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Mergers And Acquisitions: Types Of Transactions

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.

As merger and acquisition (M&A) transactions completed its most active year since the financial crisis, it is helpful to go back to basics. Activity has been prevalent in all market sectors, including large, mid and small cap and across all industries, including biotech, financial services, technology, consumer goods and services, food and beverage and healthcare, among others.

Although I've written about M&A transactions multiple times, this will be the first time I've given a broad overview of the forms that an M&A transaction can take.

Types of Mergers and Acquisitions

A merger or acquisition transaction is the combination of two companies into one resulting in either one corporate entity or a parent-holding and subsidiary company structure. Mergers can categorized by the competitive relationship between the parties and by the legal structure of the transaction. Related to competitive relationship, there are three types of mergers: horizontal, vertical and conglomerate. In a horizontal merger, one company acquires another that is in the identical or substantially similar industry eliminating a competitor. In a vertical merger, one company acquires a customer or supplier. A conglomerate merger covers all other transactions where there is no direct competitive or vertical relationship between the merging parties. The result is generally the creation of a conglomerate – thus the name.

From a legal structure perspective, an M&A transaction can be an asset purchase, a stock purchase, a forward merger or a forward or reverse triangular merger. In an asset purchase, stock acquisition, forward merger or forward triangular merger, the acquiring company remains in control. In a reverse merger or a reverse triangular merger, the target company shareholders and management gain control of the acquiring company.

In an asset purchase transaction, the acquirer can pick and choose the assets that it is purchasing, and likewise the liabilities it is assuming. An asset purchase can be complex and requires careful drafting to ensure that the desired assets are included, including all tangible and intangible rights thereto, and that only the specified liabilities are legally assumed. Third-party consents are often required to achieve the result.

In a stock acquisition, the acquiring company purchases the stock from the target company shareholders. A stock acquisition can result in a forward or reverse acquisition depending on the control of the target company shareholders at the closing of the transaction. In a stock acquisition transaction, the operations, assets and liabilities of the target remain unchanged; it just has different ownership. Complexities arise if some of the target company shareholders refuse to participate in the transaction, leaving unfriendly minority shareholders. Oftentimes a stock acquisition is structured such that a closing is contingent upon a certain percentage participation, such as 90% or even 100%.

In a forward merger or a forward or reverse triangular merger, two companies combine into one, resulting in either one corporate entity or a parent-holding and subsidiary company structure. The shareholders of the target company receive either stock of the acquirer, cash or a combination of both. All assets and liabilities are included in the M&A transaction. A triangular merger is one in which a new acquisition subsidiary is formed to complete the transaction and results in a parent-subsidiary structure.

As mentioned above, a reverse merger results in a change of control of the acquirer. In particular, in a reverse or reverse triangular merger the shareholders of the target company exchange their shares for either new or existing shares of the acquiring company so that at the end of the transaction, the shareholders of the target company own a majority of the acquiring company and the target company has become a wholly owned subsidiary of the acquiring company or has merged into a newly formed acquisition subsidiary. A reverse merger is often used as a private to public transaction for a target company where the acquiring company is a public entity.

The specific form of the transaction should be determined considering the relevant tax, accounting and business objectives of the overall transaction.

Refresher on Other Aspects of the Transaction

An Outline of the Transaction Documents

Generally the first step in an M&A deal is executing a confidentiality agreement and letter of intent followed by the merger agreement itself. In addition to requiring that both parties keep information confidential, a confidentiality agreement sets forth important parameters on the use of information, including allowable disclosure both internally and to third parties. 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.

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, 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. A “window shop” provision allows for some level of third-party negotiation. For example, a window shop provision may allow for the consideration of unsolicited proposals.

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.

A standstill provision 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. Many companies also protect their interests in the LOI stage 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:

1.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. Both parties represent as to the accuracy of public filings, financial statements, material contract, tax matters and organization and structure of the entity.

2.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. All covenants require good faith in completion.

3.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, if all conditions precedent are not met, the parties can cancel the transaction.

4.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.

5.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.

6.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. 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).

Board of Directors' Fiduciary Duties in the Merger Process

State corporate law generally provides that the business and affairs of a corporation shall be managed under the direction of its board of directors. Members of the board of directors have a fiduciary relationship to the corporation, which requires that they act in the best interest of the corporation, as opposed to their own. Generally a court will not second-guess directors' decisions as long as the board has conducted an appropriate process in reaching its decisions. This is referred to as the "business judgment rule." The business judgment rule creates a rebuttable presumption that "in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company" (as quoted in multiple Delaware cases, including Smith vs. Van Gorkom, 488 A.2d 858 (Del. 1985)).

However, in certain instances, such as in a merger and acquisition transaction, where a board may have a conflict of interest (i.e., get the most money for the corporation and its shareholders vs. getting the most for themselves via either cash or job security), the board of directors' actions face a higher level of scrutiny. This is referred to as the "enhanced scrutiny business judgment rule" and stems from Revlon, Inc. vs. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986) and Unocal vs. Mesa Petroleum, 493 A.2d 946 (Del. 1985).

A third standard, referred to as the "entire fairness standard," is only triggered where there is a conflict of interest involving directors and/or shareholders such as where directors are on both sides of the transaction. Under the entire fairness standard, the directors must establish that the entire transaction is fair to the shareholders, including both the process and dealings and price and terms.

In all matters, directors' fiduciary duties to a corporation include honesty and good faith as well as the duty of care, duty of loyalty and a duty of disclosure. In short, the duty of care requires the director to perform their duty with the same care a reasonable person would use, to further the best interest of the corporation and to exercise good faith, under the facts and circumstances of that particular corporation. The duty of loyalty requires that there be no conflict between duty and self-interest. The duty of disclosure requires the director to provide complete and materially accurate information to a corporation.

As with many aspects of the law, a director's responsibilities and obligations in the face of a merger or acquisition transaction depend on the facts and circumstances. From a high level, if a transaction is not material or only marginally material to the company, the level of involvement and scrutiny facing the board of directors is reduced and only the basic business judgment rule will apply. For example, in instances where a company's growth strategy is acquisition-based, the board of directors may set out the strategy and parameters for potential target acquisitions but leave the completion of the acquisitions largely with the C-suite executives and officers.

Moreover, the director's responsibilities must take into account whether they are on the buy or sell side of a transaction. When on the buy side, the considerations include getting the best price deal for the company and integration of products, services, staff, and processes. On the other hand, when on the sell side, the primary objective of maximizing the return to shareholders though social interests and considerations (such as the loss of jobs) may also be considered in the process.

The law focuses on the process, steps and considerations made by the board of directors, as opposed to the actual final decision. The greater the diligence and effort put into the process, the better, both for the company and its shareholders, and the protection of the directors in the face of scrutiny. Courts will consider facts such as attendance at meetings, the number and frequency of meetings, knowledge of the subject matter, time spent deliberating, advice and counsel sought by third-party experts, requests for information from management, and requests for and review of documents and contracts.

In the performance of their obligations and fiduciary responsibilities, a board of directors may, and should, seek the advice and counsel of third parties, such as attorneys, investment bankers, and valuation experts. Moreover, it is generally good practice to obtain a third-party fairness opinion on a transaction.

Dissenter and Appraisal Rights

Unless they are a party to the transaction itself, such as in the case of a share-for-share exchange agreement, shareholders of a company in a merger transaction generally have what is referred to as "dissenters" or "appraisal rights." An appraisal right is the statutory right by shareholders that dissent from a particular transaction, to receive the fair value of their stock ownership. Generally such fair value may be determined in a judicial or court proceeding or by an independent valuation. Appraisal rights and valuations are the subject of extensive litigation in merger and acquisition transactions.

Although the details and appraisal rights process vary from state to state (often meaningfully), as with other state corporate law matters, Delaware is the leading statutory example and the Delaware Chancery Court is the leader in judicial precedence in this area of law. More than half of U.S. public companies and more than two-thirds of Fortune 500 companies are domiciled in Delaware.

As is consistent with all states, the Delaware General Corporation Law ("DGCL") Section 262 providing for appraisal rights requires both petitioning stockholders and the company to comply with strict procedural requirements. Section 262 of the DGCL gives any stockholder of a Delaware corporation who (i) is the record holder of shares of stock on the date of making an appraisal rights demand, (ii) continuously holds such shares through the effective date of the merger, (iii) complies with the procedures set forth in Section 262, and (iv) has neither voted in favor of nor consented in writing to the merger, to seek an appraisal by the Court of Chancery of the fair value of their shares of stock.

Generally there are four recurring valuation techniques used in an appraisal rights proceeding: (i) the discounted cash flow (DCF) analysis; (ii) a comparable company's analysis and review; (iii) a comparable transactions analysis and review; and (iv) the merger price itself. Merger price is usually reached through the reality of a transaction process, as opposed to the academic and subjective valuation processes used in litigation challenging such price.

In a recent line of cases, the Delaware court has upheld the merger price as the most reliable indicator of fair value where the merger price was reached after a fair and adequate process in an arm's-length transaction. Where there is a question as to the process resulting in the final merger price, Delaware courts generally look to the DCF analysis as the next best indicator of fair value.

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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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