

MERGERS & ACQUISITIONS X: FINANCING M&A: DEAL POINTS

January 2023

I. Executive Summary

This is the tenth in the series of advisories we started last year on Mergers & Acquisitions (“M&A”), and the first of 2023. 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](#)”); Mergers & Acquisitions VI: Asset Purchase Transactions (“[M&A VI](#)”); Mergers & Acquisitions VII: Mergers (“[M&A VII](#)”); Mergers & Acquisitions VIII: Antitrust Merger Control & Clearance (“[M&A VIII](#)”); and Mergers & Acquisitions IX: Intellectual Property Issues (“[M&A IX](#)”) are available at the preceding links, along with other M&A resources on our website at [Kurtin PLLC Mergers & Acquisitions](#) and on Lexology.com at the [Kurtin PLLC Lexology Hub](#).

This advisory will focus on Acquiror’s financing of an M&A transaction, whether through cash, use of existing Acquiror stock, issuance of new Acquiror stock, debt, assumption of Target debt or some combination thereof. Future editions will focus on issues like Acquiror’s and Target’s corporate governance and fiduciary duties in an M&A transaction; Public M&A, in which Target is a public reporting company under the Exchange Act; Cross-border M&A, in which one of Acquiror and Target is a U.S. company and the other company is domiciled in another country; employment and equity-based compensation, like stock options; due diligence; divestitures, spin-offs, leveraged buyouts and “going private” transactions; M&A involving acquisition of distressed assets or bankruptcy; industry-specific regulatory issues; foreign investment controls; technology export controls; 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; however, we will continue to attach and update the Appendix 1 Glossary of all defined terms introduced to date. 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*.

II. Financing an M&A Transaction

We'll focus here on financing a private company M&A transaction; Public M&A, to be covered in a later edition, has special financing dynamics. There are multiple ways to finance an M&A transaction. Acquisition Consideration, the purchase price paid by Acquiror to Target, is usually paid in cash, stock, assumption of Target debt or a combination thereof.

- a. **Cash Acquisition Consideration.** Cash as Acquisition Consideration can come from Acquiror's existing cash reserves, can be borrowed, or can be earned from sale of assets or stock (see, "Raising Capital through Private Placements: Deal Points," available at [Kurtin PLLC Raising Capital](#)). Use of cash Acquisition Consideration by Acquiror almost presumes that the Acquiror and Target are of unequal size; if the transaction were a merger or acquisition of "equals," it would be unlikely for Acquiror to be able to acquire Target with ready cash; Target would almost certainly be too expensive for that. Transactions that use cash as Acquisition Consideration are usually Stock Purchases or Asset Purchases in which Acquiror is a larger company than Target, rather than Mergers (whether one-step or two-step, including tender offer), which are almost always the form that Public M&A takes.

Also, as discussed 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.

- b. **Stock Acquisition Consideration.** Acquiror may use authorized but unissued stock as Acquisition Consideration or issue new stock of an existing or new class. 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 Acquisition 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 Acquisition Consideration. 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 Preliminary Documentation 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. Stock Acquisition Consideration Control Devices

When stock is being used as Acquisition Consideration, among the issues confronting M&A parties as they plan, structure and document their transaction are the effects of changes in the value of Acquiror's stock pre-closing. 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 Ratio” 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 Ratio 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: Cash is king.

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.

Deal Point No. 2: When using stock as Acquisition Consideration, make sure to allocate risk of pre-closing volatility.

Where all or some of the Acquisition Consideration is in stock, use Fixed Exchange and Fixed Value Ratio Formulas, Collars, Caps and Floors (see Section III) to allocate risk of pre-closing Acquisition Volatility.

Deal Point No. 3: Use Tax Code reorganization provisions to improve the deal for both sides.

Tax optimization is not tax avoidance. The M&A tax structuring methods reviewed here and in more detail in [M&A II](#) 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.

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Mergers & Acquisitions: Deal Points
Cumulative Glossary
Appendix 1

- 1. Acquiror (or Acquirer, Buyer or Purchaser):** the purchaser, or “buy side” party in an M&A transaction, whether an Asset Purchase or a Stock Purchase, which acquires all or the majority of the stock or assets of another business. In a Merger, the parties are not technically purchaser or seller, but when one party is clearly the dominant party in the transaction, and is often the Surviving Entity (though not always, as in the case of a Reverse Merger or Reverse Triangular Merger), that party can be thought of as the Acquiror.
- 2. Acquisition Consideration:** the purchase price paid by Acquiror to Target in an M&A transaction, whether in cash, stock, assumed debt or a combination thereof.
- 3. Asset Purchase:** a transaction by which one party to an M&A transaction purchases all or the majority of the assets of another party. Distinguished from a sale by Target in the ordinary course of business, as in selling a part of its inventory, or surplus equipment not needed for continuing its business operations.
- 4. Asset Purchase Agreement:** a contractual agreement serving as the principal document by which an Asset purchase is effected.
- 5. Cash Election Merger:** an M&A transaction in which Target shareholders are granted an election period to decide whether to accept stock or cash as all or part of the Acquisition Consideration.
- 6. DGCL:** the Delaware General Corporation Law, serving as a paradigm corporation statute in the U.S., and frequently the basis of incorporation by U.S. companies, wherever physically based, that intend to do business across the U.S. as well as inbound subsidiaries of non-U.S. companies wishing to have operations in the U.S.
- 7. Due Diligence:** the scope of the parties’ disclosures to each other before the M&A transaction closes, generally buttressed by deal protections in the form of warranties, representations, covenants and linked rights of indemnification, termination, conditions to closing and others.

- 8. EBITDA:** Earnings Before Interest, Taxes, Depreciation and Amortization, a common accounting metric.
- 9. Exchange Act:** the Securities Exchange Act of 1934, as amended, governing resales of already-issued securities, both debt and equity, and the periodic reporting obligations of publicly registered companies.
- 10. Fixed Exchange Ratio:** 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 Ratio 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.
- 11. Fixed Value Ratio:** In a "Fixed Value Ratio" 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 Ratio 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 often use Fixed Value Ratio 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.

12. GDPR: European Union 2018 General Data Protection Regulation.

13. HSR: Hart-Scott-Rodino Antitrust Improvements Act of 1976 (§7A of the Clayton Act, 15 U.S.C. §18a).

14. IRS: the Internal Revenue Service, the U.S. federal tax regulatory and enforcement agency.

15. IP: Intellectual Property, whether Patent, Copyright, Trademark, Trade Secret, Data or other.

16. JV: Joint Venture. JVs usually imply a formal collaboration short of merger or acquisition between two or more enterprises through a newly formed business entity or contract, as opposed to Strategic Alliances, which usually involve two or more parties working to achieve a specific goal of mutual interest while remaining independent.

17. LLC: a limited liability company organized under a state's LLC statute, generally offering the limited liability protection for shareholders of corporations with the "pass-through" taxation of partnerships (i.e., not taxed at the LLC level, but taxable income or loss is "passed through" to the owners, called "members," equivalent to a corporation's shareholders). Also usually featuring less burdensome management and governance costs and formalities than equivalent corporations.

18. LP: a limited partnership under a state's limited partnership statute (usually modeled on the Uniform Limited Partnership Act), generally offering the limited liability protection for shareholders of corporations with the "pass-through" taxation of partnerships (i.e., not taxed at the LP level, but taxable income or loss is "passed through" to the limited partners, equivalent to a corporation's shareholders). Also usually featuring less burdensome management and governance costs and formalities than equivalent corporations.

19. M&A: generally used abbreviation for "Mergers & Acquisitions," a catch-all term sweeping up Stock Purchases, Asset Purchases and Mergers, all involving the legal or *de facto* acquisition of all or a majority of one business's stock or assets by another business.

- 20. Merger (or Statutory Merger):** a process set forth in the company law statutes of the individual states by which two companies merge with each other, leaving one company or its subsidiary as the Surviving Entity, while the other company merges into that company or its subsidiary and ceases to exist as a separate legal entity.
- a. Direct Merger:** A Merger structure in which Target merges directly into Acquiror, which is the Surviving Entity, while Target ceases to exist.
 - b. Reverse Merger:** A Merger structure in which Acquiror merges into Target, which is the Surviving Entity, while Acquiror ceases to exist.
 - c. Forward Triangular Merger:** A Merger structure in which Acquiror forms a subsidiary (**Merger Sub**) (or uses a pre-existing subsidiary), Target merges into Merger Sub, Merger Sub is the Surviving Entity and a subsidiary of Acquiror, while Target ceases to exist.
 - d. Reverse Triangular Merger:** A Merger structure in which Merger Sub merges into Target, Target is the Surviving Entity and becomes a subsidiary of Acquiror, while Merger Sub ceases to exist.

All of these Merger structures are diagrammed in [M&A I](#).

- 21. Merger Agreement (or Agreement and Plan of Merger):** a contractual agreement serving as the principal document by which a Merger is effected.
- 22. Preliminary Document: (MOU, or Memorandum of Understanding; LOI, or Letter of Intent; or Term Sheet. Also, NDA, or Non-Disclosure Agreement, which may be part of an MOU, LOI or Term Sheet or a standalone Preliminary Document):** forms of preliminary documentation used to set a framework for an M&A transaction and confidentiality before executing documents like an Asset Purchase Agreement or Stock Purchase Agreement. Some terms in preliminary documentation may be binding on the parties for a certain period, for example confidentiality or exclusivity, while others are usually not binding.
- 23. Public M&A:** M&A transactions involving a Target that is a public reporting company under the

Exchange Act, requiring a substantial Exchange Act and SEC regulatory overlay of requirements for the transaction. While in nearly all such cases, the Acquiror will also be a public reporting company, that is not necessarily the case. Nearly all Public M&A is conducted by Merger.

- 24. SEC:** the Securities and Exchange Commission, the U.S. federal securities regulatory and enforcement agency.
- 25. Securities Act:** the Securities Act of 1933, as amended, governing initial issuances of securities, both debt and equity.
- 26. Stock Purchase:** a transaction by which one party purchases all or the majority of the stock of another party. Distinguished from a minority investment by one party in the other, such as a typical venture capital investment, which is not an M&A transaction.
- 27. Stock Purchase Agreement:** a contractual agreement serving as the principal document by which a Stock Purchase is effected.
- 28. Surviving Entity:** the company that continues its corporate existence and operations following a merger.
- 29. Target (or Seller):** the seller, or “sell side” party in an M&A transaction, whether an Asset Purchase or a Stock Purchase, which sells all or the majority of its stock or assets to another business, the Acquiror. In a Merger, the parties are not technically purchaser or seller, but when one party is clearly the less dominant party in the transaction, and is often the merged party (though not always, as in the case of a Reverse Merger or Reverse Triangular Merger, that party can be thought of as the Target.
- 30. Tax Code:** the U.S. Internal Revenue Code, 26 U.S.C.
- 31. TCJA:** the Tax Cut and Jobs Act of 2017.
- 32. USPTO:** U.S. Patent and Trademark Office.