INSIGHTS

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M&A 101: Basic Considerations in Transaction Negotiations

Q: WHAT ARE THE KEY CONSIDERATIONS RELATED TO ANY DEAL STRUCTURE?

SHANNON S. ZOLLO: There are four: tax effects, transfer of liability, third party consents, and shareholder approval.

Tax effects from transactions can be complex and are dependent upon structure. For sellers, an asset sale typically triggers ordinary income tax treatment as well as double taxation (i.e., at the corporate level upon the closing and then upon any distributions made to shareholders) while a stock or merger will trigger long term capital gain treatment as they involve the sale of equity.

With a stock sale or merger, the target’s liabilities are transferred to the acquirer by operation of law. With an asset sale only specifically identified liabilities are contractually transferred.

Often, third party contracts require prior written consent before they can be assigned as part of an asset sale. Generally speaking, absent specific language against assignment upon a change of control or by operation of law, respectively, third party consents are not required with a stock sale or merger.

Shareholder approval requirements vary depending upon deal structure. A target’s board of directors can approve an asset sale at the corporate level without obtaining individual shareholder approval. However, unanimous shareholder approval is required with a stock sale and, typically, a negotiated greater-than-majority shareholder approval threshold is required for a merger.

Q: WHAT ARE THE DIFFERENT PAYMENT METHODS AND WHAT IMPACT WILL THEY HAVE ON M&A PERFORMANCE?

SSZ: Deals can be funded through cash, debt, equity, or some combination thereof. From the seller’s perspective, a cash transaction is the most liquid and least risky method. The impact of a payment financed by debt (credit line and/or term loan), or the issuance of equity, could decrease the acquirer’s debt rating or affect its capital structure, respectively. Conversely, the issuance of at least some equity may improve the acquirer’s debt rating by avoiding the cost of a larger debt load and typically provides a more flexible and incentive driven deal structure. Whether to issue cash or debt vs. equity will ultimately be a function of what value the acquirer places on itself and, by extension, its equity. For example, acquirers tend to offer equity when they believe their equity is overvalued and cash when they think the equity is undervalued.

Q: WHAT ARE THE PRIMARY ISSUES TO CONSIDER REGARDING INDEMNIFICATION?

SSZ: From the acquirer’s perspective, the primary issue is to what extent will each of the target’s shareholders participate in any indemnification obligations post-closing. If the sellers are jointly and severally liable, then each shareholder is individually liable to the acquirer for the full amount of any future damages. However, if the sellers are severally but not jointly liable, each of the sellers will be liable only on a pro rata basis for damages from any future claims.

Q: WHEN SHOULD PARTIES REVIEW LONG-TERM LEAD ITEMS?

SSZ: Sufficient lead time is critical to any transaction. By way of example, parties should determine deal structure, enterprise value, and the size of the respective parties for purposes of any potential HSR filing which may delay the closing. Although the review period can be reduced, or even waived, the review periods generally delay the transaction. Currently, CFIUS review of foreign-based acquirers and/or investments is also delaying deals for potentially months at a time.

Q: WITHIN AN M&A TRANSACTION, WHAT IS THE DIFFERENCE BETWEEN NON-COMPETES AND NON-SOLICITS?

SSZ: A covenant not to compete is a promise by the selling shareholder of the target, for a certain period after closing, to not engage in a defined business activity that is competitive with that of the acquirer. Prohibiting a selling shareholder from recruiting employees of the target/acquirer post-closing constitutes a non-solicit. Enforceability of such restrictions requires that the restrictions be reasonable in time and geographic scope and supported by adequate consideration.

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