MERGERS & ACQUISITIONS IV: PRELIMINARY DOCUMENTATION: DEAL POINTS

May – June 2022

I. Executive Summary

This is the fourth of a series of periodically issued advisories on Mergers & Acquisitions (M&A). 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"), "Mergers & Acquisitions III: Acquisition Consideration ("M&A III") are available with other M&A resources on our website at Kurtin PLLC Mergers & Acquisitions and on Lexology at the Kurtin PLLC Lexology Hub. 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 IV advisory will focus on the preliminary documentation used to frame an M&A transaction, usually Memorandums of Understanding ("MOUs"), Letters of Intent ("LOIs") and Term Sheets (each or collectively, a "Preliminary Document"). 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. How MOUs, LOIs and Term Sheets are Similar and How They Differ

We're going to put in a good word for MOUs, LOIs and Term Sheets here. Why the frequent contempt for them? Preliminary documentation is often a good way to lock down deal terms before the counterparty may have really focused on them. They serve to frame the prospective M&A transaction and, even when they are not binding, exert some "moral force" in subsequent negotiations; when a Preliminary Document deals with a transaction issue, it is that much harder for one party to suddenly repudiate that agreement and insist upon another resolution for that issue while otherwise proceeding with the transaction. When done attentively, and not as a throw-away afterthought, a Preliminary Document almost always reduces overall transaction costs by framing the transaction and exposing what issues the parties agree about and need not spend time on, versus issues that are really ISSUES, and which require negotiation and resolution.

More subtly, a Preliminary Document can expose what issues are "core" – critical – issues for each party. Core issues are often asymmetrical between the parties; a given issue may be a core issue for one party but irrelevant, or nearly so, for the other, providing a negotiating edge when a party realizes the asymmetry, and that a concession that the counterparty needs to have in the transaction can be readily made – in exchange for some other consideration that the party needs itself. A well-negotiated Preliminary Document can be the first thing in a transaction to reveal not only issues of contention, but expose those kinds of asymmetries issues that can provide a negotiating edge later on. A Preliminary Document almost always more than pays for itself – literally – in the reduction of subsequent and overall transaction costs. A Preliminary Document also forces the real decision-makers in both Acquiror and Target to focus on the transaction early on, since the commitments made in the Preliminary Document – even if not formally binding – require the decision-maker's sign-off before going in the document. A transaction commenced with a negotiated MOU, LOI or Term Sheet is, simply put, a transaction that is more likely to be successfully closed.

Yet, in spite of all that, especially in the entrepreneurial transaction world, Preliminary Documents are often treated as throw-away documents requiring virtually no thought or strategy, since they are often completely non-binding and viewed as not mattering. They are quickly drafted, often by people who don't have the authority to make binding commitments. They also often give the parties the illusion of having "accomplished something" without the reality of it. Treating Preliminary Documents that way begs the obviously question: if Preliminary Documents don't really matter, why do them at all? Why not skip them, and immediately move to drafting the principal M&A transaction documents, the Stock Purchase Agreement, Asset Purchase Agreement or Merger Agreement and the ancillary documentation that go with them? In fact, some people do just that. Whether it happens to come back up and bite them or not, it is almost always a mistake. Put bluntly, in M&A and other high-level corporate/commercial transactions other than the most simple, a deal attempted without a thought-out MOU, LOI or Term Sheet is usually amateur hour and often encounters road blocks later on that could have been avoided at the outset.

There are some identifiable distinctions among MOUs, LOIs and Term Sheets, but they almost don't matter because hardly anyone can tell anyone else what they are anymore and the terms are used nearly interchangeably. Here are the basic distinctions, in this writer's opinion. A Memorandum of Understanding, generally in memorandum form (no surprise), is often the least formal, most preliminary, most aspirational type of Preliminary Document. It is used in many non-M&A commercial

transactions, and often expresses the most basic intent to pursue a corporate or commercial relationship. Not surprisingly, MOUs are often the least binding type of Preliminary Document; the "Understanding" part of the title is the tip-off. They are also probably the type that most often gives the illusion of moving the ball without having really done anything. Often, they don't amount to much more than saying "sure, we're potentially interested in a relationship on some basis. Come back when you're further along and we'll discuss it." Is that worth doing? Sometimes it might be, to establish that the parties are talking, but the earth won't have moved. On the other hand, a well-thought out MOU can set action items and milestones to be achieved by each party by set dates, upon which a more binding arrangement may become appropriate, even a second Preliminary Document like a Term Sheet. Used that way, the MOU can make a lot more sense. It's always a fair question to ask if a step in a transaction is really moving the ball forward, or just giving the illusion of doing so.

Letters of Intent are the arguably the next most formal; they are usually in letter form (no surprise) on company letterhead, tend to give more specifics about not only what kind of corporate or commercial relationship is under consideration, but some actual specifics of the transaction that would bring that relationship into existence. Just as the word "Understanding" is the tip-off on the non-binding nature of most MOUs, the word "Intent" is the tip-off for LOIs. Nevertheless, while many people would say there is no difference between MOUs and LOIs, in this writer's opinion, LOIs are more likely than MOUs to have at least some binding terms (see Part III below).

Term Sheets are arguably the most formal and structured of the three types of Preliminary Document; even though usually not signed, they generally contain actual corporate and commercial terms (no surprise), such as type of transaction, acquisition structure (such as the types of transaction structures diagramed and described in M&A I), purchase price (Acquisition Consideration in the case of an M&A transaction), milestones and other terms.

III. Preliminary Document Main Negotiating Points

Following are the most significant items to be treated in most M&A Preliminary Documents, with discussion of under what circumstances they should be made binding or not.

a. Transaction Structure: The type of transaction structure, whether Stock Purchase, Asset Purchase or Merger, should be identified at the beginning of the Preliminary Document (see

M&A I). Whether any particular tax-free or tax-advantaged treatment for the transaction will be sought in the structuring should be identified high in the Preliminary Document (see M&A II).

b. Acquisition Consideration: How the Acquisition Consideration, or purchase price, is to be paid should be made clear at the Preliminary Document stage (see M&A III). Is the Acquisition Consideration to be cash, stock, cash and stock, assumption of debt or some hybrid? If cash and stock, is there to be a cash election for the Target shareholders? Whether any financing needs to be obtained by Acquiror to conclude the transaction should be identified, the amount, the type of financing, and the extent to which the transaction will be contingent on that financing being obtained.

c. Definitive or Principal Documentation: In nearly any M&A transaction, there will be a Stock Purchase Agreement, Asset Purchase Agreement or Merger Agreement as the principal deal document, but other documents will be needed in most transactions, such as investment agreements, financing documents, intellectual property license and assignment agreements, employment and equity-based compensation agreements (stock option or stock grants plans, etc.), real estate leases or conveyance documents and others. It is common for the need for new documentation not thought of at the Preliminary Document stage to emerge later in the transaction, but to the extent thought of, principal documentation and the responsibility for preparing it among the parties and their advisors, and by when, should be baked into the Preliminary Document.

d. Due Diligence: Due diligence, the scope of the parties' disclosures to each other before the M&A transaction closes, should be outlined in the Preliminary Document. When the transaction has a clear Acquiror party and a clear Target party, as a general matter most of the due diligence is sought by Acquiror of Target information. However, in a "merger of equals" scenario, discussed in M&A III as often featuring "fixed exchange" ratios of stock-for-stock Acquisition Consideration, both parties may have equal need to do due diligence on each other. The same will be true when Target shareholders will become Acquiror shareholders as a result of the transaction; they will want due diligence information on the company whose shares they will be receiving in exchange for their existing Target shares. Target shareholders who are receiving cash are typically less concerned with due diligence on Acquiror. Due diligence issues in a

Preliminary Document will frequently be mentioned but otherwise pitched out to a "due diligence checklist," in which the items required to be produced by each party are set forth.

e. Confidentiality: Confidentiality as to due diligence production and other information exchanged between the parties is often one of the most critical issues at the Preliminary Document stage and one of the most frequently sought to be binding on the parties. In fact, confidentiality provisions don't really make sense unless they ARE contractually binding. The parties frequently enter into confidentiality agreements or non-disclosure agreements (NDAs) concurrently with the Preliminary Document that specify the terms of confidentiality and its binding nature. Confidentiality provisions, whether in the Preliminary Document itself or in an NDA, are often significantly negotiated as to scope of confidentiality (what information to be exchanged by the parties is to be treated as confidential); duration of the confidentiality treatment of the disclosed information, including in the case of the transaction terminating and not closing; officers, employees and outside advisors (attorneys, accountants, financial advisors, etc.) of each party who will have access to the confidential information for purposes of due diligence and completing the transaction and under what circumstances and facilities the confidential information will be made available for those purposes (physical or virtual "deal rooms," etc.); and under what circumstances the confidentiality obligation will be relieved (expiration of confidentiality period, third party publication or disclosure, need to respond to a judicial or administrative subpoena, etc.).

f. Exclusivity: Are there exclusivity rights to complete the transaction during a certain period, without interference by third parties? Are there "No Shop" or "Go Shop" provisions affecting the exclusivity of the relationship between the time the Preliminary Document is entered into and the principal documentation? If the Preliminary Document provides for exclusivity, the extent, duration and other issues should be set forth, as well as any carve-outs or exceptions to exclusivity when consideration of a competing offer is required by Target's directors and officers in the exercise of their fiduciary duties (for example, the "fiduciary out," to be discussed in a future edition). Exclusivity, like Confidentiality, really only makes sense if it is made contractually binding, so the scope, duration and other aspects of exclusivity should be set out in the Preliminary Document.

g. Regulatory Approvals: are any federal, state, local or non-U.S. governmental or regulatory approvals required for the transaction outlined in the Preliminary Document needed to the transaction to close? Are there foreign investment or foreign ownership issues? Are there technology export issues? Are there foreign corrupt practices or money laundering issues? Do licenses need to be obtained or assigned from Target to Acquiror, or the need for them waived? Often, the need for regulatory approvals are the biggest cause for delay in closing a transaction after signing the principal transaction document or even in one terminating without closing. The Preliminary Document is a good place to memorialize the issue and plan it – the timing of getting the approvals, the party whose responsibility it is to do so, etc. - so that it doesn't come as a surprise to either party mid-transaction.

h. Major Contracts and Third Party Consents: Major Contracts may materially affect deal value, and like regulatory approvals, may require third party approvals not completely within the parties' control. The Preliminary Document is also a good place to plan for dealing with major contracts, what third party consents are needed, and whose responsibility it is to obtain them.

i. Termination and Break-up Fees: If one or both parties cannot close the transaction, for example for failure to obtain financing or a critical regulatory or third party approval, or there is delay beyond a certain point in doing so, how is it to be handled? The Preliminary Document should plan for those contingencies to the extent known by addressing under what circumstances the transaction can be terminated and whether and under what circumstances the terminating party may have the right to a "break-up" or termination fee from the other party to compensate for the time and money spent working on the transaction, foregoing discussions with other Sellers or Acquirors, and so forth. Termination provisions will feature more prominently in the principal transaction documents, but should be dealt with in the Preliminary Document to the extent necessary to cover the period before the principal transaction documents are signed.

IV. Deal Points

Deal Point No. 1: Don't sneer at the LOI, MOU or Term Sheet. We made this clear before: don't sneer at the Preliminary Document. As often as not they embody the *de facto* or even binding structure of the deal, and advantages casually given away by treating the LOI, MOU or Term Sheet as a low level document not requiring serious attention may never come back. Even when not binding, the Preliminary

Document often exerts "moral force" in subsequent negotiations that make its agreements difficult to renegotiate, so it's a smart move to think them through at the Preliminary Document stage.

Deal Point No. 2: Plan Acquisition Consideration and its structure at the Preliminary Document 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 a potential Acquisition Consideration-altering event is identified and its risk is allocated in preliminary documentation (for example, a fiduciary out event, a valuation surprise or a financing contingency), the occurrence of such an event is accounted for and should not give rise to disputes.

Deal Point No. 3: Think about core issues at the Preliminary Document stage. 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?

Deal Point No. 4: Don't break the camel's back in negotiations; find a counterparty insider as your Sherpa. Identify those counterparty core issues. Find a counterparty corporate insider to guide you on what the other side's core needs in the transaction are, what issues it can yield on, and what it can't. Everybody wants a good deal, a competitive deal, a market or better-than-market deal. But we've seen many clients and counterparties, especially those who had the edge in bargaining power, negotiate so hard for the last dollar or concession based upon that edge that a transaction that both sides initially wanted blew up. It's key to have a hierarchy not only of your own critical deal points, to know what you can give ground on and what you can't, but to have a good idea of the same critical and less critical deal considerations for your counterparty. If you know that a given issue is critical to the other party but not to you, you can accede to the other party's needs in exchange for some of your own. That's not weakness; that's smart negotiating to get your deal across the finish line.

How to know the other party's critical and less-than-critical deal issues to create that hierarchy? Some of it will be obvious from initial negotiations and discussions. Some more will be apparent from always critical industry knowledge and knowledge of each party's place in that industry. But for less obvious issues unique to your transaction, find a counterparty insider who's invested in getting the deal across

the finish line. Sometimes information like that is conveyed, on or off the record, from lawyer to lawyer. But just as often, a line business unit officer in the counterparty, often below the top executives, will be able to subtly provide valuable information about what his or her company really needs out of the deal, or why a certain issue has become an unexpected sticking point and how it can be resolved. Sometimes, they have even been specifically tasked by their company superiors to convey that kind of information without attribution. Either way, especially in a transaction with unexplained and difficult-to-resolve sticking points, look out for and cultivate that company insider on the other side who wants to help bring the deal across the finish line.

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