Merger & Acquisition Focus

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Celebrating Over 25 Years

Everingham & Kerr, Inc.

Merger & Acquisition Advisors focused on the Lower Middle Market

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M&A deal structure: Basics for buyers and sellers

Every M&A deal is unique, but they all involve one or a combination of three basic structures: stock purchase, asset sale or merger of companies. If your company is considering buying or selling, it's important to understand the differences between these types of transactions. The wrong choice could lead to negotiation difficulties and tax disadvantages and could even prevent your deal from closing.

Stock purchase primer

In a stock purchase, the buyer acquires a controlling majority, if not all, of the seller's voting shares. So the buyer essentially becomes the owner of all of the seller's assets and liabilities.

Stock purchases usually are advantageous for sellers. The proceeds of a sale generally are taxed at the lower, long-term capital gains rate. (See "The tax question" on page 3.) Also, such sales are less likely to disrupt the company's day-to-day business.

For buyers, one advantage of this type of deal can be that the seller continues running operations, helping the buyer to avoid a lengthy — and expensive — integration. Yet the buyer owns all contracts, intellectual property and assets, making it easy to begin deriving value from the acquisition. Also, all-stock deal negotiations tend to be less contentious.

The downside is that, because a buyer acquires all of the seller's outstanding liabilities, the buyer may inherit legal and financial problems that ultimately reduce the value of the purchase. And if the selling company has dissenting shareholders, a stock purchase won't make them go away. In fact, dissenting shareholders (depending on the scope of their rights) can become an uncomfortable thorn in the buyer's side once it assumes majority ownership.

The goods on asset sales

With an asset sale, the buyer acquires most of the seller's assets — typically paying cash or offering its own shares — and assumes all liabilities associated with those assets. The selling company continues to legally exist after the sale, though in many cases it may wind down operations soon after the deal closes.

Buyers enjoy many advantages with this structure. An asset sale enables them to cherry-pick assets, choosing *not* to carry over certain liabilities that might prove burdensome, such as employee pension plans or unused assets. And by avoiding the rights of appraisal issues that typically surface in a merger, buyers can sidestep complaints made by dissenting shareholders. On the other hand, buyers may lose desirable nontransferable assets such as licenses or permits.

What's more, an asset sale can trigger a costly tax event, hindering the transaction or requiring both buyer and seller to agree on a price that takes tax implications into consideration.

Asset sales offer sellers some advantages — for example, quickly available funds. However, such sales can be time-consuming and it's possible for sellers to get stuck with liabilities that the buyer declines.

Merger matters

The term "merger" is thrown around a lot, but strictly speaking a merger occurs when two distinct companies agree to legally become a new, combined entity. A merger deal starts when one party buys the other's shares or assets. Then the two combine to become a "new" company — either the buyer's or seller's company is reconstituted or they start with a fresh entity.

The upside to a merger for both buyers and sellers is simplicity. All contracts and liabilities pass into the new entity, thus requiring little negotiation about such terms. (Keep in mind that, as with a stock purchase, the buyer is on the hook for all seller obligations.) The downside: If they form a large enough block, disapproving shareholders on either side can thwart the merger by voting against it.

Working to the decision

Unfortunately, choosing a deal structure is complicated by the fact that buyers and sellers typically have competing legal, tax and other financial considerations. So, for example, a buyer preferring an asset sale may need to offer a higher price or other concessions to get a seller who wants a stock deal to play ball.

The kinds of concessions a company might be willing to make depend largely on its strategic endgame. If a buyer wants to acquire a seller's reputation, business and best employees, a straight merger may be the best option — even if it isn't the cheapest. If a selling owner is looking to cash out as quickly as possible, an asset sale could be more appealing than a stock deal.

Getting it right

Deal structure negotiations can be challenging, which is why it's important to have experienced M&A advisors working with you. In the end, it often comes down to which party wants the deal more and is willing to compromise. ■

The tax question

Each of the three main M&A structures — stock purchase, asset sale and merger — has its own tax-related advantages and disadvantages.

Mergers and stock purchases generally enable buyers to transfer the seller's tax benefits, such as net operating loss carryforwards, and avoid having to pay bulk and sales taxes. Buyers may have to pay substantial taxes on an asset acquisition, but there are benefits to this structure: The buyer has greater flexibility to step up appreciation of its assets and enjoy higher deductions.

For sellers, stock purchases generally provide the most favorable tax treatment, while asset sales are more likely to create tax burdens. With an asset sale, the seller's proceeds are likely to be taxed as ordinary income. And depending on the legal structure of the entity, the seller might incur a "double tax" — first at the corporation level and again when proceeds are distributed to shareholders.

MAC to the rescue?

WHEN BUYERS SHOULD CLAIM A MATERIAL ADVERSE CHANGE

As seasoned business buyers know, an M&A deal isn't over 'til it's over. A lot can happen on the way to closing, including dramatically weakened performance, undisclosed issues, or other negative events at your target company. But a material adverse change (MAC) clause can, in some circumstances, help buyers escape a bad deal.

Buyers, however, should think carefully before invoking a MAC clause lest it lead to litigation and financial consequences.

2 elements

Most M&A sales agreements include a MAC provision — 98% of 195 agreements surveyed by Nixon Peabody between June 2012 and May 2013. These clauses generally have two elements.

MACs shouldn't be used as an alternative to thoroughly researching potential targets.

The first is a definition of what constitutes a MAC for the purposes of the deal. Generally, this provision describes a MAC as a relatively sudden event that quickly and negatively affects a business's performance. The classic example is Dynegy's proposal to buy Enron in the early 2000s. Dynegy invoked a MAC clause after Enron disclosed that it had failed to mention some of its liabilities and its debt was downgraded to "junk" status. The prospective buyer argued that Enron was worth far less than the company had originally reported.

A MAC definition might also contain a forward-looking component, such as requiring the provision to apply to any event that has a reasonable likelihood of causing an adverse change in the future. MAC clauses typically cover the period of time between the signing of the acquisition agreement and the transaction's completion, making it a kind of emergency escape clause for buyers.

The second element describes the circumstances that would permit a buyer to withdraw from the deal without incurring a penalty. MAC clauses contain a list of carve-outs — exceptions and qualifications that shouldn't be considered when determining if a target company has experienced a MAC. This list might include general economic changes that affect the target company's industry, securities law changes that hurt the target's business and changes in the rules of Generally Accepted Accounting Principles. Unpredictable events such as terrorism, war or other catastrophes ("acts of God") are also commonly named as exceptions.

Market conditions usually dictate the number and breadth of exceptions included in the clause. For example, in a seller's market, MAC clauses typically include a wide range of exceptions, making it difficult for buyers to invoke one.

Negotiating tool

Although MACs can help buyers that get blindsided during the deal process, they shouldn't be used as an alternative to thoroughly researching potential targets or performing extensive financial and legal due diligence on your seller. Instead, think of a MAC as a negotiating tool. During the negotiation process, you and the seller should discuss what events constitute a MAC as a way to allocate risk between both parties. If you're unsure or uncomfortable about your target's exposure in certain areas, you might negotiate to include them in your agreement's MAC clause.

Even with a clearly defined MAC clause, proving in court that an adverse change has occurred can be extremely difficult. For example, in 2008 the Delaware Chancery Court ruled against Hexion Specialty Chemicals when it tried to terminate its deal to buy Huntsman Corp. The court found that no adverse event had occurred, and held that Hexion had knowingly and intentionally breached the merger agreement.

Long-term cost

During the recent recession, the number of buyers invoking MACs increased, but improving economic conditions may reverse that trend. Even if your acquisition agreement contains a MAC, think before you use it to escape a deal. Paying a breakup fee may be the better choice in the long run. ■

Making your cross-border M&A work

International companies, increasingly those from deal-hungry China, can offer great growth opportunities for U.S. businesses seeking buyers. However, foreign buyers aren't always familiar with U.S. regulations and legal obligations. So you may have to act as your buyer's translator, helping navigate the intricacies of the cross-border deal process.

China's growing presence

In recent years, China has emerged as a major international buyer. In 2013, Chinese companies invested more than $56 billion in overseas acquisitions (January through November). That's far more than the $40.7 billion invested over the same period by Japanese firms, which until 2013 were Asia's leading cross-border M&A players. According to Thomson Reuters, Asia as a whole has expanded its share of global M&A from 10% in the early 2000s to 20% today.

Driving such dramatic change is China's hunger for overseas growth. Formerly, the leading impetus behind Chinese M&As was a desire for raw materials and energy resources. Now, Chinese companies are buying everything from banks (Construction Bank Corp.'s acquisition of a 72% stake in Banco Industrial e Comercial SA) to food producers (Shuanghui International's $7.1 billion purchase of Smithfield Foods).

Resolving issues early

Growing interest in Asia and other regions in buying U.S. companies can mean greater competition and potentially a higher sale price for your business. But you may need to take on more responsibility during the deal process than you would with a domestic buyer.

Foreign buyers are under a unique set of obligations: They must comply with legal and regulatory requirements both in their home countries and in the United States. To assist your buyer, try to resolve the following issues before you reach the due diligence stage of the deal:

Invalid obligations. Are there any obligations that could be difficult for an international buyer to assume? For example, some noncompete agreements, licenses, permits and patents may not be valid under foreign ownership.

Employee benefits. Help smooth the international transfer of such arrangements as employee health and retirement plans and salary distributions. Consider, for example, how your buyer will handle currency transfers for employees in different countries.

Ongoing litigation. Try to settle any litigation or outstanding issues involving regulatory requirements, intellectual property, employees, customers or competitors before entering serious deal negotiations. No business buyer wants to assume legal liabilities, but such issues are especially off-putting to foreign companies unfamiliar with U.S. law.

Cultural tensions

Cross-border mergers make integrating operating and management cultures especially challenging. Despite the best intentions of both parties, international M&As typically generate some degree of cultural friction.

For example, your government-affiliated Chinese buyer may be used to integrating acquisitions at a faster speed than most U.S. companies are. Or your buyer might underestimate the cost of consolidating regional offices. Differing expectations can lead to frustration and confusion. So help prospective buyers by providing timeframes and cost schedules based on your homegrown experience operating in the United States.

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Employee relations can also be a live wire. International owners may be unfamiliar with U.S. holidays or such practices as sick and disability leave. They also might, because of their own country's accounting or regulatory requirements, need to "terminate" and then rehire your company's employees. Unless it's explained in advance, this could be an alarming situation for U.S. workers. To defuse possible conflicts, work proactively to acculturate both companies to each other's work practices.

Best of both worlds

Despite the many challenges, an international deal may be worth pursuing. Some analysts have noted that Chinese companies are now making the kinds of acquisitions — particularly cross-border and large-volume — that U.S. buyers have shied away from in recent years. But to reduce potential headaches — and realize the best price for your business — do what you can to bridge the inevitable financial, legal and cultural divides.

Ask the Advisor

Q. What should a company do when its CEO and CFO disagree over an M&A?

A. The interests of chief executives and boards of directors often clash with those of CFOs — particularly when it comes to M&A transactions. Differences may run deep enough to threaten a company's long-term ambitions. For your M&A deal to succeed, your company needs to reconcile both points of view. This means crafting a deal that doesn't sacrifice financial integrity for strategic ambition (or vice versa).

Question of objectives

A 2013 Deloitte & Touche survey of directors and CFOs highlights core differences. While a majority of each group surveyed agreed their company's primary M&A strategy is to seek smaller, strategic deals, they differed in the rationale for pursuing such transactions. CFOs were more likely to cite the need to diversify products and services as a primary objective. Directors more often named achieving cost synergies or efficiencies of scale.

Take, for example, the board of a Midwestern manufacturing company that proposed the acquisition of a small service provider that suddenly came on the market. The board and CEO considered it a great opportunity to lower production costs. Pointing to research on the track records of similar deals, the company's CFO countered that his colleagues were too optimistic about potential savings. The CFO also argued that such a deal, while small, presented too much financial risk. The two groups were at an impasse until the CFO resigned. The CEO eventually dropped his acquisition plans.

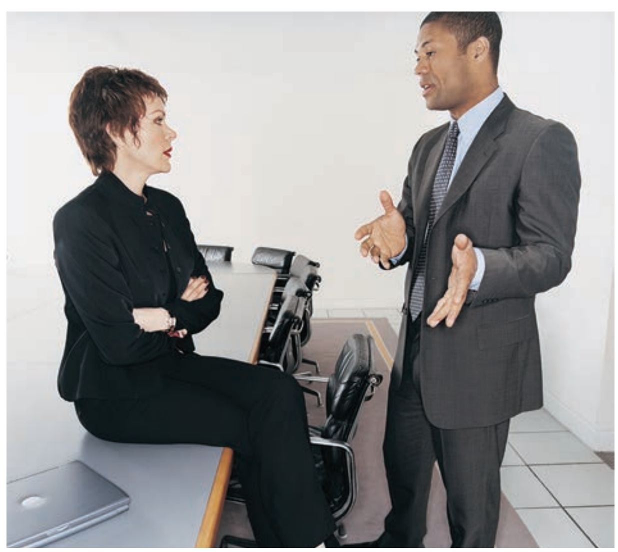
Financing quandaries

CEOs, directors and CFOs don't always see eye to eye on financing, either. Counterintuitive as it may seem, CFOs in the Deloitte survey were more likely to favor using debt to finance a deal rather than making an all-cash purchase. The majority of directors preferred using cash.

Such attitudes make sense when you consider that many companies reduced their leverage during the recent recession. For CFOs, debt financing is usually preferable when interest rates are low and a company is comfortably leveraged. To minimize conflict, a CFO may simply need to provide the CEO and directors with financial evidence of his or her position.

Reconciling opposites

Everyone's job at the executive level is to maximize growth and minimize risk. Working together is critical. CEOs who propose mergers to achieve cost synergies that their CFOs claim aren't there, or are too risky, should think long and hard before pushing ahead with the deals. Likewise, CFOs can get too deep "in the books" and miss subtler strategic implications of purchases. ■



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Passing the Business Torch ... One Successful Transaction at a Time

Our Firm:

Everingham & Kerr (E&K) is a regional merger and acquisition advisory firm focused on implementing exit and growth strategies for lower middle market companies. Our client base includes private and publicly owned companies, investor groups, family businesses and entrepreneurs. Since 1988, the firm has successfully completed nearly 200 transactions spanning virtually every industry sector.

Our Maxim:

Combining Experience, Teamwork and Persistence to Produce Superior Results.

Our Services:

Sales:
E&K provides representation to sellers of lower middle market companies including sales of entrepreneur and family owned companies as well as divestitures of business units of private and publicly owned companies.

Acquisitions:
E&K assists companies, entrepreneurs and corporate executives develop and execute customized acquisition strategies designed to result in successful transactions.

Transaction Consulting:
In some instances the parties to a transaction locate each other through informal industry or personal channels. These transactions include sales to unrelated third party acquirers, as well as management, family and partner buyouts. E&K is often engaged to structure these transactions and navigate the many issues requiring attention from the initial stages to the consummation of the transaction.

Business Valuations:
E&K provides a full range of valuation services to business owners for personal and corporate affairs. Supporting our belief that all owners should know the “real” value of their business, E&K offers the “Owner’s Planning Valuation”. This is an informal valuation that can be prepared in a cost-effective manner and updated periodically to assist owners with company and personal planning issues.

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