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Mergers And Acquisitions; The Merger Transaction

The following is written by Laura Anthony, Esq., a going public attorney focused on OTC listing requirements, direct public offerings, going public transactions, reverse mergers, Form 10 and Form S-1 registration statements, SEC compliance and OTC Market reporting requirements.

Although I have written about document requirements in a merger transaction previously, with the recent booming M&A marketplace, it is worth revisiting. This blog only addresses friendly negotiated transactions achieved through share exchange or merger agreements. It does not address hostile takeovers.

A merger transaction can be structured as a straight acquisition with the acquiring company remaining in control, a reverse merger or a reverse triangular merger. In a reverse merger process, the target company shareholders exchange their shares for either new or existing shares of the public company so that at the end of the transaction, the shareholders of the target company own a majority of the acquiring public company and the target company has become a wholly owned subsidiary of the public company. The public company assumes the operations of the target company.

A reverse merger is often structured as a reverse triangular merger. In that case, the acquiring company forms a new subsidiary which merges with the target company. The primary benefits of the reverse triangular merger include the ease of shareholder consent and certain perceived tax benefits. The specific form of the transaction should be determined considering the relevant tax, accounting and business objectives of the overall transaction.

An Outline of the Transaction Documents

The Confidentiality Agreement

Generally the first step in an M&A deal is executing a confidentiality agreement and letter of intent. These documents can be combined or separate. If the parties are exchanging information prior to reaching the letter of intent stage of a potential transaction, a confidentiality agreement should be executed first.

In addition to requiring that both parties keep information confidential, a confidentiality agreement sets forth important parameters on the use of information. For instance, a reporting entity may have disclosure obligations in association with the initial negotiations for a transaction, which would need to be exempted from the confidentiality provisions. Moreover, a confidentiality agreement may contain other provisions unrelated to confidentiality, such as a prohibition against solicitation of customers or employees (non-competition) and other restrictive covenants. Standstill and exclusivity provisions may also be included, especially where the confidentiality agreement is separate from the letter of intent.

The Letter of Intent

A letter of intent ("LOI") is generally non-binding and spells out the broad parameters of the transaction. The LOI helps identify and resolve key issues in the negotiation process and hopefully narrows down outstanding issues prior to spending the time and money associated with conducting due diligence and drafting the transaction contracts and supporting documents. Among other key points, the LOI may set the price or price range, the parameters of due diligence, necessary pre-deal recapitalizations, confidentiality, exclusivity, and time frames for completing each step in the process. Along with an LOI, the parties' attorneys prepare a transaction checklist which includes a "to do" list along with the "who do" identification.

Many clients ask me how to protect their interests while trying to negotiate a merger or acquisition. During the negotiation period, both sides will incur time and expense, and will provide the other with confidential information. The way to protect confidential information is through a confidentiality agreement, but that does not protect against wasted time and expense. Many other protections can be used to avoid wasted time and expense.

Many, if not all, letters of intent contain some sort of exclusivity provision. In deal terminology, these exclusivity provisions are referred to as “no shop” or “window shop” provisions. A “no shop” provision prevents one or both parties from entering into any discussions or negotiations with a third party that could negatively affect the potential transaction, for a specific period of time. That period of time may be set in calendar time, such as sixty days, or based on conditions, such as completion of an environmental study, or a combination of both.

A “window shop” provision allows for some level of third-party negotiation or inquiry. An example of a window shop provision may be that a party cannot solicit other similar transactions but is not prohibited from hearing out an unsolicited proposal. A window shop provision may also allow the board of directors of a party to shop for a better deal, while giving a right of first refusal if such better deal is indeed received. Window shop provisions generally provide for notice and disclosure of potential “better deals” and either matching or topping rights.

Generally, both no shop and window shop provisions provide for a termination fee or other detriment for early termination. The size of the termination fee varies; however, drafters of a letter of intent should be cognizant that if the fee is substantial, it likely triggers an SEC reporting and disclosure requirement, which in and of itself could be detrimental to the deal.

Much different from a no shop or window shop provision is a “go shop” provision. To address a board of directors’ fiduciary duty and, in some instances, to maximize dollar value for its shareholders, a potential acquirer may request that the target “go shop” for a better deal up front to avoid wasted time and expense. A go shop provision is more controlled than an auction and allows both target and acquiring entities to test the market prior to expending resources. A go shop provision is common where it is evident that the board of directors’ “Revlon Duties” have been triggered.

Another common deal protection is a standstill agreement. A standstill agreement prevents a party from making business changes outside of the ordinary course, during the negotiation period. Examples include prohibitions against selling off major assets, incurring extraordinary debts or liabilities, spinning off subsidiaries, hiring or firing management teams and the like.

Finally, many companies protect their interests by requiring significant stockholders to agree to lock-ups pending a deal closure. Some lock-ups require that the stockholder agree that they will vote their shares in favor of the deal as well as not transfer or divest themselves of such shares.

The Merger Agreement

In a nutshell, the Merger Agreement sets out the financial terms of the transaction and legal rights and obligations of the parties with respect to the transaction. It provides the buyer with a detailed description of the business being purchased and provides for rights and remedies in the event that this description proves to be materially inaccurate. The Merger Agreement sets forth closing procedures, preconditions to closing and post-closing obligations, and sets out representations and warranties by all parties and the rights and remedies if these representations and warranties are inaccurate.

The main components of the Merger Agreement and a brief description of each are as follows:

- Representations and Warranties – Representations and warranties generally provide the buyer and seller with a snapshot of facts as of the closing date. From the seller the facts are generally related to the business itself, such as that the seller has title to the assets, there are no undisclosed liabilities, there is no pending litigation or adversarial situation likely to result in litigation, taxes are paid and there are no issues with employees. From the buyer the facts are generally related to legal capacity, authority and ability to enter into a binding contract. The seller also represents and warrants its legal ability to enter into the agreement. Both parties represent as to the accuracy of public filings, financial statements, material contract, tax matters and organization and structure of the entity.
- Covenants – Covenants generally govern the parties' actions for a period prior to and following closing. An example of a covenant is that a seller must continue to operate the business in the ordinary course and maintain assets pending closing and, if there are post-closing payouts that the seller continues likewise. All covenants require good faith in completion.
- Conditions – Conditions generally refer to pre-closing conditions such as shareholder and board of director approvals, that certain third-party consents are obtained and proper documents are signed. Generally for public companies these conditions include the filing of appropriate shareholder proxy or information statements under Section 14 of the Securities Exchange Act of 1934 and complying with shareholder appraisal rights provisions. Closing conditions usually include the payment of the compensation by the buyer. Generally, if all conditions precedent are not met, the parties can cancel the transaction.
- Indemnification/remedies – Indemnification and remedies provide the rights and remedies of the parties in the event of a breach of the agreement, including a material inaccuracy in the representations and warranties or in the event of an unforeseen third-party claim related to either the agreement or the business.
- Deal Protections – Like the LOI, the merger agreement itself will contain deal protection terms. These deal protection terms can include no shop or window shop provisions, requirements as to business operations by the parties prior to the closing; breakup fees; voting agreements and the like.

- Schedules – Schedules generally provide the meat of what the seller is purchasing, such as a complete list of customers and contracts, all equity holders, individual creditors and terms of the obligations. The schedules provide the details.

In the event that the parties have not previously entered into a letter of intent or confidentiality agreement providing for due diligence review, the Merger Agreement may contain due diligence provisions. Likewise, the agreement may contain no shop provisions, breakup fees, non-compete and confidentiality provisions if not previously agreed to separately.

Disclosure Matters

In a merger or acquisition transaction, there are three basic steps that could invoke the disclosure requirements of the federal securities laws: (i) the negotiation period or pre-definitive agreement period; (ii) the definitive agreement; and (iii) closing.

(i) Negotiation Period (Pre-Definitive Agreement)

Generally speaking, the federal securities laws do not require the disclosure of a potential merger or acquisition until such time as the transaction has been reduced to a definitive agreement. Companies and individuals with information regarding non-public merger or acquisition transactions should be mindful of the rules and regulations preventing insider trading on such information. However, there are at least three cases where pre-definitive agreement disclosure may be necessary or mandated.

The first would be in the Management, Discussion and Analysis section of a company's quarterly or annual report on Form 10-Q or 10-K, respectively. Item 303 of Regulation S-K, which governs the disclosure requirement for Management's Discussion and Analysis of Financial Condition and Results of Operations, requires, as part of this disclosure, that the registrant identify any known trends or any known demands, commitments, events or uncertainties that will result in, or that are reasonably likely to result in, the registrant's liquidity increasing or decreasing in any material way. Furthermore, descriptions of known material trends in the registrant's capital resources and expected changes in the mix and cost of such resources are required. Disclosure of known trends or uncertainties that the registrant reasonably expects will have a material impact on net sales, revenues, or income from continuing operations is also required. Finally, the Instructions to Item 303 state that MD&A "shall focus specifically on material events and uncertainties known to management that would cause reported financial information not to be necessarily indicative of future operating results or of future financial condition."

It seems pretty clear that a potential merger or acquisition would fit firmly within the required MD&A discussion. However, realizing that disclosure of such negotiations and inclusion of such information could, and often would, jeopardize completing the transaction at all, the SEC has provided guidance. In SEC Release No. 33-6835 (1989), the SEC eliminated uncertainty regarding disclosure of preliminary merger negotiations by confirming that it did not intend for Item 303 to apply, and has not applied, and does not apply to preliminary merger negotiations. In general, the SEC's recognition that companies have an interest in preserving the confidentiality of such negotiations is clearest in the context of a company's continuous reporting obligations under the Exchange Act, where disclosure on Form 8-K of acquisitions or dispositions of assets not in the ordinary course of business is triggered by completion of the transaction (more on this below). Clearly, this is a perfect example and illustration of the importance of having competent legal counsel assist in interpreting and unraveling the numerous and complicated securities laws disclosure requirements.

In contrast, where a company registers securities for sale under the Securities Act, the SEC requires disclosure of material probable acquisitions and dispositions of businesses, including the financial statements of the business to be acquired or sold. Where the proceeds from the sale of the securities being registered are to be used to finance an acquisition of a business, the registration statement must disclose the intended use of proceeds. Again, accommodating the need for confidentiality of negotiations, registrants are specifically permitted not to disclose in registration statements the identity of the parties and the nature of the business sought if the acquisition is not yet probable and the board of directors determines that the acquisition would be jeopardized. Although beyond the scope of this blog, many merger and/or acquisition transactions require registration under Form S-4.

Accordingly, where disclosure is not otherwise required and has not otherwise been made, the MD&A need not contain a discussion of the impact of such negotiations where, in the company's view, inclusion of such information would jeopardize completion of the transaction. Where disclosure is otherwise required or has otherwise been made by or on behalf of the company, the interests in avoiding premature disclosure no longer exist. In such case, the negotiations would be subject to the same disclosure standards under Item 303 as any other known trend, demand, commitment, event or uncertainty.

The second would be in Form 8-K, Item 1.01 Entry into A Material Definitive Agreement. Yes, this is in the correct category; the material definitive agreement referred to here is a letter of intent or confidentiality agreement. Item 1.01 of Form 8-K requires a company to disclose the entry into a material definitive agreement outside of the ordinary course of business. A "material definitive agreement" is defined as "an agreement that provides for obligations that are material to and enforceable against the registrant or rights that are material to the registrant and enforceable by the registrant against one or more other parties to the agreement, in each case whether or not subject to conditions." Agreements relating to a merger or acquisition are outside the ordinary course of business. Moreover, although most letters of intent are non-binding by their terms, many include certain binding provisions such as confidentiality provisions, non-compete or non-circumvent provisions, no shop and exclusivity provisions, due diligence provisions, breakup fees and the like. On its face, it appears that a letter of intent would fall within the disclosure requirements in Item 1.01.

Once again, the SEC has offered interpretative guidance. In its final rule release no. 33-8400, the SEC, recognizing that disclosure of letters of intent could result in destroying the underlying transaction as well as create unnecessary market speculation, specifically eliminated the requirement that non-binding letters of intent be disclosed. Moreover, the SEC has taken the position that the binding provisions of the letter, such as non-disclosure and confidentiality, are not necessarily "material" and thus do not require disclosure. However, it is important that legal counsel assist the company in drafting the letter, or in interpreting an existing letter to determine if the binding provisions reach the "materiality" standard and thus become reportable. For example, generally large breakup fees or extraordinary exclusivity provisions are reportable.

The third would be in response to a Regulation FD issue. Regulation FD or fair disclosure prevents selective disclosure of non-public information. Originally Regulation FD was enacted to prevent companies from selectively providing information to fund managers, big brokerage firms and other "large players" in advance of providing the same information to the investment public at large. Regulation FD requires that in the event of an unintentional selective disclosure of insider information, the company take measures to immediately make the disclosure to the public at large through both a Form 8-K and press release.

(ii) The Definitive Agreement

The definitive agreement is disclosable in all aspects. In addition to inclusion in Form 10-Q and 10-K, a definitive agreement must be disclosed in Form 8-K within four (4) days of signing in accordance with Item 1.01 as described above. Moreover, following the entry of a definitive agreement, completion of conditions, such as a shareholder vote, will require in-depth disclosures regarding the potential target company, including their financial statements.

(iii) The Closing

The Closing is disclosable in all aspects, as is the definitive agreement. Moreover, in addition to item 1.01, the Closing may require disclosures under several or even most of the Items in Form 8-K, such as Item 2.01 – Completion of disposal or acquisition of Assets; Item 3.02 – Unregistered sale of securities; Item 4.01 – Changes in Certifying Accountant; Item 5.01 Change in Control; Item 5.06 – Change in Shell Status, etc.

Due Diligence in a Merger Transaction

Due diligence refers to the legal, business and financial investigation of a business prior to entering into a transaction. Although the due diligence process can vary depending on the nature of a transaction (a relatively small acquisition vs. a going public reverse merger), it is arguably the most important component of a transaction (or at least equal with documentation).

At the outset, in addition to requesting copies of corporate records and documents, all contracts, asset chains of title documents, financial statements and the like, due diligence includes becoming familiar with the target's business, including an understanding of how they make money, what assets are important in revenues, who are their commercial partners and suppliers, and common off-balance-sheet and other hidden arrangements in that business. It is important to have a basic understanding of the business in order to effectively review the documents and information once supplied, to know what to ask for and to isolate potential future problems.

In addition to determining whether the transaction as a whole is worth pursuing, proper due diligence will help in structuring the transaction and preparing the proper documentation to prevent post-closing issues (such as making sure all assignments of contracts are complete, or where an assignment isn't possible, new contracts are prepared).

In addition to creating due diligence lists of documents and information to be supplied, counsel for parties should perform separate checks for publicly available information. In today's internet world, this part of the process has become dramatically easier. Counsel should be careful not to miss the basics, such as UCC lien searches, judgment searches, recorded property title and regulatory issues with any of the principals or players involved in the deal, including any bad actor issues that could be problematic going forward.

The Author

Attorney Laura Anthony
Founding Partner
Legal & Compliance, LLC
Corporate, Securities and Going Public Attorneys
LAnthony@LegalAndCompliance.com

Securities Law Blog is written by Laura Anthony, Esq., a going public lawyer focused on OTC Listing Requirements, Direct Public Offerings, Going Public Transactions, Reverse Mergers, Form 10 Registration Statements, and Form S-1 Registration Statements. Securities Law Blog covers topics ranging from SEC Compliance, FINRA Compliance, DTC Chills, Going Public on the OTC, and OTCQX and OTCQB Reporting Requirements. Ms. Anthony is also the host of LawCast.com, the securities law network.

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