MERGERS & ACQUISITIONS III: ACQUISITION CONSIDERATION: DEAL POINTS

May 2022

I. Executive Summary

This is the third of a series of periodically issued advisories on Mergers & Acquisitions (M&A) that we started in April 2022. Its predecessors in the series, "Mergers & Acquisitions I: Overview and Transaction Types" ("M&A I") and "Mergers & Acquisitions II: Tax Structuring Considerations ("M&A II"), are available with other M&A resources on our website at Kurtin PLLC Mergers & Acquisitions and on Lexology at https://www.lexology.com/contributors/kurtin-pllc. Following the discussion are "Deal Points" on important considerations in the purchase or sale of a business: what to do, and *what at all costs not to do.*

This M&A III advisory will focus on how to pay the "Acquisition Consideration," the purchase price for the business being acquired, with cash, stock, assumption of debt, a combination, or some other form of payment. Future editions will drill down on issues like preliminary documentation - letters of intent ("LoIs"), memoranda of understanding ("MoUs") and term sheets; due diligence; transaction documents - the Stock Purchase Agreement, Asset Purchase Agreement or Merger Agreement embodying the transaction and ancillary documents; securities; financing the M&A transaction with debt, equity or a hybrid or debt and equity combination; antitrust (competition) and merger control clearance; employment and equity-based compensation like stock options; valuation and accounting issues; closing agendas and how to close an M&A transaction (a surprisingly dark art) industry-specific regulatory regimes; issues specific to "Public M&A," meaning when Target is a public reporting company and there is a substantial Securities Exchange Act of 1934 (the "Exchange Act") regulatory compliance overlay; and issues specific to cross-border M&A, between Acquirors and Targets based in different countries, including foreign investment review and technology export rules. We will also publish editions dealing with specialty topics like buy-outs, divestitures, spin-offs and "going private" transactions, often associated with M&A in the private equity sector. In this and all future editions of this M&A series, familiarity with the preceding editions linked above will be assumed and previously defined terms will be used without further introduction.

II. Acquisition Consideration

Acquisition Consideration, the purchase price paid by Acquiror to Target, is usually paid in cash, stock, the assumption of Target debt or a combination thereof. When Acquiror stock is all or part of the Acquisition Consideration, Acquiror may use existing authorized but unissued stock as Acquisition Consideration or authorize and issue new stock. Acquiror may also finance all or part of the Acquisition Consideration through issuance of stock and/or incurrence of debt.

a. Cash Acquisition Consideration. As described in M&A II, if Acquiror's Acquisition Consideration is paid in cash, the transaction will not be eligible for "tax-free" treatment under Tax Code section 368(a)(1)(A) - (D). However, the tax effects of a cash transaction may be ameliorated by use of the Tax Code section 338(g) and 338(h)(10) elections also described in M&A II. Cash consideration may be payable in full at closing or in installments and subject to various post-closing contingencies. But cash on the barrelhead, paid in full at closing, is the most valuable and risk-free consideration from Target and Target's shareholders' point of view. A cash-in-full offer should command a significant discount from other types of Acquisition Consideration, including competing offers that are not cash. Any non-cash-in-full offer should be considered as in some measure contingent and command a risk premium for Target and its shareholders. Put simply, any Acquiror willing to pay cash in full at closing should be able to pay less than other potential Acquirors offering non-cash deals in most circumstances, the main exceptions being when Target/Target shareholders expect a significant appreciation in Acquiror's share value as a result of the transaction or over time, want to participate in the post-transaction business for that or other reasons, or when tax-free structuring more than compensates for the assessed risk premium in taking stock instead of cash.

b. Stock Acquisition Consideration. Target and its shareholders, all other things being equal, usually favor being paid in cash than in stock; after all, if paid in cash, they can always buy Acquiror stock with some of the cash later if they want (assuming it was available at the same price as it was in the transaction, which may not be the case, especially if the M&A transaction adds value to the post-acquisition business as intended), and stock Acquisition Consideration should ordinarily be subject to a risk premium and a higher purchase price than a cash deal would require, with the exceptions noted above. Conversely, Acquiror's use of stock as Acquisition Consideration can result in tax-free treatment for the transaction when the deal is structured properly, as described in M&A II, which may compensate for some or all of the risk premium, and of course the parties may be buying into a business case in which the combined companies will be worth more post-closing than the sum of their parts. In fact, if they *don't* believe that, it may be that they shouldn't be doing the deal.

c. Hybrid Cash and Stock Consideration. The risk premium to Target in accepting Acquiror stock as Acquisition Consideration can be partially mitigated by structuring a deal in which part of the Acquisition Consideration is Acquiror stock, and part is cash. In a "cash election" merger or other M&A transaction, Target shareholders are granted an election period in which to decide to accept stock or cash for the cash part of the Acquisition Consideration, allowing them to assess market reaction to the announced transaction and its effect on Acquiror's share value. The length of the election period is often heavily negotiated, as is whether to treat all Target shareholders the same way in terms of cash election rights.

d. Assumption of Debt. Assumption of Target's debt is a key and frequent part of M&A Acquisition Consideration, and often should command a premium, especially when the debt is restructured in the course of the M&A deal – the interest rate lowered, maturity date extended, the terms or collateral eased. Assumption of debt may also be tax deductible for the Acquiror, although, since the 2017 Tax Cuts and Jobs Act ("TCJA") lowered the maximum corporate tax rate from 35% to 21%, granted a 20% deduction on qualified business income and capped business interest (whether paid or accrued) deductibility, previously unlimited with a few minor exceptions, at 30% of EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization) through 2021, and 30% of EBIT thereafter, deductibility of interest is less of a transaction-structuring driver than it used to be.

As an aside, the limitation on business interest deductibility should disfavor debt financing as a general matter, especially in a time of rising interest rates. Among other things, convertible debt instruments, term loans, revolving credit facilities, debentures and short-term notes will all change in relation to each other and to equity as a result of the loss of the full deduction, with the incurring of debt by a business a more expensive proposition than before. The relative availability of debt finance may also be affected.

However, it is important for Acquiror to remember when considering assumption of Target debt that the M&A transaction thereby becomes a marriage with three or more parties: the Target's creditor or creditors are also in the deal. Creditors' consent to the assumption of debt and transfer of obligation from Target to Acquiror, as well as what they might demand in exchange for that consent, as a contingency and a risk must be sought and programmed into the transaction, from the point of LoI, MoU or term sheet on; deals have cratered on failure to obtain creditor consent to assumption of Target debt, as when, for example, the debt instrument makes a "change of control" without creditor consent an "event of default," creditor does not consent and declares an event of default by reason of the M&A transaction. Not only that, but the LoI, MoU, term sheet, Stock Purchase Agreement, Asset Purchase Agreement or Merger Agreement, as the case may be, may make failure to obtain creditor consent a Target covenant or Acquiror condition to closing, allowing Acquiror to terminate the transaction and walk away from the deal without penalty.

III. Acquisition Consideration Control Devices

Among the issues confronting M&A parties as they plan, structure and document their transaction are the effects of changes in the value of Target and/or Acquiror's stock when stock is being used as Acquisition Consideration. Various techniques to control or limit those changes in value can be used.

a. Fixed Exchange and Fixed Value Ratio Formulas

Where not all the Acquisition Consideration is in cash, parties can also allocate risk of pre-closing volatility through adjustable pricing formulas. In a "fixed exchange" ratio, each of Target's shares is converted into a fixed number of Acquiror's shares based on a negotiated and fixed exchange ratio. Under a fixed exchange structure, the dollar value of the fixed number of Acquiror shares received by Target/Target shareholders can rise or fall in the period after the deal is signed and when it closes, thereby changing the value of the Acquisition Consideration, either as a result of Acquiror's business performance, market reaction to the pending deal, or general market/industry conditions incidentally affecting Acquiror. Fixed exchange ratios are most common in larger, stock-for-stock "merger of equals" transactions, since both parties share the risk of movement in Acquiror's share price. Fixed exchange transactions are also traditionally common in sectors of perceived volatility, such as the tech sector, and Acquiror's resulting position that volatility risk in its stock price should be shared.

In a "fixed value" transaction, it is the exchange ratio that floats and Target shareholders receive a fixed dollar value of Acquisition Consideration, however many Acquiror shares that works out to cost. The formula usually provides for measuring Acquiror's stock price during a negotiated period of days or weeks prior to closing or a meeting of Target's stockholders to approve the transaction. A fixed value pricing formula is used to insulate Target's shareholders from risk from changes in Acquiror's share value prior to closing, whether from the Acquiror's business performance, market reaction to the pending deal, or general market/industry conditions incidentally affecting Acquiror. Fixed value transactions are traditionally most common when one party is clearly Acquiror and the other clearly Target, rather than in the "merger of equals" context and, unlike in fixed exchange ratio transactions, pose the risk for Acquiror that it may have to issue more shares to purchase Target's shares if Acquiror's share value declines during the measuring period, which may reduce the stock value and dilute existing Acquiror shareholders (of course, a rise in Acquiror's stock value prior to closing will allow it to close the transaction on fewer shares). Also, in Public M&A, hostile bidders use fixed value structures because they have more appeal for Target shareholders, who may be solicited under a tender offer and are more likely to tender based on a known dollar compensation for their shares.

Fixed Exchange and Fixed Value pricing formulas can be used with hybrid cash and stock transactions, in which the cash component can vary in inverse relation with the variations in the stock component, potentially altering both the overall Acquisition Consideration and the risk premium-modifying aspects of the cash component already discussed, factors which will be heavily negotiated and on which Target shareholders may have divergent interests.

b. "Collars," "Caps" and "Floors" are used to limit the volatility of fixed value transactions or other transactions in which Acquiror stock is all or part of the Acquisition Consideration. A Collar would set a maximum and minimum limit on the number of Acquiror shares that Target/Target shareholders would receive, even if market volatility and pre-closing valuation justified a higher or lower amount. For example, an Acquisition Consideration price Collar in a deal signed up for Acquiror use 1,000 shares of its stock to purchase 1,000 Target shares $1,000 per shares at a 1:1 exchange ratio with a 10% plus/minus Collar might provide for an adjusted price at closing of 10% fewer or more Acquiror shares, equal at closing to up to 1,100 or as little as 900 Acquiror shares. Above or below the Collar, the volatility protection ends, and for the excess above or below the Collar, Target/Target shareholder bear the risk of Acquiror stock rise or fall, as the case may be, at closing, as though in a fixed exchange ratio structure. A price Collar on Acquisition Consideration can also be used to allocate risk in other pre-closing scenarios, such as due diligence, regulatory approvals, third party consents and other events affecting Target value pre-closing. A Cap sets a maximum on a variable Acquiror shares or purchase price and a Floor sets a minimum under any of the same scenarios as would be the case for a Collar.

c. Deferred Consideration and Earn outs

A transaction may be structured in which Target, in whatever form it exists post-closing, is required to hit certain milestones to receive a portion of the Acquisition Consideration. That portion may be set aside in escrow or simply deferred until the milestone is reached, earning the payout or release from escrow of the segregated purchase price portion.

IV. Deal Points

Deal Point No. 1: Plan Acquisition Consideration and its structure at the LoI, MoU or Term Sheet stage. Nobody, especially on the Target – sell side, wants to hear about a change in purchase price after the deal is signed up and before closing. When the issue is identified and its risk is allocated in preliminary documentation and the main deal documents, the occurrence of an Acquisition Consideration-altering event is accounted for and should not give rise to disputes.

Deal Point No. 2: Think about the effects of Acquisition Consideration structuring in negotiations. Do Target/Target shareholders want to cash out? Or do they want to participate in the post-closing business? Will using Acquiror's stock limit Acquiror's strategic options going forward, or impair Acquiror's existing shareholders' interests? What is the "cheapest" price to pay, cash, stock or assumed debt? Can an Acquisition Consideration decision solve a particular need of Target/Target shareholders or Acquiror/Acquiror shareholders?

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