should the value be allowed to diverge?
      - The easiest approach is to have a fixed exchange ratio for each share of Seller's stock and a fixed amount of cash consideration for each share of Seller's stock

The Basics – Public Deals (cont'd)

- The Basics – Public Deals
  - Part Stock and Part Cash
    - Considerations
      - Since the value of the stock component in a part stock/part cash transaction can vary, the Seller should consider negotiating for a floating exchange ratio for the stock component
      - Stock and cash election procedures need to be carefully scrutinized and the allocation procedures need to be sensitive to possible significant oversubscriptions of one component of the consideration (stock, if the Buyer's stock price increases, and cash, if the Buyer's stock price declines)

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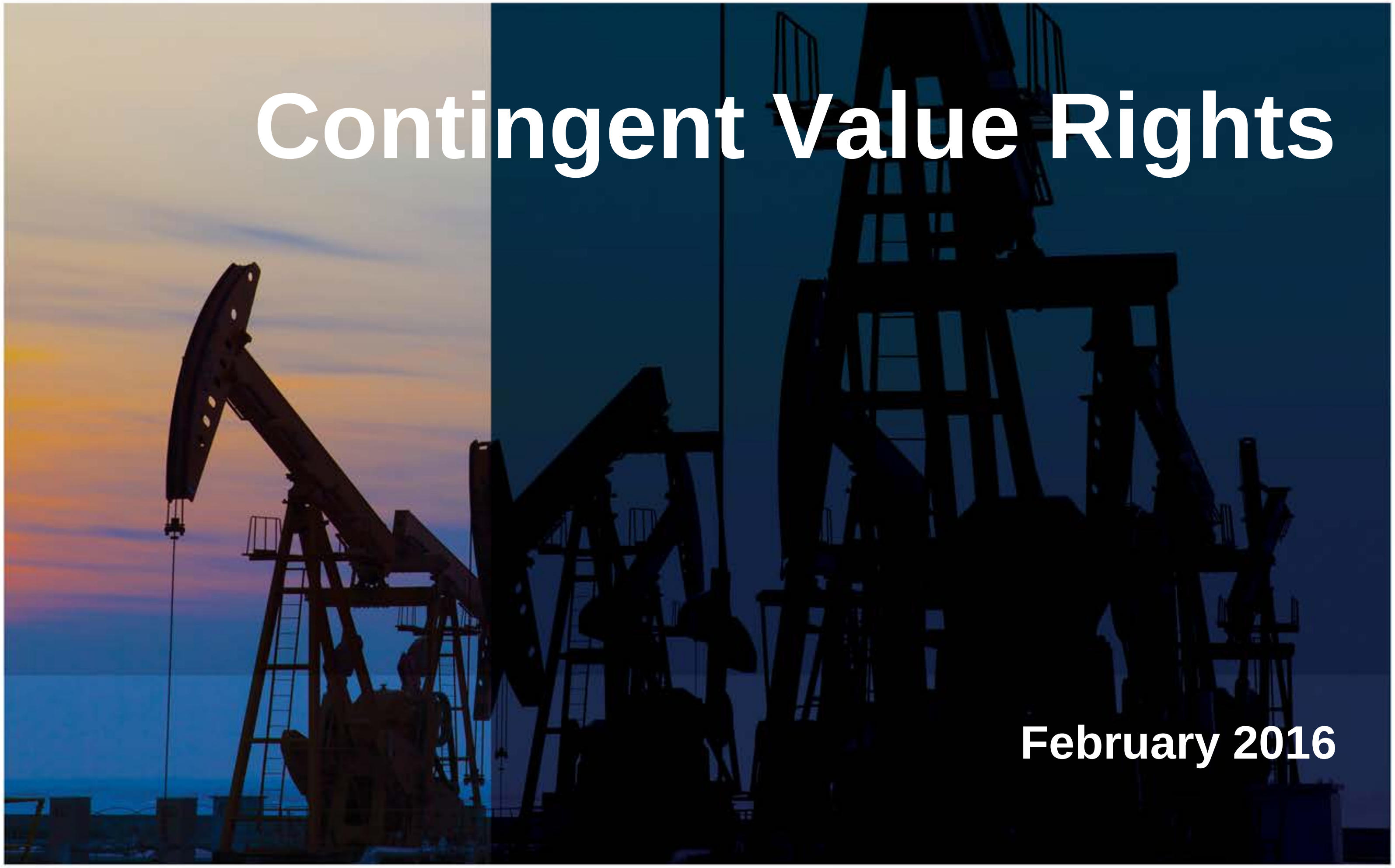
Contingent Value Rights



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What are Contingent Value Rights (CVRs)?

- Instruments that selling stockholders receive upon closing which obligate the Buyer to provide payment upon the occurrence of specified contingencies
- Two types of CVRs
  - **Event-driven** – bridge valuation gaps of Target’s business or asset by linking future payments upon the occurrence of certain future events
  - **Price Protection** – provide selling stockholders protection against (and consideration for) decreases in the Buyer’s stock received

Contingent Value Rights

- Event-Driven CVRs are typically linked to
  - Regulatory approvals (*i.e.*, drug approval)
  - Financial performance (*i.e.*, product sales)
  - Other specific contingencies
    - Litigation or tax settlements
    - Disposition of assets
- Event-Driven CVRs provide
  - Increased deal certainty by providing a mechanism to account for contingencies – the Buyer and Seller need not agree on valuation at closing
  - A bridge for valuation gaps
  - Financing benefits – reduces consideration amount required at close

Contingent Value Rights (cont'd)

- Event-Driven CVR considerations
  - May require registration under the Securities Act or compliance with the Trust Indenture Act
  - Choose Type of Consideration
    - Cash vs. stock (or combination)
    - Stock consideration may result in dilution concerns for Buyers
  - The time duration depends on the type of payment trigger. Financial performance triggers typically range from 1 to 5 years while litigation settlement triggers may exist for a longer period
  - Control of assets/restrictions on operations relating to assets may need to be addressed
  - Regulatory concerns and increased risk of dispute

Contingent Value Rights (cont'd)

- Price Protection CVRs
  - Provide some continued protection after close to selling stockholders against decreases in Buyer's stock
    - Typical maturity ranges from one to three years
    - Payment may be of cash, stock or a combination
- Price Protection CVRs Considerations
  - Buyers will want protection against significant price declines in the Buyer's stock
  - Consider regulatory implications
  - Consider settlement triggers

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The Basics – Private Deals

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The Basics – Private Deals

- The Basics – Private Deals
  - Cash (whether debt or equity financed)
  - Stock
    - Should management be required to roll-over some equity?
    - Will the shares be registered or unregistered?
      - If unregistered, are all of the recipients of the stock accredited investors?
      - What disclosure should be provided to the Seller's stockholders regarding the Buyer's business?
  - Combination of cash and stock
  - Seller notes
  - Purchase price adjustments and earnouts

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Structuring and Negotiating Earnouts

February 2016

What is an Earnout?

- Contingent payment of purchase price for a business with amount and timing determined by applying a method of calculation based upon the occurrence of one or more events related to the ongoing financial results of the acquired business
- Earnout must be contingent
  - Deferred purchase price is not an earnout
  - Purchase price adjustments are not earnouts
- Tied to post-closing performance of acquired business
- If tied to ongoing employment or services of Seller, may be considered compensation

When Are Earnouts Used?

- Uncertainty over value of Target
  - Purchase price based entirely on projections (*e.g.* new products)
  - Turnaround situations
  - Industry in flux
  - No stand-alone operating history (former division)
  - Key personnel may leave
- Incentive to incumbent management/owners to perform post-closing
- Buyer has insufficient funds to pay asking price
- Method of bridging unrealistic valuation expectations of Seller

Who Uses Earnouts?

- Typically acquisitions of private companies or divisions of larger companies
- Can be challenging in public M&A transactions (but see discussion of Contingent Value Rights)
- Roll-ups of smaller stand-alone businesses

How To Structure Earnouts – General

- Determine the “business” being measured
  - Entire Target (most common)
  - Specific products
    - Usually when costs are less relevant
  - Specific division(s)
  - Overlap with Purchaser’s business
    - Very difficult to draft
- Determine the appropriate financial performance measures
  - Gross Revenues
    - May be useful where costs have little variability
  - Net Income
    - Can be influenced by factors not related to acquired business
  - EBITDA or EBIT
    - Most common measure of performance

How To Structure Earnouts – General (cont'd)

- Determine the value of the earnout as of the measurement date(s)
  - Lump sum vs. sliding scale
  - Period-by-period vs. catch up/carry-forward provisions
  - Percentage or multiple of indicator
- Choose the method of payment for achievement of performance measures
  - Cash vs. stock (or combination)
  - If unregistered stock is used, take steps to make sure exemption from registration is available (*i.e.*, satisfy Reg. D and prohibit transfers of right to receive earnout consideration)

How To Structure Earnouts – Seller Considerations

- The Seller (*i.e.*, recipient of the earnout payment if the performance measures are achieved) should consider the following factors:
  - Use consistent accounting methodology when establishing the earnout structure (pre-closing) and when measuring the results (post-closing)
    - GAAP has many applications and changes from time to time, so it is important to avoid unintended consequences resulting from changes in GAAP or accounting methodologies
  - Exclude Transaction-related charges
    - Goodwill amortization
    - Increased depreciation (from basis step-up as a result of the transaction)
    - Fees associated with acquisition debt

How To Structure Earnouts – Seller Considerations (cont'd)

- Evaluate appropriateness of allocations of Buyer's expenses:
  - Corporate allocations (negotiate parameters)
  - Legal/general allocations
  - Executive compensation at parent level
  - Insurance
  - Management fees
- Consider the implications of tax sharing agreements
- Evaluate possible restrictions on the post-closing operation of the business being sold
- Assess the appropriate circumstances that should result in an acceleration of the right to receive the earnout payment
  - Change of control or sale of acquired business
  - Cross-defaults

How To Structure Earnouts – Buyer Considerations

- The Buyer (*i.e.*, provider of the earnout payment if the performance measures are achieved) should consider the following factors:
  - Retain flexibility to operate business as Buyer sees fit (Buyer will, after all, own the business)
  - Limit post-closing restrictions on operation of business to acting in good faith
  - Require continued employment of owners?
  - Exclude operating results from future acquisitions
  - Beware of distorted incentives
  - Include right of offset against earnout obligations for indemnification claims

How To Structure Earnouts – Buyer Considerations (cont'd)

- Consider a buy-out mechanism to avoid "hold out" issues
- Make sure earnout obligations do not cause problems under other agreements
  - For example, earnouts may be considered "debt" under financing instruments
- Generally, Buyer will want to negotiate for the converse of the "Seller Considerations" described above

How To Structure Earnouts – Other Considerations

- Both the Buyer and the Seller should consider the following factors:
  - Determine whether and how to account for synergies from combining businesses
  - Settle on accounting/dispute resolution mechanisms
    - Typically Buyer prepares statement following period end, Seller has period to object, objections resolved through negotiations or independent accounting expert
      - Many earnouts refer disputes to an independent accounting firm for resolutions, while a small number contemplate arbitration to resolve disputes
  - Appoint Sellers’ representative if there are multiple Sellers

How To Structure Earnouts – Other Considerations (cont'd)

- Tax Considerations
  - Deferred purchase price generally treated as capital gain to Seller (capital asset of Buyer)
  - Earnouts more properly characterized as compensation for services may result in ordinary income to Seller and be deductible as expenses to Buyer
  - Disadvantageous tax treatment may be triggered where payment is tied to continued employment
- Accounting Considerations
  - Deferred purchase price generally treated as additional cost of acquired enterprise
  - Some agreements for contingent consideration may be considered compensation for services and accounted for as expenses in appropriate periods

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Purchase Price Adjustments

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What is a Purchase Price Adjustment?

- The parties will need to determine the methodology to calculate the final purchase price
  - A portion of a purchase price is often based upon a variety of assumptions. For example: cash free / debt free; normalized working capital; net asset value; etc.
  - As a contractual matter, the parties may negotiate for variations between these assumptions and reality to result in a purchase price adjustment to a base number
  - The purchase price adjustment may be calculated as of the closing, a date prior to closing and/or have a portion calculated as of a post-closing date (*e.g.*, an earn-out)
- Generally limited to private deals

Examples of Purchase Price Adjustments' Importance

- Capture the value proposition in the business deal
- Ensure sufficient working capital post-closing / size of the debt facility
- Allocate economic benefits of the Target between the Buyer/Seller as of particular dates
- Protect Buyer against potential Seller abuses (*e.g.*, liquidating inventory, distributing cash, accelerating/delaying collections/payments, making distributions, assuming liabilities, etc.)

Working Capital Adjustment

Net Working Capital = Current Assets – Current Liabilities

- "Current Assets" – assets readily converted to cash. *E.g.*, some inventory, accounts receivable, liquid securities, prepaid expenses, etc.
  - Often excludes cash, which is calculated separately
- "Current Liabilities" – liabilities due and payable in the short term. *E.g.*, accounts payable, accrued expenses, deferred revenue, etc.
  - Often excludes the near-term portion of long term liabilities, which is calculated as part of debt
- Subject to customization as a contractual matter

Working Capital Importance

- Ability to meet company obligations and operate the business in due course
- May capture additional value for the Sellers
- Partially protects Buyers against pre-closing events/behavior
- May encompass a large part of the value/liabilities of the business
- May be necessary to satisfy capital adequacy requirements

Indebtedness and Cash Adjustments

- The business deal is often delivered on a “debt-free, cash-free” basis
  - Purchase price increases for any “Cash” of the Target and decreases for any indebtedness of the Target at closing
- Generally combined with a working capital adjustment
  - Cash and indebtedness need to be excluded from working capital to avoid double counting
- “Cash” and “Indebtedness” are negotiated terms
  - Buyer will seek to only include Cash in readily available accounts without any costs to withdraw, and which is not required for capital adequacy
  - Target will seek to include all Cash regardless of restrictions/repatriation
  - Similarly, Buyers/Targets debate content of “Indebtedness.” *E.g.*, long-term debt, guarantees, potential earn-outs, capital leases, etc.

Net Asset Value Adjustment

Net Assets = Total Assets – Total Liabilities

- Changes in Net Assets between the measurement date and closing date typically increase or decrease the purchase price on a dollar-for-dollar basis
- Unlike the Working Capital Adjustment, the Net Asset Adjustment captures changes to all items on the balance sheet (long-term and short-term)

Key Elements of Calculation Methodology

- Accounting procedures used to calculate elements of adjustment
- Heavily negotiated defined terms
- Measurement Date(s)
  - Closing date, particular period in time
- Dispute Resolution Procedures
- Sometimes third parties calculate elements of adjustment

Accounting Procedures

- Generally Accepted Accounting Principles (GAAP)
- International Financial Reporting Standards (IFRS)
- Statutory Accounting Principles (SAP)
- Cash Accounting
- Specifically Delineated Procedures
  - Ideal for complicated adjustments
  - Requires significant advance planning and client/accountant cooperation

Accounting Procedures (cont'd)

- Historical Practices of the Company
  - Typically based upon one of the above-listed principles
  - Accounting principles allow flexibility, so reference to using historical practices provides greater specificity: reserve methodology, E&O inventory, revenue recognition/deferral; IVNR/IVNP; etc. Buyer needs to be intimately familiar with these procedures and specify how certain one-time items are treated
  - Assists in specifying Seller-accounting vs. purchase accounting
  - Need to be mindful of consolidation issues / intercompany transactions
- Sample balance sheet / calculation
  - Often helps avoid disputes

Dates For Adjustments

- Closing Date – commonly used date
- Pre-Signing Date Lock-Box
  - Buyer and Seller agree to a balance sheet at the time of signing – requires extensive pre-signing financial diligence. Greater comfort if date is an audit date
  - Buyer absorbs all operational and financial risk (and reward) of the Target Company from the time of signing onward
  - Need to close the system, and only adjust the purchase price for leakage (*e.g.*, dividends, bonuses, etc.)

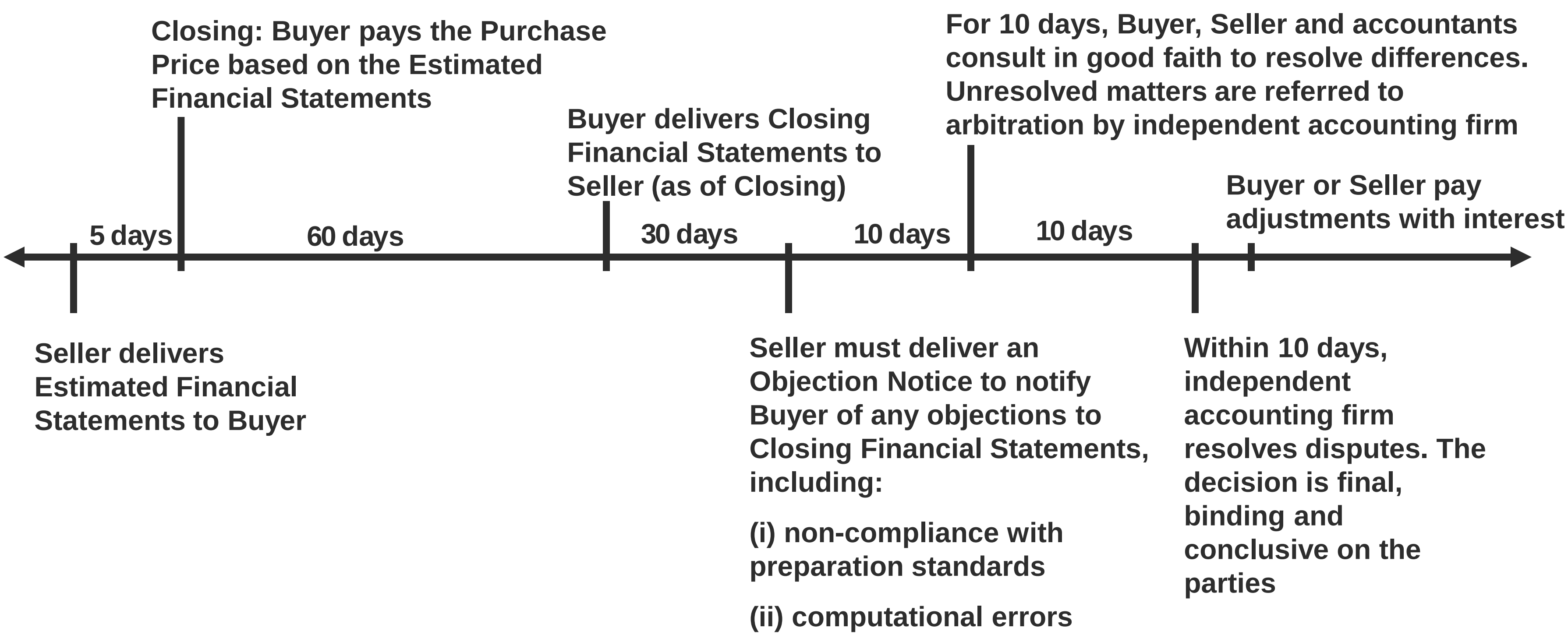
Dates For Adjustments (cont'd)

- Date between signing and closing
  - Rare, but will sometimes provide for adjustment based upon interim date, and becomes a lock-box thereafter
  - Generally predicated on a business decision that the benefits/risks of the business should pass to Buyer if closing does not occur by a certain date
- Post-Closing Earn-out Date(s)
  - Varies dramatically by business deal
  - Long earn-out period can prove challenging for businesses because they often limit operational flexibility

Dispute Resolution

- Typically the parties have some period of time to negotiate in good faith to come to an agreement
  - Information sharing covenants are key
- Disputes typically referred to a nationally recognized accounting firm
- Occasionally, third parties calculate portions of the adjustment – avoids disputes on those items

Example Closing Price Adjustment Mechanics



Example of Simple Adjustment(s)

Base Purchase Price: $100MM

Targets:

- W/ C=$10MM
- Debt=$0
- Cash=$0

Closing Payment: Seller Estimate

- W/ C=$15MM ($5MM more than Target)
- Debt=$2MM
- Cash=$1MM
- Closing Payment=$100MM+$5MM+($2MM)+$1MM=$104MM

Post-Closing Adjustment: Buyer Calculation

- W/ C=$12MM ($2MM more than Target, $3MM less than Estimate)
- Debt=$4MM ($2MM more than Estimate)
- Cash=$1.5MM ($0.5MM more than Estimate)
- Post-Closing Adjustment=($3MM)+($2MM)+$0.5MM=($4.5MM) $4.5MM paid to Buyer
- Final Purchase Price=$99.5MM

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Timelines – Public and Private Deals

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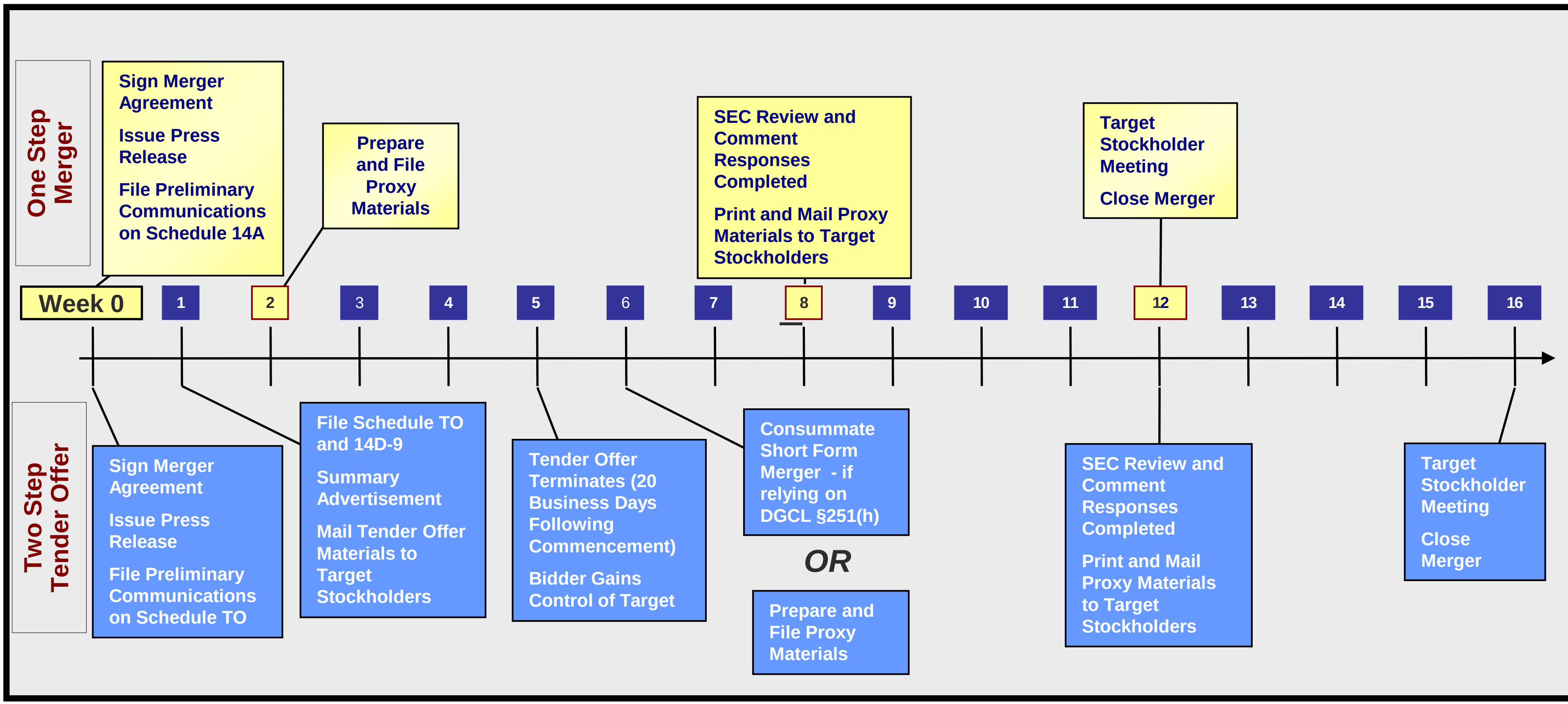
Timelines: Private Deals

- Three Key Gating Factors
  - Time for due diligence
  - Time for contract negotiation
  - Time for HSR and other regulatory review
- Stockholder approval can typically be obtained in days
  - No SEC review
- If deal is small enough to be HSR exempt or gets early HSR clearance, closing can be only days or several weeks after signing
- While hard to generalize, 60–90 days from first handshake to closing is often achievable, barring any regulatory hurdles

Timelines: Public Deals

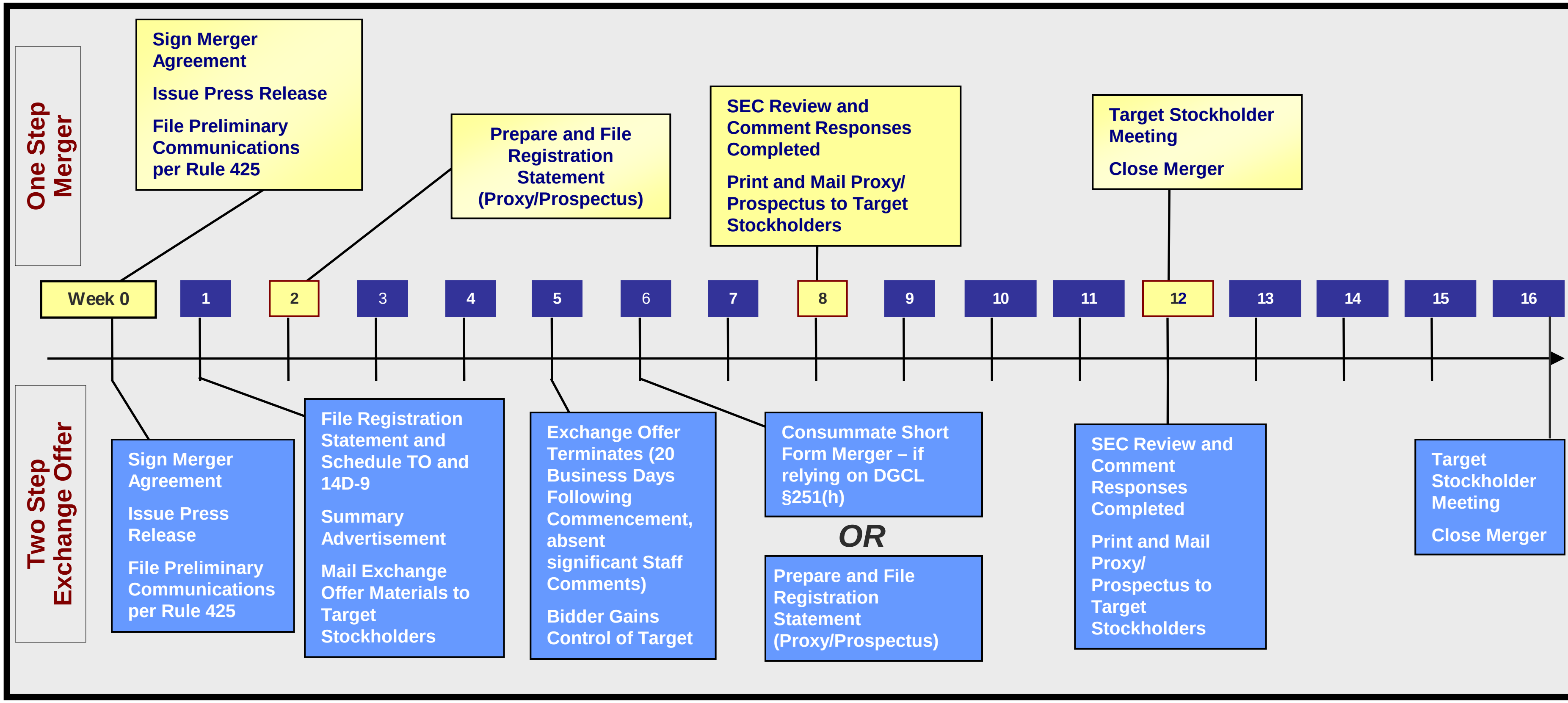
- Three Key Gating Factors
  - Time for contract negotiation
  - Time for stockholder approval
  - Time for HSR or other regulatory review
- Where stockholder vote is required, preparation and processing of SEC disclosure document requires:
  - 20–30 days after contract signing if no SEC review
  - 60–90 days after contract signing with SEC review
  - Stockholders then get 30–40 days to vote
  - Total time from contract signing to closing: 60–120 days
- Timeline to closing can be substantially shorter for:
  - Cash tender offer (35–40 days from contract)
- Private transactions do not have the complexity of SEC disclosure and review and, therefore, the main gating item is often antitrust approval, if required

Illustrative Timeline – Public Cash Transactions



Note: Assumes no antitrust or other regulatory delay.

Illustrative Timeline – Public Stock Transactions



Note: Assumes no antitrust or other regulatory delay, and no bidder stockholder approval required.

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Due Diligence

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Setting the Stage

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Due Diligence – Setting the Stage

- Purpose of due diligence
  - **Buyer**: Needs to understand what it is purchasing
    - Helps Buyers evaluate the Target's assets, operations, human resources, customers, suppliers, financial, legal and regulatory exposure, etc.
    - Helps management identify risks of ownership and obtain a holistic view of the Target
      - Enables management to correctly value the Target, plan for the acquisition, and, if necessary, adjust deal terms or price
  - **Seller**: Ensure that everything needed to effect the sale is completed so the deal can close and the Target can be sold
    - Includes ensuring all stockholder and third-party notices and consents are given and obtained, change-of-control provisions are identified and addressed in its contracts, etc.
    - Verify that the representations and warranties in the acquisition agreement are accurate to prevent post-closing issues
      - Ensure disclosure schedules are complete and accurate

Due Diligence – Setting the Stage (cont'd)

- Due diligence influences virtually every part of a deal
  - Dictates deal structure
    - Change of control provisions, consent requirements, tax issues, regulatory impediments
  - Serves to confirm valuation and manage risks
    - Legal rights to general earnings, no unknown liabilities or contingencies, transaction expenses
    - Identify commercial problems
      - Most Favored Nations clauses, non-competes, agreements with competitors
  - Essential for drafting the acquisition agreement
    - Scope and content of representations, covenants, and indemnification provisions
  - Provides a defense to fraud claims under federal securities laws
  - Aids post-closing integration of the Target into the Buyer's operations
  - Diligence is virtually always the excuse for a re-trade

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Getting Started

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Due Diligence – Getting Started

- Due diligence includes:
  - Legal diligence
    - General corporate, material agreements, litigation, real estate, employment, labor, benefits, IP, etc.
  - Regulatory diligence
    - Environmental inspections, tax audits, other regulatory issues
  - Business diligence
    - Customer and supplier interviews, human resources, compensation, financial and other business-related topics
- Every due diligence exercise is different
  - Public vs. private company
  - Technology and logistics (electronic or physical data rooms)
  - Availability and secrecy
  - Timing concerns
  - Antitrust constraints

Due Diligence – Getting Started (cont'd)

Diligence should begin shortly after execution of a letter of intent (with appropriate non-disclosure agreement)

- Develop a plan for due diligence
  - Business team and counsel should develop a plan together
  - Remember that every due diligence exercise is different and the plan must be tailored to the situation
  - Plan should include:
    - Agreement on time and subject matter objectives
    - Protocols for communications among responsible parties
    - Form of work product (oral report, digest, detailed memo, etc.)
- Build the diligence team and assign tasks to responsible parties
  - Divide responsibility between in-house and outside counsel based on business knowledge, substantive expertise, resource availability, and transaction experience
  - Provide enough background to make team members effective

Due Diligence – Getting Started (cont'd)

- Sellers
  - Organize data room
    - Gather, organize and keep inventory of relevant documents
    - May be necessary or appropriate to redact documents, or withhold until later in the process
  - Prepare Disclosure Schedule
    - Information from data room or interviews of relevant parties
  - If Seller is receiving stock as consideration, more thorough due diligence may be appropriate, including diligence of the Buyer

Due Diligence – Getting Started (cont'd)

- Buyers
  - Everything is not as it appears
    - Problems unknown or unrecognized by the Seller
    - Seller's "spin" may not represent reality
      - Generally trust but always verify
  - Diligence should be done up front. No such thing as post-signing "confirmatory" diligence
  - Diligence is not a rote exercise
    - Need to know what you are looking for
    - Focused requests much more effective
    - Complete diligence interviews and follow up
    - Be **inquisitive** and **persistent**

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U.S. Laws and Regulations Restricting International Business Activities

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Due Diligence – U.S. Laws and Regulations Restricting International Business Activities

- Foreign Corrupt Practices Act
  - Prohibits promises to pay or illicit payments to “foreign officials” in return for business or favorable treatment
  - Anti-bribery rules apply to all U.S. persons and U.S. companies
  - Books and records must be maintained by public companies which reflect issuer transactions and disposition of assets
  - Aggressive enforcement by DOJ and SEC (for issuers)
- Trade and economic sanctions
  - Maintained and enforced by OFAC in the Treasury Department
  - Target certain countries (*e.g.*, Iran, Sudan)
  - Also prohibits dealings with targeted persons and entities on the Specially Designated Nationals list
  - Aggressive enforcement, broad definitions of “U.S. person,” “facilitation,” and potential for strict liability

Due Diligence – U.S. Laws and Regulations Restricting International Business Activities (cont'd)

- Exon-Florio, CFIUS, FINSA rules
  - Review of investments or acquisitions by foreign persons
    - Often involving sensitive U.S. technologies, national security
    - Not always mandatory for parties to file notice for review by CFIUS, but CFIUS has authority to unwind the transaction
- Export and reexport controls
  - Maintained and enforced by various agencies, including Departments of Commerce and State
  - Restricts exports of "dual use" products and technology with both commercial and military applications, transfers to sensitive destinations or end-users
  - Controls apply to reexports (transfers between foreign countries) and retransfers of U.S.-origin items or even foreign items containing U.S. content or based on U.S. technology

Due Diligence – U.S. Laws and Regulations Restricting International Business Activities (cont’d)

- Anti-boycott laws – OAC and EAR rules
  - Restricts furthering or supporting most aspects of the Arab League’s and other countries’ boycott of Israel, or any unsanctioned boycott
    - Includes complying with requests to verify compliance with the boycott
  - Reporting requirements as well as prohibitions
    - Report quarterly requests received to take actions to comply with, further, or support an unsanctioned foreign boycott
- Anti-money laundering laws – FINRA rules
  - Impose “know your customer” screening and other compliance obligations on “financial institutions” (broadly defined)
  - Used as a tool by enforcement authorities to add additional counts for violations of certain laws noted above

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Additional Considerations

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Due Diligence – Additional Considerations

- Address Seller’s and Target’s information-sharing issues
  - Understand who knows and who needs to know
- Access public sources
  - SEC and regulatory filings
  - Google, trade periodicals, Nexis search
  - Consider UCC searches, docket searches, private investigators
- Communication is crucial
  - Issues may have ramifications unknown to diligence team members
- Structured communications are necessary
  - Make formal updating arrangements
  - Timing is critical

Due Diligence – Additional Considerations (cont'd)

- What if due diligence reveals problems?
  - If the problem is identified before signing
    - Renegotiate the deal (price, terms, risk allocation)
  - If the problem is identified after signing but prior to closing and it breaches a representation or warranty:
    - Threaten not to close and renegotiate price
    - Waive and close (or close and seek indemnity if permitted)
    - Terminate acquisition agreement
  - If the problem is identified after closing and it breaches a representation or warranty:
    - Seek indemnity if available
    - Not available for certain consequences of criminal violations
    - Proving fraud is difficult