MERGERS & ACQUISITIONS V: STOCK PURCHASE TRANSACTIONS: DEAL POINTS

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I. Executive Summary

This is the fifth in our series of advisories on Mergers & Acquisitions (M&A). Its predecessors in the series, "Mergers & Acquisitions I: Overview and Transaction Types" ("M&A I"), "Mergers & Acquisitions II: Tax Structuring Considerations ("M&A II"), "Mergers & Acquisitions III: Acquisition Consideration ("M&A III") and "Mergers & Acquisitions IV: Preliminary Documentation" ("M&A IV") 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 advisory will focus on one of the three principal types of transactions used in M&A, a Stock Purchase. We'll discuss specific issues and attributes of Stock Purchase deals, and in section III, review the common elements of Stock Purchase Agreements, the main transaction document used to put a Stock Purchase deal together. Future editions in the series will focus on Asset Purchase and Merger transactions, as well as in "specialty" topics introduced in section III, like antitrust (competition), intellectual property, real property, employment and equity-based compensation, financing and others. 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. Stock Purchase Deals

Stock Purchase transactions are ostensibly the simplest M&A transaction type outlined and diagrammed in M&A I section III(a). As explained there, a Stock Purchase can be accomplished as simply as by Acquiror, as purchaser, buying Target's stock from Target's shareholders. The Target is not a party to the transaction, and becomes Acquiror's subsidiary post-transaction. If the Acquisition Consideration, or purchase price, is cash to Target's shareholders, Target shareholders are cashed out and have no further role in Target's company life.

If, on the other hand, the Acquisition Consideration paid to Target shareholders is Acquiror stock, in whole or in part, Target shareholders become Acquiror shareholders, as explained in M&A III section II(b). In a properly structured stock-for-stock Stock Purchase transaction, in which Target's stock is acquired using only Acquiror's or its affiliate's voting stock, the transaction can qualify for "tax-free" treatment under Tax Code section 368(a)(1)(B), in which Target shareholders recognize no tax gain (or loss) on the transaction, as explained in M&A II section II(b). Even if tax-free treatment is not available or possible, Tax Code sections 338(g) and/or 338(h)(10) elections can provide more favorable tax treatment for the parties, thereby facilitating a transaction, improving the Acquisition Consideration to be paid, or allowing other concessions (M&A II section III). All that said, Stock Purchase transactions can require specific treatment of Target human and other assets, such as employees, intellectual property, real property, third party contracts, and others. So, while the general terms of the Stock Purchase Agreement that frames the Stock Purchase transaction may have many common elements with others, the specific treatment of those elements and less-common ones may require transaction-specific negotiation. Following is a discussion of Stock Purchase Agreement common elements.

III. Stock Purchase Agreement Common Elements

Following are the most significant items treated in most M&A Stock Purchase Agreements, not necessarily in the order in which they would appear in the agreement itself.

a. Definitions: Just as we have defined terms for this M&A Deal Points series, which when introduced eliminate the need to re-explain them each time, Stock Purchase Agreements will invariably have a definitions section, often at the beginning, sometimes at the end, sometimes pitched out to an annex or schedule. Definitions are often inattentively or dismissively treated, but they can influence the whole transaction. See below, ***Deal Point No. 1: Don't sneer at the defined terms, use them and use them consistently.***

b. Transaction Description: A concise statement of what shares (of what company, what class or series, how many, etc.) are being purchased and sold in the transaction, by whom, from whom. If the Target is another type of legal entity, such as a limited liability company ("LLC"), the Target equity interests to be purchased may be LLC "membership interests" or another form of equity security equivalent to a corporation's shares.

c. Purchase Price: The Acquisition Consideration or purchase price, whether in the form of cash, stock, a hybrid of cash and stock, assumption of Target debt, other assets, and whether there is a "cash election" in a cash and stock deal (see M&A III). How and by what method the Acquisition should be paid should also be set out. In general, payment of Acquisition Consideration in full at closing is the default, but it is possible to structure payment in installments, subject to post-closing adjustments (see below) with a portion of the Acquisition Consideration held back, perhaps in a third party escrow.

d. Purchase Price or Acquisition Consideration Adjustments: Whether any pre-closing or post-closing discoveries or events can cause an adjustment to the Acquisition Consideration; these can be any variety of negotiated things: pre-closing change in Target valuation relating to failure to obtain a third party consent or transfer a third party contract or regulatory approval; a change in Target stock price; due diligence revelations; issues relating to accounting, such as changes to expected accounts receivable or cash on hand.

e. Closing: When closing will occur and under what circumstances should be set out.

f. Closing Deliveries: Each party's required deliveries at closing, from certificates to executed documents to certified checks or wire transfer receipts.

g. Representations and Warranties: Each party's undertaking that a state of affairs exists as of the date of the Stock Purchase Agreement and (usually) will continue to exist until the closing. Some are very basis and nearly universal: that each party is properly formed and organized; in good standing in its home jurisdiction of domicile and every jurisdiction in which it does business; has no liens, tax or otherwise, against it, etc.; that the shares being purchased are fully authorized, issued, outstanding and non-assessable, etc.; that the M&A transaction has been duly authorized by proper corporate action; that the transaction will not contravene any law, regulation or third party right; that except as listed in an annexed schedule, there are no material undisclosed liabilities or contingencies like debts, threatened or pending litigations or administrative/regulatory proceedings, etc.

   Other representations and warranties are more technical, specific to the parties and transaction, and asymmetrical, made by only one party and not the other: that a certain material Target third party contract is in good standing and has not been breached; that the Target has certain government licenses and permits in place and in good standing; that Target owns or has the right to use (by license, assignment or otherwise) certain intellectual property and the extent and duration of those rights; that Target and any subsidiaries have not incurred or guaranteed any more than a stated level of indebtedness:

h. Intellectual Property: Ownership and right to use intellectual property. Whether the M&A transaction may infringe any third party IP rights.

i. Real Property: Ownership or leasehold to real property to be included in the M&A transaction and any to be excluded from it.

j. Employment and Employment Benefits: Key personnel employment contracts and equity-based compensation arrangements, like stock option pools, plans and grants; collective bargaining agreements and other agreements affecting Target employer-employee relations.

k. Other Assets: A schedule of other Target assets and any being excluded from the transaction; examples might include inventory; cash and cash equivalents; and office equipment.

l. Material Contracts: a schedule of contracts materially affecting Target's business.

m. Insurance: Insurance policies constituting Target assets; their status; claims made or threatened against them.

n. Covenants: Sometimes confused with representations and warranties, but different in that they not representations that a state of affairs exists and will continue to do so until closing, but each party's promises either to do something (or continue doing something) until and sometimes after closing (affirmative covenants) or to refrain from doing something until/until after closing (negative covenants). Examples might include Target covenants to maintain various regulatory approvals or licenses (affirmative), or not to let an approval or license lapse (negative), not to compete with the acquired business after closing, etc.

o. Conditions to Closing: A list of conditions to each party's obligation to close the transaction, the failure of which to occur will excuse that party's obligation to close, such as that all previously made representations and warranties continue to be true as of closing; that no "Material Adverse Change" or "Material Adverse Event" as defined in the Stock Purchase Agreement affecting Target's business has occurred (often called a MAC clause); that all third party consents have been obtained; that insurance commitments have been obtained, "fairness opinion" letters obtained and others.

p. Tax Treatment: Whether tax-free or tax-advantaged treatment for the transaction will be sought in the transaction structuring (see M&A II).

q. Indemnification: Indemnification rights, the right of one party to claim against another for indemnification from third party claims. There are also "carve-outs" to indemnification rights, such as when a generally indemnified type of event has a subset that might occur without either party being at fault, or when an indemnified event falls short of an agreed-to threshold in potential damages. There are even sometimes "exceptions to carve-outs."

r. Compliance with Law: The parties will frequently negotiate obligations (whether by covenant or otherwise) to comply with applicable laws, such as those governing foreign corrupt practices or bribery, technology export restrictions, foreign investment controls, money laundering and others.

s. Termination and Effects of Termination: If there is a failure of a condition to close, such as a breach of representation, warranty or covenant; another material breach of the Stock Purchase Agreement; a failure to obtain financing or a critical regulatory or third party approval; or there is delay beyond a certain point in doing so, whether the non-breaching party may terminate the Stock Purchase transaction. Some breaches may give the non-offending party the right to terminate immediately; some may give the breaching party the chance to cure the breach before closing, or allow for purchase price adjustment to reflect the damage caused by the breach. There are sometimes "break-up fees" provided for to the non-breaching party to compensate it for its transaction time, effort and costs, and the opportunity costs of not have sought or obtained a deal with another party.

t. The "Boilerplate:" Almost invariably, the final article of every Stock Purchase Agreement will have sections derisively known as the "boilerplate" or "general" provisions. Like the definitions, the boilerplate does not always repay the sneers. Some provisions, like choice of governing law, choice of dispute resolution forum, assignment rights, confidentiality, third party beneficiaries, releases, rules of construction and others may provide critical rights; like the definitions, they should not be dismissively treated.

IV. Deal Points

Deal Point No. 1: Don't sneer at the defined terms, use them and use them consistently.

We made this point at the top of section III(a). An in-house general counsel friend swears that if he can write a contract's definitions sections, he almost doesn't care what's in the rest of the document. I'm not sure that I'd go that far, but I get his point. Also, a lot of lawyers skip glassy-eyed over the definitions section, and let things go into them unremarked that are time bombs for their clients – that's the extension of my friend's point. Worst of the worst are M&A lawyers who go to the trouble of defining terms in the definitions section and then forget to use them in the text, or don't use them consistently. I had this come up a few years ago, when a highly specific and negotiated defined term list of "Indemnifiable Events" was ignored by opposing counsel in the text, allowing a non-listed event to also creep in and be subject to indemnification by his client. And…it actually happened. That's like seeing a vampire lurking outside your second floor window, opening the window and saying "come on in." It's amateur hour, a low percentage move. Don't sneer at the defined terms.

Deal Point No. 2: Any non-cash-paid-in-full-at-closing Acquisition Consideration is in some measure contingent, and should require a premium over a cash on the barrelhead deal.

Any non-cash-on-the-barrelhead deal is in some measure contingent, and Acquiror should pay more overall than if paying cash in full at closing. Cash on the barrelhead should command a premium over any non-cash-on-the-barrelhead deal. A cash on the barrelhead offer is superior to a non-cash-on-the-barrelhead offer and should cost an Acquiror less for the same acquisition than the non-cash competing deal. The only real exception is in a stock or partial stock deal, where Target shareholders actively want to be owners in the Acquiror going forward and/or are getting their Acquiror stock at below fair market value.

Deal Point No. 3: A cash-for-stock deal is generally assumed to be, for Target shareholders; that as long as they get their cash, they're happy. But they still need to be careful not to expose themselves to future claims based on representations, warranties, covenants, etc.; or to third party claims on indemnification or fraud. In a stock-for-stock deal, Target shareholders become Acquiror shareholders, and should be as interested in Acquiror's status as Acquiror is in Target's.

The "cash out and walk away" aspect of a cash-for-stock deal for Target shareholders is overstated; Target shareholders may still have potential liabilities from breach of representations, warranties or covenants and, potentially, fraud. All of that means that Target shareholders should be paying attention to the negotiation of the deal overall and the Stock Purchase Agreement and ancillary agreements. A stock-for-stock deal makes Target shareholders into Acquiror shareholders, and they should be as interested in Acquiror's representations, warranties, covenants, financials and other indicators of Acquiror status and health as Acquiror is interested in Target's status and health.

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