BAKER & MCKENZIE

Mergers & Acquisitions Series 2012

Managing risk in M&A transactions

Sydney
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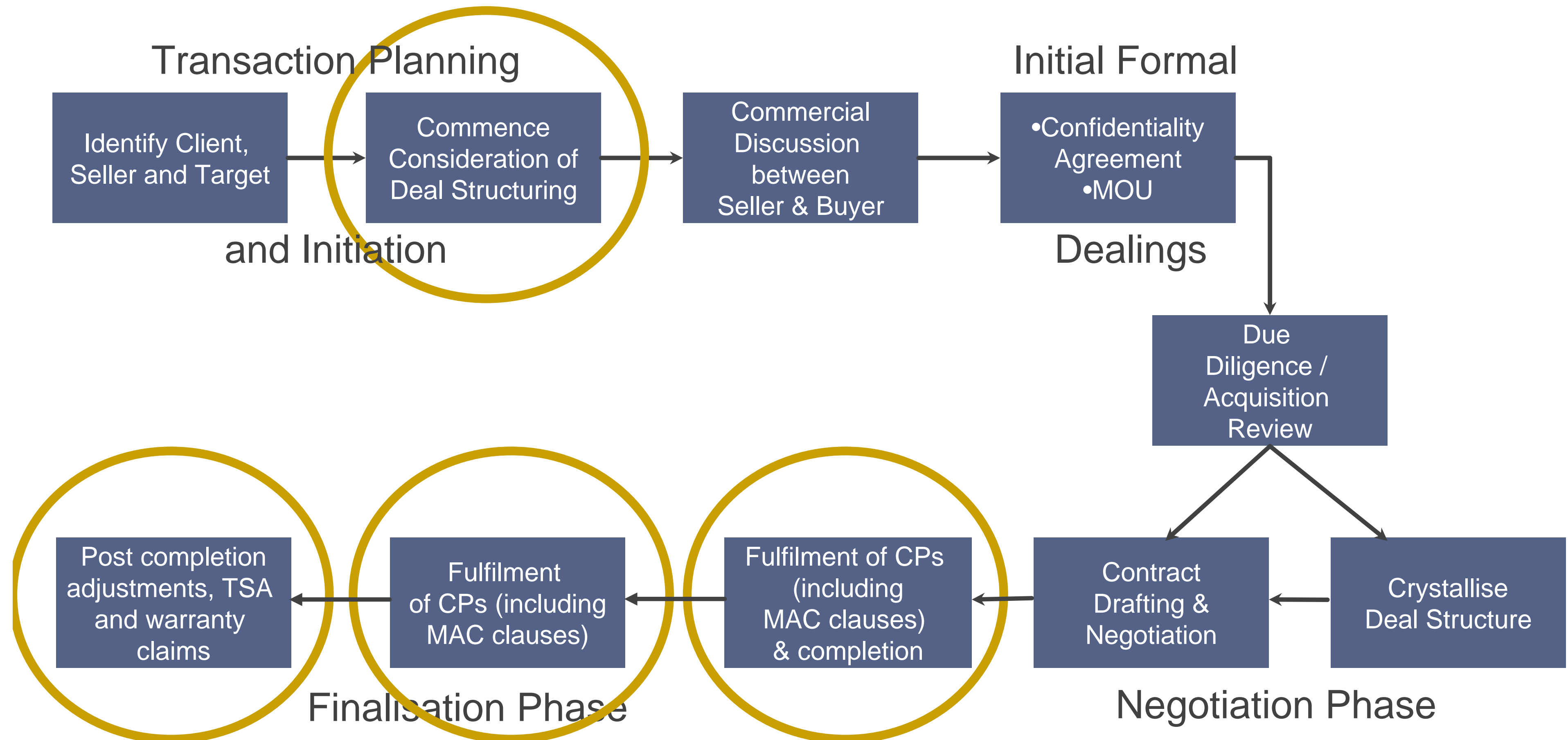
James Halliday – Partner
Adrian Lawrence – Partner
Justin Gross – Special Counsel

Typical transaction timeline – sale by private tender



Outline

- Managing risk through deal structuring
- **M**aterial **A**dverse **C**hange (MAC) clauses
- Warranty and indemnity insurance
- Deferred consideration and earn-outs
- Transitional services agreements

What is risk?

- Where one person bears financial or other consequences of a problem because either:
  - it cannot claim against another party
  - it cannot refuse to complete
- Risk is usually greater where there is a long completion period

Managing risk through deal structuring

- Careful due diligence is key to identify risk
  - Ordered process
  - Materiality thresholds and limits on scope
  - Management questionnaires to supplement documents provided
  - Address risks and issues through restructuring and/or sale and purchase documentation

Ways of managing known risks

- Restructure transaction to be an asset purchase
  - Price calculation
  - Closing accounts (working capital: NTA)
  - Earn out
  - Warranties
  - Indemnities
  - Pre-completion restructuring

Managing risk through deal structuring

- Acquisition of shares vs assets
  - Shares: Inherit all risks and liabilities of the target in a share acquisition, including tax and disputes
    - sale agreement needs to deal with limitations on inherited liabilities
  - Assets: particular assets or liabilities can be excluded
    - less tax risk
    - less litigation risk
- Combination of shares and assets

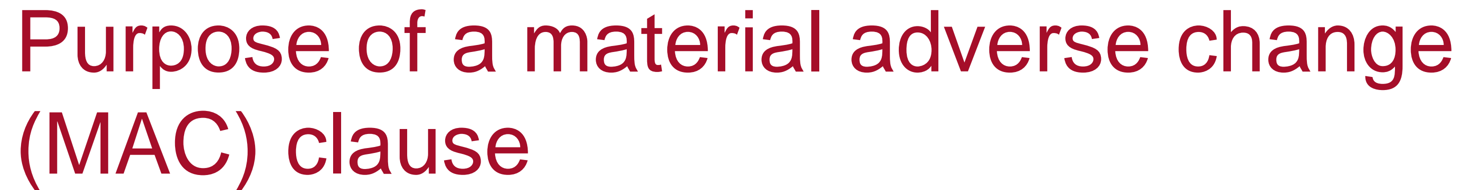
Managing risk through deal structuring

- Consider pre-acquisition re-structuring
  - Isolate and remove any problem assets or liabilities before the acquisition
  - Hive-out/spin off entities containing problem assets or liabilities
  - Transfer assets between group entities and exclude non-essential entities
  - Set up a Newco to acquire the target or business
  - Cross-border issues

Managing risk through deal structuring

- Trends in the market
  - Increasingly conservative nature of buyers
  - Longer due diligence and negotiation periods
  - Buyers seeking greater access to information
  - Shift to buyer friendly terms
  - Risk reflected in purchase price

Material adverse change clauses



Purpose of a material adverse change (MAC) clause

- Method of risk allocation between signing and closing
- Condition precedent or representation/warranty
- Conflicting desires:
  - seller wants deal certainty
  - buyer wants an exit mechanism in case of events which trigger a MAC on Target or Target's prospects
- Increasing focus on the scope, drafting and enforceability of MAC clauses in Australia

Increasing prevalence of MAC clauses

- 78% of public M&A transactions announced in 2011 included a condition that a MAC did not occur in respect of Target
- Increased use of MAC clauses in private M&A transactions
- Reasons for increase:
  - market volatility and uncertain economic environment
  - increased Buyer conservatism
- Moving towards US position where MAC clauses are used in almost all M&A transactions

Current position in Australia

- Very little Australian authority on MAC clauses
- Takeovers Panel decisions
- Lack of definitive guidance leads to consideration of leading US and UK cases
- Current market potentially gives buyer greater negotiating power with MAC clauses

UK authority – WPP Group's offer for Tempus Group (2001 UK Takeovers Panel)

- WPP made offer for Tempus on 10 September 2001
- WPP sought ruling from UK Takeovers Panel that it could rely on MAC clause to withdraw offer
- WPP was not permitted to withdraw its offer following events of 9/11
- Test requires "an adverse change of very considerable significance striking at the heart of the purpose of the transaction…analogous…to something that would justify frustration of a legal contract".
- "A temporary effect on profitability [is] not of itself sufficient."
- UK Takeovers Panel considered US past practice in reaching decision

Hexion Specialty Chemicals, Inc. v Huntsman Corporation (2008 Delaware Chancery Court)

- Hexion was majority owned by Apollo, an asset manager
- Apollo's desire to acquire Huntsman meant MAC clause was very seller friendly
- Huntsman failed to achieve its financial projections following onset of GFC
- Followed earlier US authority applying a very fact driven assessment of application of MAC clause
- Hexion had not proven occurrence of a MAC
- Court noted it was no coincidence that Delaware courts have never found a MAC to have occurred in context of an acquisition agreement

Hexion v Huntsman – Key findings

- Burden of proof:
- Absent clear language to the contrary, burden of proof with Buyer
- Materiality:
- MAC event must "substantially threaten the overall earnings potential of Target"
- Duration:
- Need a "durationally significant" impact on earnings (years not months)
- Transaction Knowledge and Context
- MAC clause a back-stop protecting buyers from the occurrence of unknown events
- Relevant Data:
- Projected financial results cannot be a benchmark for MAC determination where Sale Agreement expressly states no warranties given regarding projections

NGM Resources [2010] ATP 11

- Paladin sought to walk away from proposed all scrip bid to acquire NGM Resources under MAC clause following terrorist activity
- General MAC clause:
  - "no change occurs… which has or could reasonably be expected to have a materially adverse effect on the assets liabilities, financial position, performance, profitability or prospects of NGM"
- Takeovers Panel found Paladin had not proved "material adverse effect"
- Decision demonstrates need for clear, casual connection between relevant events and their impact on Target
- MAC clauses used in public M&A transactions must be capable of objective interpretation

MAC clauses – Drafting considerations

- Quantifiable materiality thresholds
- Include specific quantifiable materiality thresholds (e.g. fixed percentage or dollar reduction in net asset position or annual EBITDA) that are objectively clear
- Explicit MAC events
- Particular occurrences that are important to the Buyer should be listed as MAC events
- Explicit MAC exclusions
- Seller focus on ensuring MAC events specifically related to Target business
- Buyer focus on MAC trigger for generic events which disproportionately effect Target
- Forward looking standard
- MAC triggered if event has, or could reasonably be expected to, have a materially adverse effect
- Allocate burden of proof
- Buyer may want to shift burden of proof that no MAC has occurred to Seller

Warranty & indemnity insurance

Insurance solutions for transaction risk

Traditional deal security measures

- Retentions
- Escrow
- Earn out
- Deferred consideration
- Bank guarantee
- Parent/third-party guarantee
- Charge or mortgage over Seller’s assets

W&I Insurance

Bespoke insurance product to protect either the buyer or seller in an M&A transaction from financial loss arising from a breach of the representations and warranties given by the seller on the transaction.

M&A insurance solutions

– Insurance markets provide an alternative capital source to facilitate transactions:

– Warranty & Indemnity Insurance
– Tax Liability Insurance
– Contingent Liability Insurance
– Litigation Insurance
– Environmental Insurance
– Prospectus Liability Insurance

Insurance capital used to de-risk, facilitate and enhance transactions

Types of W&I policies

- Buyer Side Insurance – Protects the buyer from financial loss arising from a breach of the warranties given by the seller (including seller fraud).
- Seller Side Insurance – Insures the seller for claims by the buyer in respect of financial loss arising from a breach of the warranties given by the seller (excepting seller fraud).
- Vast majority of W&I Policies are buyer-side

Strategic use of W&I Insurance: Buyer

- Enhance amount and/or duration of recourse
- Offer a clean exit for the seller
- Enhance/differentiate bid in auction scenario
- Protect key relationships (e.g. continuing management)
- Address collection concerns (e.g. multiple sellers or financially weak sellers)
- Acquisition from distressed seller or receiver
- Insure certainty of purchase price

Strategic use of W&I Insurance: Seller

- Enable clean exit
- Distribute sale proceeds
- Avoid/lessen escrow
- Enhance purchase price by
  - attracting more bidders with increased warranty package
  - providing warranties where seller would be unable to do so – e.g. distressed seller.
- Protect passive sellers
- Expedite sale

Coverage basics

- Coverage Candidates: Typically private deals; $10 million to $3 billion in purchase price
- Capacity: $350 – 400 million (dependent on jurisdiction and nature of transaction)
- Ratio of Deal Value to Policy Limits: 100% ($10 million) – 10% ($500 million+)
- Coverage Breadth: Covers all warranties (including the tax warranties) and tax indemnity in SPA; bespoke coverage for specific indemnities
- Pricing: 1.0% to 1.4% of limit of liability; one time payment
- Pricing Factors: Business industry, transaction value, amount of insurance, coverage, policy period, retention/deductible, claims history, policy structure (buyer/seller, layers), other general factors.
- Retentions: 1-5% of transaction value; minimum retention generally 1%
- De minimis: 0.1% of transaction value generally
- Policy Period: Mirrors underlying agreement, up to seven years

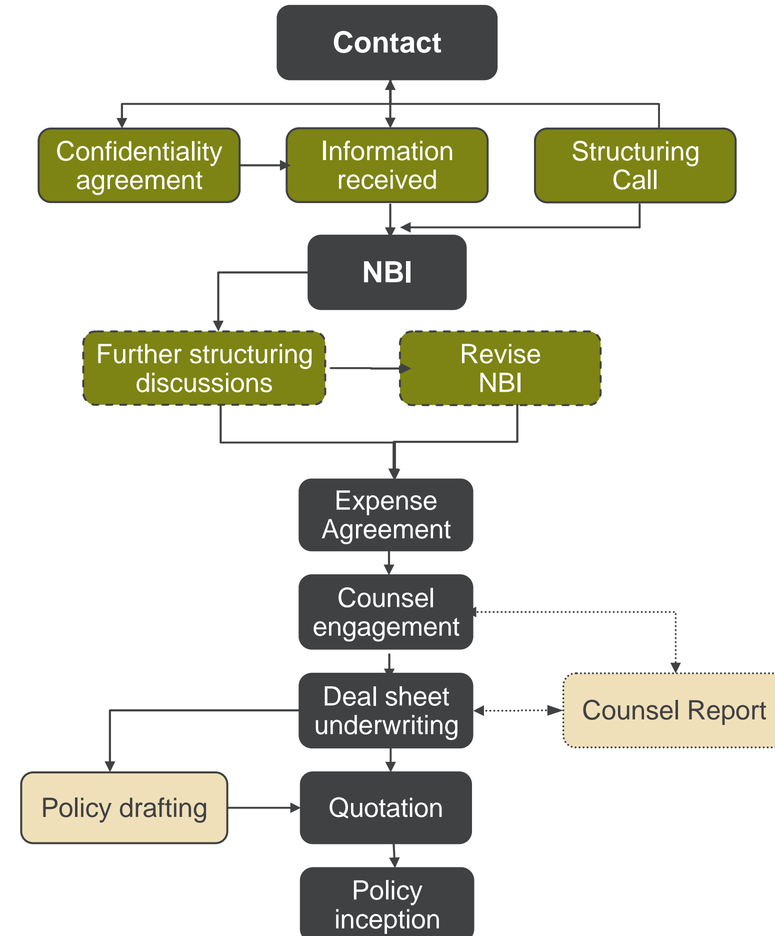
What is not covered

- W&I Policies do not cover:
- Known matters
- Forecasts, forward-looking warranties
- Warranties drafted to operate too broadly
- Consequential loss (with some exceptions)
- Purchase price adjustment or breach of other terms of SPA

- Risk of coverage gap:
- Difference between policy exclusions and claims limitations in SPA
- Tipping retentions
- Uninsured specific indemnities (usually known issues)
- New matters arising between signing and completion

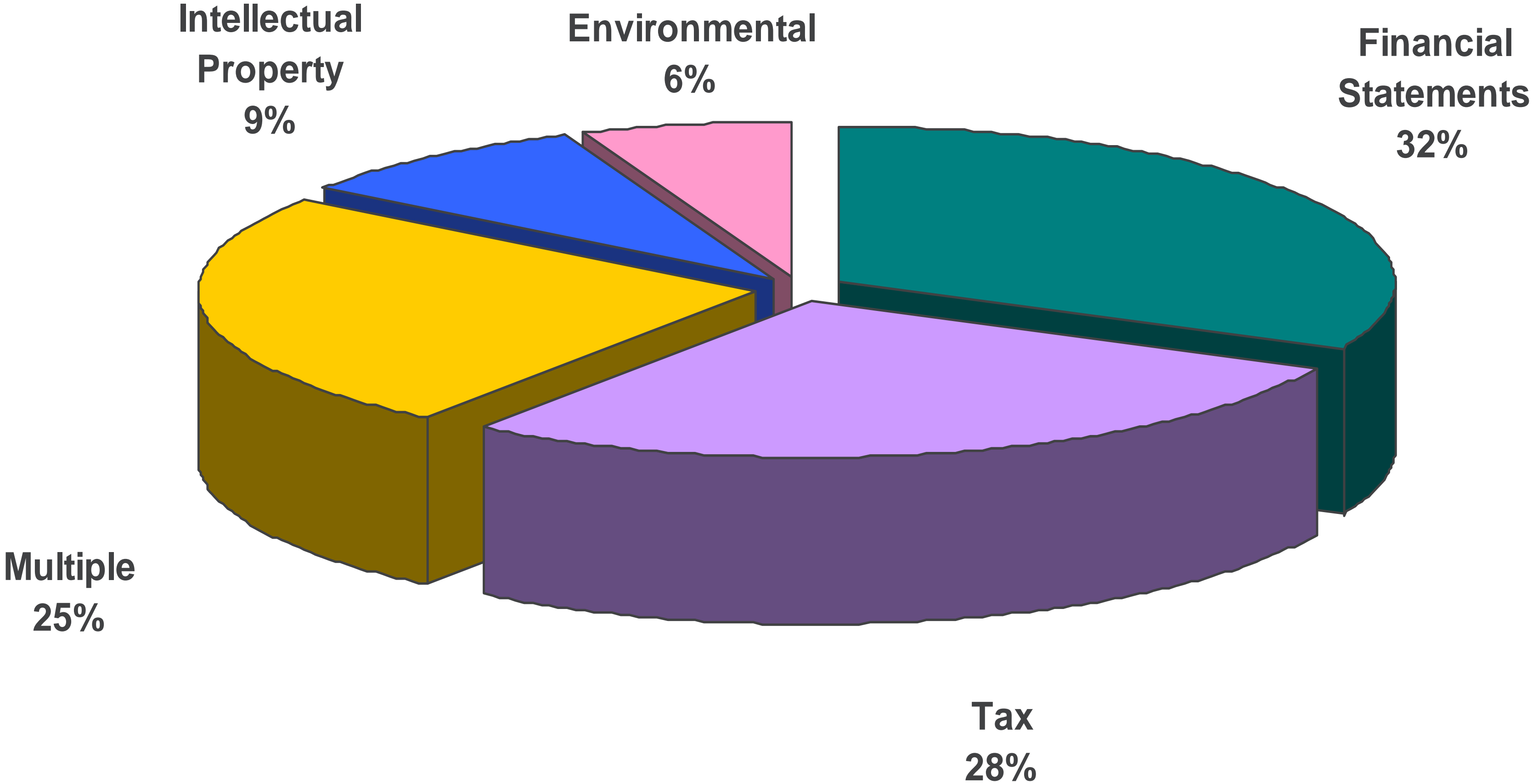
Process

1. **Structuring Discussion**
2. **Non-Binding Indication**
   - Draft SPA
   - Deal Structure
   - **1-3 Days**
3. **Engagement**
   - Expense Agreement and Non-Reliance Letters
   - Time table
   - Desired program
4. **Risk assessment**
   - Full deal documentation and data room access
   - External due diligence
   - Access to deal / advisors
   - **2-7 days**
5. **Binding Proposal**
   - Price
   - Retention
   - Policy wording
6. **Inception**
   - At signing/completion



Claims

Type of warranty breach



Claims

Claims notices

- 16% of the policies issued in Australasia (compared with 22% of the policies issued in North America)
- Although twice as many buyer-side policies are issued than seller-side policies, the number of claims reported by buyers and sellers are roughly equal

Claims timing

- 66% of claims are notified during the first 12 months following inception
- 85% of claims are notified during the first 24 months following inception

Claims paid

- Number of paid claims is significantly lower than the number of claims notices received

(Note: all claims data provided by largest insurer of W&I insurance)

Deferred consideration and earn outs

Issues in M&A transactions

Types of deferred consideration

- Scrip for scrip deals
- Vendor finance/loan
  - Also includes payment by instalments
- Completion Adjustments
  - Net Tangible Assets
  - Working capital
  - Locked box
- Earn outs

What is an earn out?

An arrangement for the sale or purchase of a business where at least part of the consideration is calculated by reference to future performance (usually profitability) of the "thing" being sold

Why use an earn out?

- Bridges the valuation gap
- Apportions risk
- Assists the buyer’s cash flow
- Forms part of the purchase price
- Verifies the accuracy of EBIT valuations
- Anticipated change/restructure

Isolation

Typical issues

– Prevents a clean break
– Buyer loses opportunity to realise synergies during the earn out period
– Management may become focussed on earn out rather than long term

Risks for the Seller

- Earn outs expose the Seller to risks, including the following:
  - How to preserve the isolation
  - Creative accounting
  - Transparency & reporting
  - Disputes
  - Security and interest
  - Set off and double recovery
  - Practical remedies (limited to damages)

Mechanisms to manage risks

- The contract will normally include the following undertakings:
  - all transactions must be on arm's length and in the ordinary course
  - reporting provisions by buyer
  - buyer must promise not to make any changes to business strategy, acquisitions or disposals
  - buyer must not divert business opportunities to the Buyer Group
  - buyer must not make any changes to accounting policies
- Extent of the above dependent on proportion earn out consideration bears to total consideration and certainty of payment

Accounting issues

- Problems often arise due to a failure to establish a clear hierarchy for basis of preparation or getting the hierarchy wrong
- Should start with the most precise measures and end with A-IFRS, that is:
  - policies specified in schedule (including pro forma statement)
  - policies used in preparation of historical statements, including notes
  - A-IFRS

Some specific policies

- Typically the buyer will seek to:
  - Exclude windfall profits
  - Add back cost savings from synergies
  - Exclude specific adjustments identified as part of due diligence
- Typically the seller will seek to exclude:
  - related party transactions with buyer group
  - long term expenses
  - the cost of transitional services

Tax – Stamp duty

- Acquisition Agreement can only be “interim stamped” as final consideration will be unknown
- Acquisition Agreement will require upstamping at a later date
  - But: not all jurisdictions provide for upstamping
- In an asset sale, difficult to apportion the earn out amounts to different assets acquired

Tax – CGT – Existing Law

- CGT will apply to the disposal of the assets the subject of the Agreement
- CGT payable in year of disposal
- Earn out is itself a CGT asset with a cost base equal to its market value
- If consideration received under the earn out is greater than the cost base (ie market value) of the earn out, then CGT consequences will arise at the time of the payments

Tax – CGT – Proposed Law

- The ATO is proposing a ‘look through’ approach
- If adopted, this would mean an earnout “right” not treated as a separate asset (i.e. right to payment under earnout ignored)
- Instead, payments treated as relating to the original asset
- Under this approach, there will only be CGT consequences if payments received exceed cost base of the asset
- From 12 May 2010 option to apply the existing law or proposed law until (or if) the proposed law is enacted

Other considerations (1)

- Who prepares post-completion adjustments?
  - usually this will be the target management or the buyer
  - often with assistance from the auditors

- The Seller generally has a period of time to review and raise any objections

Other considerations (2)

- The contract needs to provide for the following:
  - Appropriate timing to prepare statement and respond
  - Access to calculations and working papers by the reviewing party
  - A fair dispute resolution mechanism in place
    - Materiality limits - using a range or single target?
    - Dollar for dollar adjustment?

Managing transitional risk

1. Transition v separation
2. Term and termination
3. Pricing structures
4. Liability and service levels
5. Third party consents

1. Transition v separation

Transition

– The provision of services, generally on a short-term (but steady-state) basis, while replacement services are established

Separation

– The rights, obligations and processes required to facilitate the actual separation of the purchased business

2. Term and termination

- Purpose of transitional arrangements
  - Vendor: certainty of commitment; likely push for shorter exposure
  - Purchaser: avoid any "gap" in service provision; avoid unnecessary service fees
- Fixed v extendable/flexible term?
- Obligation on purchaser to transition away?
- Consider term/termination by service line:
  - added flexibility
  - cross-dependency of services
- Also consider ongoing rights/licences

3. Pricing structures

- Common structures include:
  - “Cost-plus”
  - Fixed price
- Service definition is key:
  - Cost build-up by task; by position; by service line?
  - History of internal payment/cost-allocation structures?
  - How to deal with part-time allocations?
  - Potential for significant changes in work scope?
- Dealing with stranded costs

4. Liability and service levels

– Commitments to quality
  – Often linked to pricing structures: vendor generally “not a commercial provider” of services
  – Minimum quality commitments based on service levels prior to transaction

–Limitations/exclusions follow similar path
  – Liability often more limited than for a commercial provider
  – Is service provision simply a pass-through?
  – Note relationship with liability regime in sale documentation
  – However, purchaser is relying on service

5. Third party consents

- Range of third party inputs to vendor's provision of services, including:
  - Leases
  - Licences (part. software/systems)
  - Services including outsourced service provision
- When might consents be required?
  - Pre-completion
  - During transitional period
  - Upon separation
- Who bears the risk of obtaining/maintaining third party consents?

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Questions?

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