MERGERS & ACQUISITIONS VII: MERGERS: DEAL POINTS

July 2022

I. Executive Summary

This is the seventh 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"), "Mergers & Acquisitions IV: Preliminary Documentation" ("M&A IV"), "Mergers & Acquisitions V: Stock Purchase Transactions" ("M&A V") and "Mergers & Acquisitions VI: Asset Purchase Transactions" ("M&A VI") are available at the preceding links, 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 the third of the three principal types of transaction structures used in M&A, Mergers. By "Mergers," we mean not a generic kind of business combination, but "statutory Mergers" executed pursuant to one or more states' merger statutes, in which one company merges into another. We'll use as statute paradigm the Delaware General Corporation Law ("DGCL"). DGCL section 251 is the general merger statute for mergers between Delaware corporations, while section 252 provides for mergers between Delaware corporations and "foreign" (domiciled in another state) corporations.

We'll discuss specific issues and attributes of Mergers, and in section III, review the common elements of Merger Agreements or "Plans of Merger." Future editions in the series will focus on "specialty" topics such as antitrust (competition); intellectual property; real property; employment and equity-based compensation; financing a M&A transaction; Public M&A (in which the Target is a public reporting company under the Exchange Act); cross-border M&A, when one of Acquiror or Target is a U.S. company and the other is domiciled in another country; fiduciary duties; leveraged buyouts; spin-offs and divestitures; acquisition of distressed assets in bankruptcy proceedings and otherwise; industry-specific regulatory issues; foreign investment; technology export issues 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. Mergers

In M&A V and M&A VI, we discussed Stock Purchases and Asset Purchases, and one of the points we made was that basic transactions of both types are fundamentally negotiated contracts between two or more companies for the purchase of one's stock or assets by another, notwithstanding that the parties, whether corporations or other forms of legal entity, were created pursuant to statute. The parties decide, subject to some requirements of the corporation statutes of their states of domicile, antitrust review and other regulatory requirements as applicable, what is necessary to close their transaction, and declare the transaction closed when they both are satisfied that all the terms and conditions they decided upon have been met. Mergers are different. Mergers are not simply private contracts between legal entities created by statute; Mergers as a transaction structure exist only pursuant to state merger statutes contained in their corporate laws. To effect a legally binding Merger, the parties have to comply with the merger statutes of the states in which both Acquiror and Target are domiciled. For purposes of this discussion, we'll assume that both Acquiror and Target are Delaware corporations, but one or both can be domiciled in other states, or other countries. Either or both of Acquiror and Target may also be another form of legal entity like limited partnerships ("LPs") or ("LLCs"). DGCL sections 263 and 264, respectively, provide for mergers between Delaware corporations and partnerships (including LPs) and LLCs, and the Delaware LP and LLC statutes have corresponding provisions.

Mergers are stock-for-stock transactions, generally structured as either "fixed exchange" ratio transactions, in which the number of Target shares to be exchanged for Acquiror shares is fixed and the dollar value of the "Merger Consideration" (as opposed to Acquisition Consideration) – Acquiror's stock - can rise or fall prior to closing (fixed exchange ratio transactions are usually used in larger "mergers of equals" transactions, as well as transactions in sectors of perceived volatility, since both parties share the risk of movement in Acquiror's share price); or "fixed value" transactions, in which the dollar value of the Merger Consideration – also Acquiror's shares - is fixed based on measurement during a negotiated period or an agreed-upon valuation as of a certain date, but the number of shares to be exchanged for Target's stock can rise or fall prior to closing, placing the risk of movement in Acquiror's share value or price squarely with Acquiror, since Target/Target shareholders are assured of the same dollar value Merger Consideration (fixed value ratio transactions are more common when one company is clearly the Acquiror and the other company is clearly the Target (see M&A III, section III(a)). Price protection provisions to limit Merger Consideration volatility in fixed value transactions

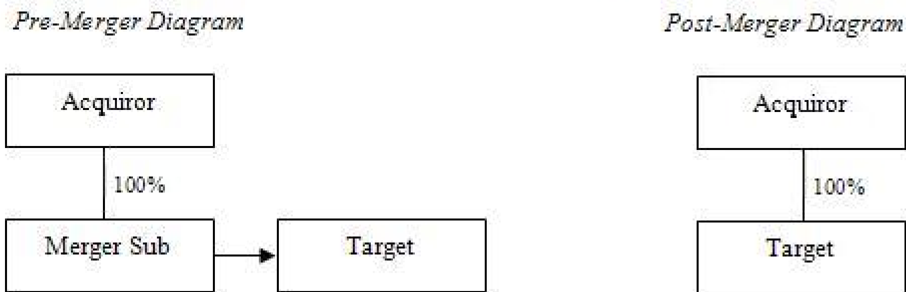
like "Collars," "Caps" and "Floors," can also be used to limit Acquiror's risk (also discussed in M&A III, section III(b)).

Execution of a Merger requires several steps. For example, DGCL section 251 requires, broadly, that the board of directors of each merging corporation must adopt a resolution approving a Merger Agreement, which must set forth the terms and conditions of the Merger, mode of putting the Merger into effect, changes to be made in the Surviving Entity's certificate of incorporation, the manner of conversion of shares of the merging companies into the Surviving Entity's shares, and other provisions desired by the merging parties. The Merger Agreement must then be submitted to each merging company's stockholders at an annual or special meeting for their approval. The Merger Agreement and the amended/amended and restated certificate of incorporation of the Surviving Entity or a certificate of merger is filed with the Delaware Secretary of State, and the Merger is complete. Here, we'll discuss two of the merger paradigm structures described and diagrammed in M&A I, a Direct Merger and a Reverse Triangular Merger. Then, in Part III, we'll review the structure of a Merger Agreement itself.

Direct Merger. In a direct merger, the Target merges into Acquiror. The Target ceases to exist, and the Acquiror is the Surviving Entity, succeeding to the Target's assets and liabilities.

Reverse Triangular Merger. In a Reverse Triangular Merger, Acquiror forms a new subsidiary shell corporation, usually cunningly named Merger Sub and Merger Sub merges into Target, rather than Target merging into Acquiror (that's what makes it a "reverse" Merger, and the presence of Merger Sub in the transaction is what makes it a "triangular Merger," since there are three parties). In the result, Merger Sub ceases to exist, because it has been merged into Target, and post-transaction, Acquiror is the parent of Target, now Acquiror's wholly-owned subsidiary. That's an important takeaway; compared to

the Direct Merger paradigm, in which Target ceases to exist, in a Reverse Triangular Merger, Target continues its corporate existence and business life, but as Acquiror's wholly-owned subsidiary.



When properly executed, a statutory Merger, including the Direct Merger and Reverse Triangular Merger structures diagrammed here, qualifies for tax-free treatment pursuant to Tax Code section 368(a)(1)(A) and, depending on the transaction, potentially other Tax Code section 368(a)(1) subsections and 26 Code of Federal Regulations ("CFR") section 1.358-6 (Tax Code regulations for the stock basis in certain triangular reorganizations) (see M&A I). It is also possible to execute a taxable Merger, and in that case, it may be possible to make a Tax Code section 338 election (see M&A II, section III). Nevertheless, taking advantage of tax-free treatment is often one of the main reasons to do a statutory Merger as opposed to other, taxable transaction structures.

III. Merger Agreement Common Elements

Many of the elements of a Merger Agreement are similar to those in a Stock Purchase Agreement as described in Stock Purchase Transactions, M&A V, section III. However, as noted above, DGCL section 251 requires certain elements to be present in the Merger Agreement, and allows others provided by the parties. Following are the most significant items treated in most M&A Merger 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, Merger 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 and lay traps for the unwary or dismissive. See below, ***Deal Point No. 3: Don't sneer at the defined terms, use them and use them consistently.***

b. Transaction Description: DGCL section 251 requires a statement describing the Merger transaction; what party to the transaction is to be merged into which other, and what the Surviving Entity is to be (section 251 also permits "Consolidations," in which both merging companies merge into a newly formed corporation, which is the Surviving Entity). Per section 251, the "effect" of the Merger should also be set forth.

c. Conversion of Target Shares: The Acquiror stock to be used as Merger Consideration for Target's stock, whether the Merger is structured as a fixed exchange ratio or fixed value transaction, and how Acquiror stock used as Acquisition Consideration is to be valued. Whether any price protection devices to limit Acquiror stock volatility, such as Collars, Caps and Floors, apply.

d. Payment of Merger Consideration: How the Merger Consideration is to be paid, in Acquiror stock and any non-Acquiror stock comprising part of the Merger Consideration, whether cash or otherwise.

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. Surviving Entity: Changes to the Surviving Entity's certificate of incorporation, by-laws and any changes to its board of directors and officers as a result of the Merger should be set forth.

h. Representations and Warranties: Each party's undertaking that a state of affairs exists as of the date of the Merger Agreement and (usually) will continue to exist until the closing. Some are very basic 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 their financial disclosures are accurate as of the

date stated; that Target has title to its Assets, etc.; that the Merger has been duly authorized by proper corporate action; that the Merger 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 liabilities, debts, threatened or pending litigations or administrative/regulatory proceedings, etc. In Public M&A transactions, in which Target is a reporting company under the Exchange Act, some of these representations and warranties by Target are unnecessary because of the information contained in its periodic Exchange Act reports. However, in M&A transactions in which Target is a private company, the scenario discussed here, Target representations and warranties can be critical. Representations and warranties are typically structured to refer to annexed disclosure schedules that contain carve-outs disclosed in the schedule: for example, "except as set forth in Schedule 3.2, there are no pending or threatened litigations against Target."

One of the reasons the Reverse Triangular Merger structure is used is that the Target continues its corporate existence and operations, albeit as a wholly-owned subsidiary of Acquiror, rendering the need to obtain third party consents to assign or otherwise transfer contracts in many cases unnecessary. However, due diligence still needs to be done on third party agreements, since some may require third party consent when a transaction results in a change of control of Target. If third party consent for a change-of-control assignment is unobtainable, the contract may need to be carved out of the Merger and settled on whatever basis the contract provides for and on which the Merger parties and the third party can agree. In some cases, failure to obtain a necessary third party consent might actually tank the deal. Obtaining third party consents is normally Target's primary responsibility, since Target has a pre-existing relationship with the third party, although Acquiror will often be expected to reasonably cooperate in the effort. For example, if the third party wants some information on Acquiror before giving its consent (financial means to pay the third party license, lease fees, etc., Acquiror is normally required to reasonably cooperate in giving adequate assurances to the third party.

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.

i. Intellectual Property: Target's ownership and/or right to use intellectual property.

j. Real Property: Target's ownership or leasehold to real property.

k. 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.

l. Other Assets: A schedule of other Target assets.

m. Material Contracts: a schedule of contracts materially affecting Target's business, and third party consents or contract novations confirming that the third party accepts Target's change in control to Acquiror when the contract so requires.

n. Insurance: Target insurance policies; claims made or threatened against them.

o. Covenants: Sometimes confused with representations and warranties, but different in that they are 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 closing (affirmative covenants) or to refrain from doing something until closing (negative covenants). Examples might include Target covenants to obtain financing, maintain various regulatory approvals or licenses (affirmative), or not to let an approval or license lapse (negative).

p. 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 Merger Agreement affecting Target's business has occurred (often called a MAC or MAE clause); that all third party consents have been obtained; that financing and insurance commitments have been obtained, "fairness opinion" letters obtained and others.

q. Tax Treatment: Whether tax-free or tax-advantaged treatment for the Merger transaction will be sought in the transaction structuring, generally pursuant to Tax Code section 368(a)(1)(A) (see M&A II).

r. Indemnification: Indemnification rights, the right of one party to claim against another for indemnification from third party claims, are a little different in a Merger than in an Asset Purchase or Stock Purchase transaction, in which indemnification rights often survive the closing. In a Merger, Target shareholders generally have no obligation to indemnify Acquiror post-closing, and the Merger Consideration is usually rapidly disbursed, so indemnification rights, like representations and warranties, typically end at closing and really serve as conditions to closing.

s. Compliance with Law: The parties will frequently negotiate obligations until closing (whether by covenant or otherwise) to comply with applicable laws, such as those governing foreign corrupt practices or bribery (the Federal Corrupt Practices Act); technology export restrictions (U.S. State Department International Traffic in Arms Regulations, or ITAR; U.S. Commerce Department Export Administration Regulations, or EAR); foreign investment controls (Committee on Foreign Investment in the U.S., or CFIUS); sanctions (U.S. Treasury Department Office of Foreign Assets Control, or OFAC); money laundering and others. As with third party contracts, provision will usually be made for the parties' reasonable cooperation in obtaining any necessary government consents and permits.

t. 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 Merger 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 Merger transaction and what effects and remedies such a termination will have. 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.

u. Exclusivity: It's common for Merger Agreements to contain "no shop" or "go shop" clauses prohibiting or permitting (in some cases) Target to solicit, encourage or entertain competing offers for a Merger from third parties for a certain period within with closing is expected to occur. Often, such clauses have a "fiduciary out" carve-out, which allows Target's board of directors to consider competing offers when its fiduciary duty to Target shareholders require it. We will discuss that and related issues in a future M&A: Deal Points edition on fiduciary duties, the "Business Judgment Rule" and related topics.

v. The "Boilerplate:" Almost invariably, the final article of every Merger 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: Make sure that a Merger is the Transaction Structure Desired.

It sounds obvious, but Mergers generally involve Acquiror assuming all of Target's assets and liabilities. There are often good reasons to do so, but often good reasons to choose a non-Merger Stock Purchase or Asset Purchase structure, such as Acquiror's ability, subject to Target's agreement, to pick and choose assets in an Asset Purchase or obtain a "stepped-up" basis in Target's assets in a standard Stock Purchase pursuant to a Tax Code section 338 election. Also, it should be remembered, that although Tax Code section 368(a)(1)(A) tax-free treatment is only available for statutory mergers, other section 368(a)(1) subsections are available for properly structured non-Merger Stock Purchases and Asset Purchases (see M&A II, section II).

Deal Point No. 2: Tax Optimization is Not Tax Avoidance. It's important to remember: tax optimization is not tax avoidance. The M&A tax structuring methods reviewed above are U.S. federal statutes expressly set out in the Tax Code. Expertise is required to use them correctly, but they are there to be used. Don't be timid. Use them when appropriate. Pay required M&A transaction taxes, but not more than required.

Deal Point No. 3: Don't sneer at the defined terms, use them and use them consistently.

We made this point at the top of section III(a). 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. 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…the unintended indemnifiable event actually happened. It's amateur hour, a low percentage move. Don't sneer at the defined terms.

Deal Point No. 4: Use, but don't rely on, MAC or MAE clauses.

MAC and MAE clauses have been staples of M&A panels at legal and investment banking conferences for years, but only one case is known in which the Delaware Chancery Court excused a party from closing a transaction because of the occurrence of a MAC or a MAE. For one thing, the "C" in MAC and "E" in MAE stand for "Change" and "Event." MAC and MAE clauses generally refer to changes or events that occur after the Merger Agreement is signed but before closing, like war, pandemic, economic collapse, and so on, not to buyer's remorse or finding out something that due diligence should have revealed or that disclosure *did* reveal.

[Continued on following page]

Deal Point No. 5: Collars, Caps and Floors are valuable price protection, anti-volatility tools, so use them.

Collars, Caps and Floors can protect not only against volatility, but against overpaying. In a fixed value deal, the Acquiror assumes significant risk of change in the number of its shares as Merger Consideration that the Merger may cost it. Price protection devices can limit that risk. They can even be tied to termination rights, giving Acquiror an exit ramp if a deal starts becoming too expensive before closing.

Owen D. Kurtin

Kurtin PLLC is a New York City-based law firm focused on corporate, commercial and regulatory representation in the Biotechnology & Life Sciences, Communications & Media, Information Technologies & Internet, Satellites & Space and Venture Capital & Private Equity sectors. For further information about our professional services, please visit our website at https://kurtinlaw.com/ and contact us at info@kurtinlaw.com or +1.212.554.3373. To subscribe to our publications, please email publications@kurtinlaw.com with the message "subscribe" and your coordinates.

The materials contained in this advisory have been prepared for general informational purposes only and should not be construed or relied upon as legal advice or a legal opinion on any specific facts and circumstances. The publication and dissemination, including on-line, of these materials and receipt, review, response to or other use of them does not create or constitute an attorney-client relationship.

To ensure compliance with requirements imposed by the Internal Revenue Service, we inform you that any tax advice contained in this communication (including any attachments) was not intended or written to be used, and cannot be used, for the purpose of (i) avoiding tax-related penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any tax-related matter(s) addressed herein.

These materials may contain attorney advertising. Prior results do not guarantee a similar outcome.

Copyright © Kurtin PLLC 2022. All Rights Reserved.