

Morgan Lewis

M&A ACADEMY

Deal Structuring: Threshold Questions to Ask and Answer from Either Side of the Table

Benjamin Stein and Tara McElhiney

January 16, 2024

Agenda

- Overview of the Acquisition Process
- Forms of Acquisitions
- Issues To Consider In Structuring The Deal
- Select Public Company Issues
- Considerations in Selecting Form of Acquisition
- Hypothetical Facts
- Key Takeaways

Overview of the Acquisition Process

I. Role of Lawyer:

- If representing Buyer, advice on structuring and go/no go decision
- If representing Seller, advice on sale process and deal structure, and possibly evaluating bids from multiple Buyers
- Due diligence (buy-side/sell-side)
- Negotiation and documentation
- Getting to closing

Practice Tip: At the beginning of every proposed deal, ask the following questions:

- Process:
 - Is there a confidentiality agreement in place?
 - Is there a letter of intent, term sheet or even exchanges of emails on proposed terms?
- Leverage dynamics:
 - For a Buyer, who else is competing to buy this business?
 - For a Seller, what are the alternatives to the proposed Buyer or transaction?

Overview of the Acquisition Process (cont'd.)

II. Motivations of Buyer and Seller:

- Practice Tip – at the beginning of every deal, spend a little time thinking through why each side is pursuing the transaction, and their key motivations
- Motivations for each side often boil down to the same considerations, but for different reasons
 - What do the buyer and seller hope to get out of this?
 - For a buyer – new product line, additional functionality, shortcut development cycle / time to market
 - For a seller – accelerated growth, liquidity for shareholders
 - What are each party's primary concerns?
 - For a buyer – chain of title to key assets (e.g., IP), projected synergies, customer and employee retention
 - For a seller – deal certainty, speed to closing (and payment of purchase price), limiting liability under post-closing indemnity
 - When does each party want to do this?
 - For a buyer – upcoming conference / earnings call as forum for deal announcement
 - For a seller – timing of payment (e.g., this vs. next tax year)
 - What is the proposed process for getting to a signed deal?
 - What approvals are necessary (stockholder, board)?
 - Multi-party process (e.g., auction) vs. bilateral negotiation?

Overview of the Acquisition Process (cont'd.)

III. Typical Acquisition Process

- Process can be different for different types of deals
 - Bilateral negotiations
 - Auction process with multiple bidders
 - Asset purchase vs. acquisition of entity
 - Bankruptcy
 - Public vs. private target
- Common elements:
 - Preliminary discussions
 - Confidentiality agreement
 - Letter of Intent / term sheet
 - Diligence
 - Negotiation of deal documentation
 - Signing
 - Period between signing and closing (if not simultaneous)
 - Closing
 - Post-closing integration

Overview – Basic Forms of Acquisitions

- **Three main types of structures:**
 - Asset acquisition (purchasing the assets of target entity)
 - Stock purchase (purchasing the stock of target entity)
 - Merger (direct or indirect merger with target entity)
- **When looking at acquisition structures, there are several primary considerations that must be balanced**
 - Business & economics (e.g., acquiring less than the whole business, financing and risk allocation, integration and synergistic concerns)
 - Tax & accounting (e.g., tax free transactions, getting a “step up” in basis)
 - **Practice Tip – As tax treatment can be a big driver of economics based on the resulting deal structure, it is important to involve tax counsel early in the process**
 - Corporate & securities (e.g., needed approvals & applicable thresholds)
 - Contract (e.g., required third party consents)

Basic Forms of Acquisitions

A. Acquisition of Assets

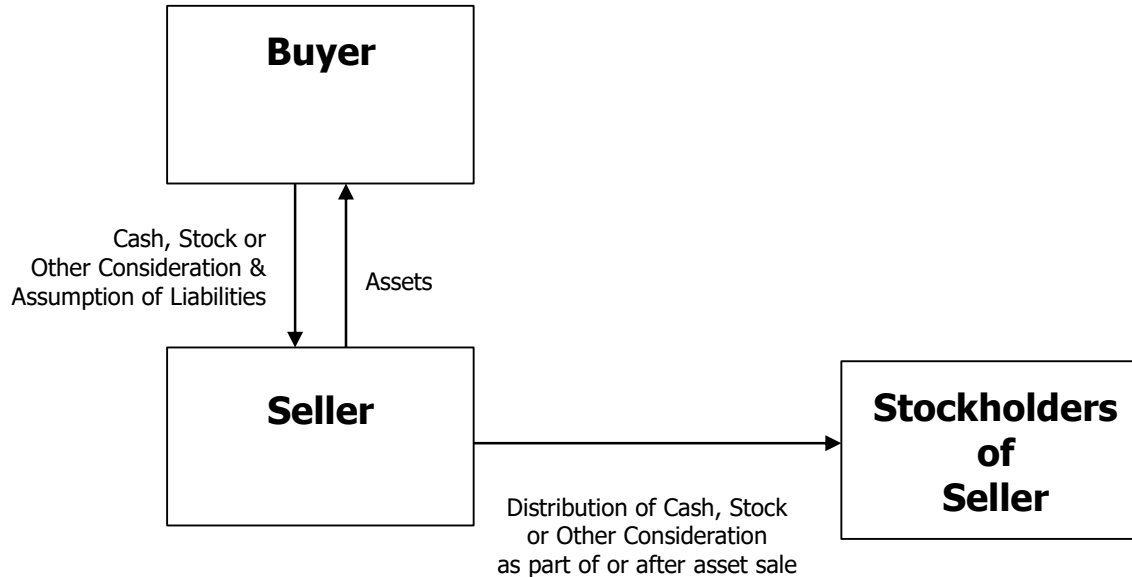
- Buyer acquires specific assets of Seller for stock of Buyer, cash or other consideration and the assumption of none, some or all of the related liabilities of Seller
- Completed through asset purchase agreement
 - negotiate directly with Seller's management
 - able to specify assumed and excluded assets and liabilities
 - Seller survives acquisition holding:
 - excluded assets
 - excluded liabilities and
 - unless distributed to Seller's creditors or stockholders, the cash, stock or other items paid as consideration

Practice Tips:

- Post-closing transitional (or shared) services are typically handled via a Transition Services Agreement (TSA), and any IP cross license (or license back) are typically handled in a separate IP agreement
- When doing due diligence on a target, the focus on diligence changes: (1) anti-assignment clauses need to be reviewed since contracts need to be transferred manually and (2) employees will not "auto-transfer" and need to be hired by Buyer

Basic Forms of Acquisitions – Asset Acquisitions

Acquisition of Assets



Basic Forms of Acquisitions – Asset Acquisitions (cont'd)

Pros and Cons to Asset Acquisition Structure

- Buyer
 - Can pick and choose specific assets and liabilities
 - No money wasted on unwanted assets (but may inadvertently fail to purchase an important asset)
 - Lower risk of assuming unknown or undisclosed liabilities – but see Practice Tip below
 - Often better tax treatment than stock acquisitions
 - Separating intermingled businesses (e.g., manual contract and employee transfers, dealing with shared services and IP)
- Seller
 - Left with known/unknown liabilities not assumed
 - If Seller is not a disregarded entity, often better tax treatment when selling stock
 - More complicated (e.g., assigning specific assets, transferring employees, transitional services and shared IP)
 - Lengthier time to closing
- **Practice Tip** - If representing the Buyer in an asset acquisition, can't assume that Buyer has no risk with respect to unassumed liabilities. Among other things, need to address potential types of liabilities that raise successor liability issues (for example, product liability) and any potential fraudulent conveyance risks.

Basic Forms of Acquisitions – Stock Purchases

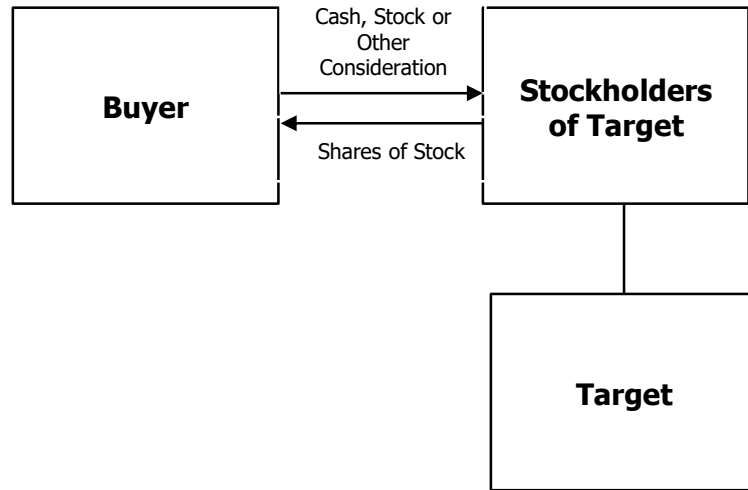
B. Acquisition of Stock

- Buyer acquires Target's outstanding stock from the stockholders of Seller for stock of Buyer, cash or other consideration
- Completed through stock purchase agreement
 - negotiate directly with Seller's stockholders
 - may acquire less than or 100% of outstanding shares (most strategic Buyers will want 100% ownership)
 - **Practice Tip** – may not work with larger shareholder bases where direct acquisitions of shares can be cumbersome or logistically difficult in the private company context
 - Target continues to hold all of its assets and liabilities both before and after the transaction – now with different stockholder(s)

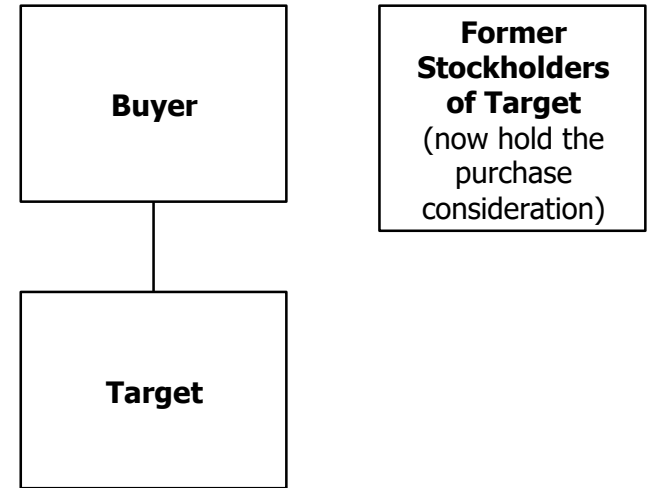
Basic Forms of Acquisitions – Stock Purchases (cont'd)

Acquisition of Stock

Before:



After:



Basic Forms of Acquisitions – Stock Purchases (cont'd)

Pros and Cons to Stock Acquisition Structure

- Buyer
 - Cannot pick and choose specific assets and liabilities – will assume all liabilities (known and unknown)
 - Often worse tax treatment than assets acquisitions
- Seller
 - Not left with any contingent liabilities
 - Often better tax treatment than sale of assets
- Not practical if the Target has large number of stockholders, as holders must individually agree to sell and negotiations with multiple shareholders can be costly and time consuming
- Few (if any) statutory requirements for negotiated stock sales

Basic Forms of Acquisitions – Mergers

C. Merger

- Three basic structures, all of which involve statutory mergers in which Target's outstanding stock is converted into the right to receive stock of Buyer, cash or other consideration:

Straight Merger:	<ul style="list-style-type: none">• Target merges into Buyer, with Buyer as surviving corporation• Note: requires approval of Buyer's stockholders (as well as Target's stockholders)
Reverse Triangular Merger:	<ul style="list-style-type: none">• Subsidiary of Buyer merges into Target with Target as surviving corporation
Forward Triangular Merger:	<ul style="list-style-type: none">• Target merges into Subsidiary of Buyer, with Subsidiary as surviving corporation

- Reverse Triangular Mergers tend to be the most common structure, as it allows the entity to be purchased and survive post-closing as a subsidiary of Buyer (fewer third party consents, no direct hiring of employees, etc., allowing more work to be done post-closing as opposed to prior to closing)

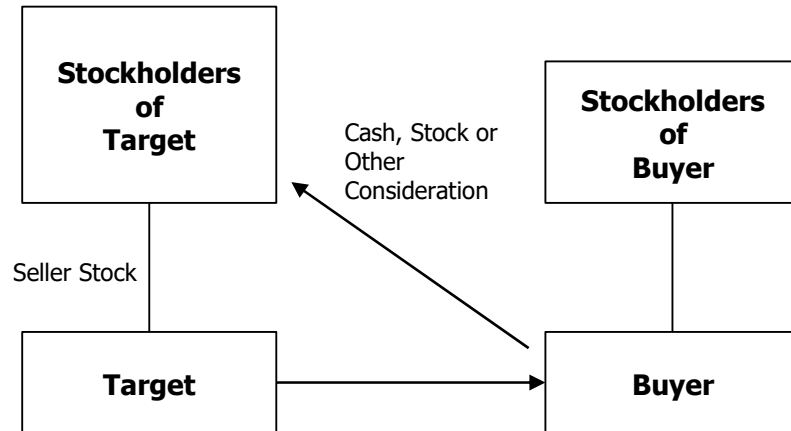
Basic Forms of Acquisitions – Mergers (cont'd)

- **Three basic forms**
 - Straight merger
 - Forward triangular merger
 - Reverse triangular merger
- **Completed through merger agreement**
 - specific terms of merger negotiated with Target's management or key stockholders
 - merger occurs by operation of state law for the jurisdiction(s) where the merging entities are organized
 - one of the constituent corporations survives the merger and succeeds to all assets and liabilities of the constituent corporations
- Must comply with the applicable state law merger statutes (e.g., Delaware General Corporation Law ("DGCL") §§251-271)

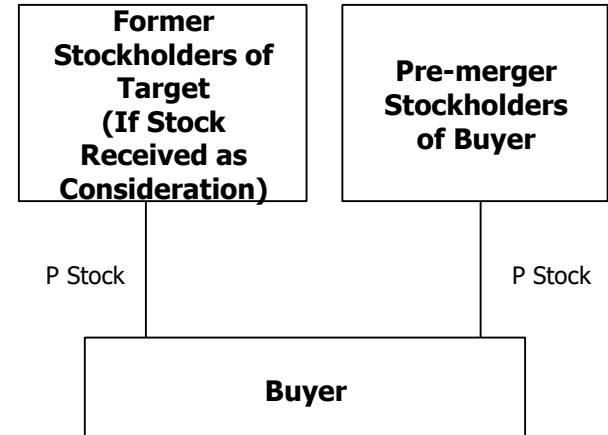
Basic Forms of Acquisition – Mergers (cont'd)

Straight Merger

Before:



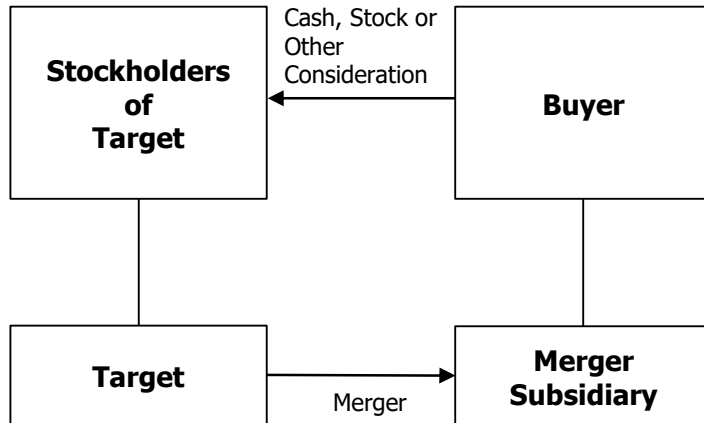
After:



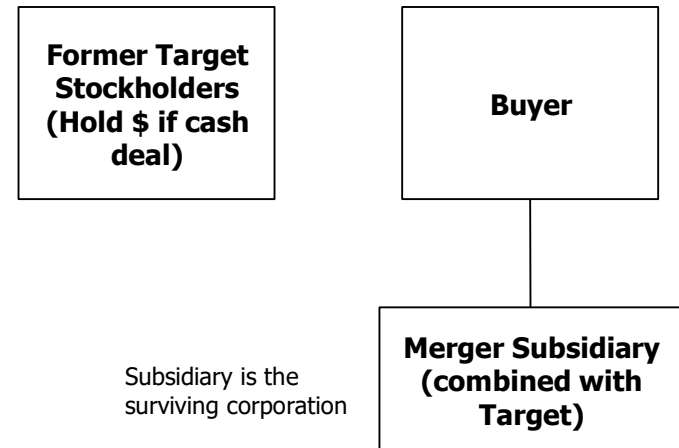
Basic Forms of Acquisition – Mergers (cont'd)

Forward Triangular Merger

Before:



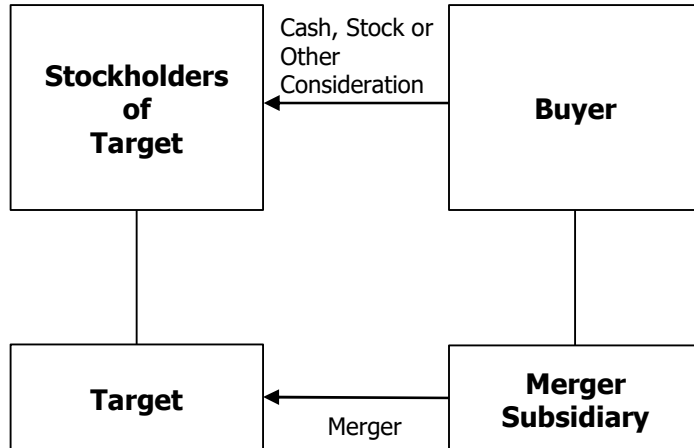
After:



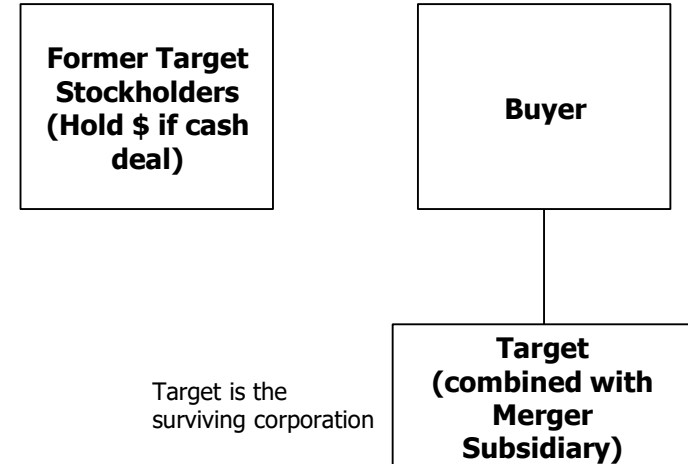
Basic Forms of Acquisition – Mergers (cont'd)

Reverse Triangular Merger

Before:



After:



Basic Forms of Acquisition – Mergers (cont'd)

Pros and Cons to Merger Structure

- Buyer
 - Cannot pick and choose specific assets and liabilities and assumes all liabilities (known and unknown)
- Seller
 - Not left with any contingent liabilities
- Typically only majority consent of Target stockholders required – very effective way of completing acquisition of a Company with a large number of stockholders
- Numerous third party consents may be required if Target merged out of existence (alternatively, if a reverse triangular merger, many third party consents may be avoided)
- Target stockholders may need to sign a written consent or voting/support agreement to support the merger
- Appraisal rights providing dissenting shareholders with the right to require a Company to pay them the “fair value” for their shares may apply
- **Practice Tip** – Need to be mindful of issues raised in Cigna case.

Other Issues to Consider in Structuring the Deal

Cigna v. Audax

- It had been a common practice for acquisitions of private companies with a large number of stockholders to structure the transaction as a merger, with all or part of the merger consideration being subject to an indemnity by the Target stockholders, who may or may not be parties to the merger agreement.
- In Cigna v. Audax, the Delaware Chancery Court held that two separate attempts to impose obligations on non-signatory stockholders in a private company merger were unenforceable:
 - First, the Court invalidated an attempt to force such a stockholder to agree to a general release of the buyer via a separate document in order to receive its merger consideration. The Court held that the stockholder was already entitled to its merger consideration by virtue of the closing of the merger, so the release was rendered unenforceable due to lack of consideration.
 - Second, the Court held that certain indemnification obligations violated DGCL 251(b), which requires a merger agreement to clearly state what consideration each stockholder would receive for its shares. Given that indemnity obligations survived indefinitely and were only capped at the pro rata merger consideration received by stockholders, a stockholder could never definitely ascertain its consideration being received in connection with the merger. The Court invalidated the indemnification obligation because it violated the requirement that the merger consideration be firm and determinable.

Other Issues to Consider in Structuring the Deal (cont'd)

Ways to address Cigna case

- Structure the deal as a stock purchase agreement rather than a merger so that all stockholders sign the purchase agreement
- In private company acquisitions, hold a portion of the purchase price in escrow, which may be decreased as stockholders sign support agreements
- Put temporal and monetary limits on the indemnification obligations to increase the likelihood of enforceability
- Condition the closing of the merger on acceptance by key stockholders, often by requiring stockholders to sign a separate support agreement
- If including a condition for payment or obligations in a separate contract or letter, provide for additional consideration for the stockholder's agreement
- Purchase (or require Target to purchase) representations and warranties insurance

CLE

- If you registered noting that you need CLE credit, the code is:

24MJG02

- Please save this number; you will need this to receive a Certificate of Attendance. You will be contacted within 30-60 days by our CLE administrative team.
- We will process your credits for other states where this program has been approved.
- Questions? Please email Keegan Early at keegan.early@morganlewis.com

Select Public Company Issues

Tender Offers v. One-Step Mergers

One-Step Merger Process (e.g., a public company merger):

- Target and Buyer sign merger agreement
- Target prepares proxy statement, which is reviewed by the SEC
- After the proxy statement is cleared, Target sets date for stockholders meeting, complying with notice requirements in charter
- If stockholders approve the merger, deal typically closes shortly thereafter, subject to regulatory approvals
- Merger is effected and Target stockholders receive merger consideration in exchange for ownership interest in the Target

Select Public Company Issues (cont'd)

Tender Offers v. One-Step Mergers

Tender Offer Process (e.g., a public company stock purchase):

- Seller and Buyer sign merger agreement (typical for “friendly” deal, but not required)
- Pursuant to merger agreement, Buyer launches tender offer directly to stockholders
- After end of tender offer period, if sufficient shares are tendered and other conditions are met, tender offer is closed and Buyer acquires tendered shares
- Buyer may thereafter complete a “back end” merger and squeeze out remaining stockholders, subject to compliance with state merger statute. The approval of the stockholders representing a majority of the remaining shares (which the Buyer holds after the tender offer) usually is necessary to authorize the back-end merger and complete the acquisition.

Select Public Company Issues (cont'd)

Benefits of a Tender Offer vs. a One-Step Merger

- **No SEC Pre-Clearance.** SEC pre-clearance of cash tender offer materials is not required before mailing to Seller shareholders. SEC review of cash tender offer materials after distribution is often limited
- **Speed.** A cash tender offer can be completed relatively quickly – 20 business days following commencement in the case of a friendly deal not involving any regulatory or other timing impediments (Delaware Section 251(h) eliminates prior delays in completing back-end merger)
- **Direct.** A tender offer is made directly to shareholders and does not require a shareholder meeting or board approval (could be used for hostile offer, although Section 251(h) may not be used).

Select Public Company Issues (cont'd)

Tender Offers and Section 251(h) of the DGCL

- Tender offers are frequently used as the first step in the acquisition of a Seller's common equity and must be followed by a "back-end" merger, where the bidder squeezes out the remaining shareholders for the same consideration offered to shareholders in the tender offer
- Under Delaware law, a back-end merger following a tender offer has long required shareholder approval unless the acquirer owned following the completion of the tender offer at least 90% of each class of target stock otherwise entitled to vote on the merger
- Effective August 1, 2013, Delaware eliminated the possible need for shareholder approval for second-step squeeze-out mergers in qualifying two-step acquisitions
- Under Section 251(h) of the DGCL (as amended), shareholder approval is not required for the back-end merger if, following the tender offer, the acquirer owns at least the percentage of stock that would otherwise be required for stockholder adoption of the merger agreement (typically >50%) subject to eligibility and other requirements

Additional Structuring Considerations

Generally, the structure of the transaction involves a balancing of competing and sometimes adverse business, tax, corporate law, contract, securities law and accounting considerations.

Leading a client through this analysis is one of the most important roles for an M&A lawyer.

Basic Questions About Seller

- Public company/private company
- Private company – number and identity of equityholders
- State of incorporation, and type of entity (e.g., LLC, LLP, S Corp, C Corp, etc.)
- What is Buyer buying?
- Is Seller business in a standalone entity or operated as a division of a larger entity?
- Are there assets/businesses the Buyer does not want to Acquire

Tax Treatment

- Tax treatment for Seller
- Tax treatment for Seller stockholders
- Availability and allocation of tax benefits
- Tax treatment for Buyer if later sells all or part of the business
- Compliance with specific tax requirements (for example, REIT rules)

Corporate Law

- Seller shareholder approval
- Buyer shareholder approval
- Appraisal rights

Additional Structuring Considerations (cont'd)

Timing/Other

- Relative leverage (and motivation) of the parties
- Liability profile of the target business
- Ability to obtain indemnity from credit-worthy party
- Financing structures
- Buyout fund structures
- Third party/other consents, regulatory requirements (including Hart-Scott-Rodino antitrust filing)
- State statutes
- Availability of adequate indemnity from seller to cover liability issues that can't be addressed with chosen structure for deal
- Parties' respective timelines

Key Takeaways

- At the outset, consider the parties' respective motivations, priorities and leverage dynamics
- Involve tax counsel early in determining deal structure
- Does the transaction involve the whole of Seller's business?
- Consider the Seller's structure – public vs. private company, (if Seller is private) size of stockholder base, corporate vs. disregarded entity, etc.
- Consider any other specific hurdles – timing, stakeholder approval requirements, third party consents, financing needs and (if Seller is private) indemnity parameters

QUESTIONS?

Biography



Benjamin J. Stein

Boston, MA

T +1.617.341.7775

E benjamin.stein
@morganlewis.com

Benjamin Stein represents public and private companies in a variety of corporate transactional matters, including mergers and acquisitions, private equity and debt financings, and US Securities and Exchange Commission (SEC) registered securities offerings. He counsels public companies with respect to securities disclosure issues, corporate governance matters, New York Stock Exchange (NYSE) and Nasdaq compliance issues, and reporting obligations under the Securities Exchange Act of 1934. Ben also has experience representing both companies and underwriters in a variety of capital markets transactions.

Biography



Tara R. McElhiney

Houston, TX

T +1.713.890.5732

E tara.mcelhiney
@morganlewis.com

Tara R. McElhiney represents clients in a broad range of complex corporate transactions, with an emphasis on advising public and private companies, including private equity funds and their portfolio companies, in domestic and cross-border mergers and acquisitions and joint venture transactions. She also advises clients with respect to financing transactions and general securities and corporate governance matters, including equity and debt financings. Tara represents companies in a variety of industries, primarily within the energy, healthcare, technology, and manufacturing sectors.

THANK YOU

© 2024 Morgan, Lewis & Bockius LLP
© 2024 Morgan Lewis Stamford LLC
© 2024 Morgan, Lewis & Bockius UK LLP

Morgan, Lewis & Bockius UK LLP is a limited liability partnership registered in England and Wales under number OC378797 and is a law firm authorised and regulated by the Solicitors Regulation Authority. The SRA authorisation number is 615176.

Our Beijing and Shanghai offices operate as representative offices of Morgan, Lewis & Bockius LLP. In Hong Kong, Morgan Lewis operates through Morgan, Lewis & Bockius, which is a separate Hong Kong general partnership registered with The Law Society of Hong Kong as a registered foreign law firm operating in Association with Luk & Partners. Morgan Lewis Stamford LLC is a Singapore law corporation affiliated with Morgan, Lewis & Bockius LLP.

This material is provided for your convenience and does not constitute legal advice or create an attorney-client relationship. Prior results do not guarantee similar outcomes. Attorney Advertising.