The Real Deal Webinar Series: Trends and Developments in M&A (Part II): Private Company Targets

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M&A Overview
M&A Overview: 2013 vs. 2014

• 2013 was one of the least active years in M&A since 2007

• Deal activity is up so far in 2014 as compared to 2013
  – $500 million+ transactions are up so far in 2014\(^1\)

\(^1\) Dealogic M&A Snapshot, May 6th, 2014
M&A Overview: Q1 2013 vs. Q1 2014 (cont.)

• Industries with the biggest increases in M&A deal activity in Q1 2014 as compared to Q1 2013:
  
  – Commercial Services (516 v. 370)
  
  – Consumer Services (212 v. 142)
  
  – Health Services (134 v. 104)
  
  – Finance (337 v. 307)
  
  – Industrial Services (120 v. 91)¹

¹ FactSet Flashwire US Monthly, April 2014
M&A Overview: Possible Rationale for Less Activity in 2013

- General risk aversion based on uncertain economic outlook
- Fear of a double-dip recession following the 2008-2009 economic turndown
- Fear of impending changes in tax laws
- Political gridlock/fiscal cliff
- US government shutdown
- Treasury downgrade
- Continued global uncertainty
M&A Overview: Expected improvement in 2014

• More confidence in the economy

• Improving economic conditions leads to more certainty
  – Improved consumer confidence
  – Stronger debt and equity markets
  – Recovery of financial service sector

• Favorable conditions for deals
  – Historically high levels of cash reserves and commitments
  – Historically low interest rates
M&A Overview: Expected improvement in 2014 (cont.)

• Favorable conditions for deals (cont.)
  – Debt to EBITDA multiples are increasing
  – Availability of credit on favorable terms

• Desire to enhance operations and grow
M&A Overview: Potential Impediments to M&A Activity

- Implementation of healthcare reform
- Continued high unemployment
- Valuation gap between buyers and sellers
- Fewer financing conditions being accepted
M&A Overview: Expected High Growth Industries for 2014

- Telecommunications
- Technology
- Real Estate
- Retail and Consumer
- Energy
- Healthcare
M&A Overview: Takeaway

• Strong momentum in the M&A markets is expected to continue

• Buyers and sellers are focusing on core assets
  – Growth through acquisitions of synergistic assets
  – Divestitures of non-core assets
Indemnification
Indemnification: Key issues

- Critical M&A concept
- Along with price, the most important issue
- Key issues include caps, deductibles, escrows/holdbacks, survival
Indemnification: Caps

- Most deals include "caps" on losses relating to breaches of reps and warranties
- Different representations have different caps
  - So called “fundamental reps” related to title, authority, etc., are generally capped at purchase price received by seller
- Caps for reps relating to the Company’s condition (“Company representations”) have fallen from 40% range to much lower
  - Caps today are often 10% or less of purchase price
  - According to one study, 89% of caps are 15% or less of purchase price*
    - Varies with market
    - UK deals feature higher caps (e.g., 40-50%)
- Many sellers are demanding "no rep" or "as is where is" deals
  - Essentially sets cap at zero for all reps (other than "fundamental" reps)
  - Aggressive/risky position for buyers, but gives sellers perfect peace of mind
  - How good is the price?
  - How comfortable is buyer with due diligence?
  - How comfortable is buyer with industry?
  - Seller’s bargaining power
  - Ultimately a business issue;
    - Indemnities are like "extended warranties" on cars and appliances; are they worth paying for?
    - Rep & warranty insurance may be used to reduce risk
- Caps generally don’t apply to breaches of covenants

*ABA Deal Points Study
Indemnification: Deductibles v. Tipping Baskets

• Purchase agreements typically require losses to exceed "basket" level before indemnification applies
  • Typically 0.5% to 1.0% of purchase price
  • Essentially an increase of purchase price
  • "Tipping baskets" revert to "dollar 1"

• “Mini baskets” provides that losses under a de minimis amount do not apply to the basket
  • Included in 30% of 2012 deals.* Becoming more prevalent.
  • Usually a de minimis amount, such as $10,000 to $50,000 (depending on size of deal)
  • Again, a seller-friendly development

• Baskets and mini baskets serve as global materiality qualifier for indemnification
  • Watch effect of materiality qualifier in reps
  • May create additional barrier to recovery
  • "Scrape" qualifiers
  • Quantify "material"

*ABA Deal Points Study
Indemnification: Escrows / Holdbacks

• Buyers often negotiate escrows or holdbacks to provide security for breaches of representations
  • Avoids problems of chasing individual sellers
  • May not be as important when seller is a large established company
• Escrows and holdbacks have declined as a percentage of transaction value
• Increasingly, the escrow or holdback is the exclusive source of recovery for Company representations (32% of deals in 2012)*

*ABA Deal Points Study
Indemnification: Survival Periods

- Eighteen months is a common survival period for general reps and warranties.
- Survival periods are generally shortening, in favor of sellers.
- Instead of a definite time period, survival periods can be linked to financial audits.
- Fundamental reps (e.g., title to shares) survive indefinitely.
- Special reps (e.g., environmental) may survive for longer period.
- Tax reps often limited to statute of limitations.
To Recap:

• Sellers are demanding lower caps, shorter survival, higher baskets and mini-baskets

• “Rep free” or “as is, where is” deals are not the norm but are happening

• For buyers, underlines importance of thorough due diligence and cold-eyed focus on price paid

• Rep and warranty insurance may help
The Strategic Use of Representation and Warranty Insurance by Buyers and Sellers
Representation and Warranty Insurance (RWI) Overview

- Protects an insured from unanticipated and unknown losses that may arise subsequent to the closing
- Generally, covers all representations and warranties in the purchase agreement
- Historically, designed to bridge gap between buyer and seller
- More recently, used as strategic tool in auctions to get best deal terms
- Either buyer or seller can be insured under the policy
- No need for other side to know about insurance at the outset
Why the Increased Prevalence of RWI?

• Reports suggest that the sale of RWI insurance doubled in 2012 and is estimated to double each year. This can be attributed to the following:

  – Lower cost (often 2 - 3.5% of the amount being insured)
  – Improved process (coverage can be bound in as quickly as a few days)
  – Better terms and conditions (after years of negotiations, policies can provide narrower exclusions, longer policy periods and higher limits of liability)
  – Claims paying history (over the past 15 years, millions of dollars in claims have been paid out for breaches of representations and warranties, with a number of clients with positive claims stories)
  – Greater acceptance in the deal community (some sellers now include RWI proposals in bid request packages when marketing their business for sale, and buyers are using RWI as a tool to win auctions)
## Win Win?

<table>
<thead>
<tr>
<th>Pros for Buyer</th>
<th>Pros for Seller</th>
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</thead>
<tbody>
<tr>
<td>Increased protection against loss from breach of seller’s representations and warranties</td>
<td>Ability to receive more purchase price upfront instead of tying it up in escrows and holdbacks</td>
</tr>
<tr>
<td>Coverage for liabilities where creditworthiness of seller(s) or ability to collect from multiple sellers a concern</td>
<td>Can ease tension among sellers related to the often contentious point of several and/or joint liability</td>
</tr>
<tr>
<td>May ease tension where buyer seeks indemnification from former shareholder management members who are employed by buyer after the closing</td>
<td>Ability to make a “cleaner exit” from the investment with limited (if any) indemnification obligations</td>
</tr>
<tr>
<td>Attractiveness of bid in competitive auction process</td>
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Strategic Use of RWI in Auctions

- **Strategic Use By Buyer in Auctions:**
  - Distinguish bid in auction by requiring seller to cover only limited (scope, time, dollars) indemnification coverage
  - Increase desired indemnification to buyer (scope, time, dollars)

- **Strategic Use by Seller in Auctions:**
  - Allows seller in auctions to specify exactly what it is willing to provide in terms of indemnification (scope, time, dollars)
  - Message to buyer is to offer best purchase price given limited scope of indemnification but knowing RWI is available
  - “You’ll still get protection but it’s not coming from me”
  - Similar to seller offering “stapled financing”
Key Considerations

• The terms of the RWI policy may not completely mirror the terms of the representations and indemnities in the purchase agreement, so there could be a gap in coverage

• RWI caps breaches of any representation and warranties, including fundamental representations (i.e. the coverage may be less than what would be negotiated with seller, as fundamental representations are typically uncapped)

• Just like negotiating indemnification provisions in an M&A agreement and several provisions can be (if negotiated) more buyer favorable:
  – Consequential damages can be covered
  – Lost profit, multiple of damages can be covered

• Importance of “Actual knowledge” definition:
  – In US, actual knowledge of a breach limited to 2 or 3 designated people on the deal team (not include third party professionals)
  – As a result, typically get broader coverage if policy purchased by buyer not seller

• All diligence (legal, financial and environmental) reports must be provided to insurer

• RWI does not cover losses arising out of facts or circumstances that were known to the insured prior to the closing (including matters described in any diligence reports or disclosed in the disclosure schedules to the purchase agreement), so specific line items would be needed in the policy to cover those known potential losses
Key Terms

• Pricing
  – One-time payment at closing based on policy coverage limit
  – Premiums: 2 – 3.5% in US
  – Lower outside the US: Recent deal in UK at 1.25% - 1.75%
  – Typically, need to buy at least $5 million of insurance (or even $7.5 million or $10 million depending on provider)

• Deductible
  – Typically, lines up with indemnity cap or size of escrow in underlying deal

• Time periods
  – Typically coverage extends for at least the survival period in the contract, but perhaps longer (typically not longer than 5 – 7 years)
## Example of RWI from a Recent Transaction

<table>
<thead>
<tr>
<th>Provision</th>
<th>M&amp;A Agreement Coverage</th>
<th>Insurance Coverage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fundamental Reps</td>
<td>5 years (less competitive deals would be indefinite)</td>
<td>6 years</td>
</tr>
<tr>
<td>Operational Reps</td>
<td>15 months</td>
<td>2 years</td>
</tr>
<tr>
<td>Intellectual Property Reps</td>
<td>15 months</td>
<td>3 years</td>
</tr>
<tr>
<td>TAX, Environmental and ERISA Reps</td>
<td>3 years (less competitive deals would be statute of limitations)</td>
<td>6 years (note that we did get separate environmental insurance policy)</td>
</tr>
</tbody>
</table>

### Dollar Thresholds

<table>
<thead>
<tr>
<th>Provision</th>
<th>DeMinimus</th>
<th>Deductible for Operational and Intellectual Property Reps</th>
<th>Indemnity Cap on Operational and IP Reps (also matched the escrow)</th>
</tr>
</thead>
<tbody>
<tr>
<td>DeMinimus</td>
<td>$50,000</td>
<td>1% of purchase price</td>
<td>5% of purchase price (matches M&amp;A indemnity cap) with step down in deductible to 1% of purchase price after 15 months (when indemnification for these items expires under the M&amp;A agreement)</td>
</tr>
<tr>
<td>Deductible for Fundamental, TAX and ERISA Reps</td>
<td>None</td>
<td>1% of purchase price</td>
<td>20% of purchase price</td>
</tr>
</tbody>
</table>

### Limitations

<table>
<thead>
<tr>
<th>Provision</th>
<th>Consequential Damages, Lost Profit, Multiple of Earnings</th>
<th>Mitigation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Affirmatively disregarded</td>
<td>Silent</td>
<td>Silent</td>
</tr>
<tr>
<td>Duty to mitigate affirmatively stated</td>
<td>Silent</td>
<td>Silent</td>
</tr>
</tbody>
</table>
Material Adverse Effect
MAE/MAC: Background

• Widespread notion that successfully alleging the occurrence of a MAE/MAC is difficult

  − The Delaware Chancery Court has never found a material adverse effect to have occurred in the context of a merger agreement

    • IBP, Inc. v. Tyson Foods, Inc. (2001)
    
    • Frontier Oil Corp. v. Holly Corporation (2005)
    
    • Hexion Specialty Chemicals, Inc. v. Huntsman Corp. (2008)
MAE/MAC: Takeaway from the Hexion line of cases

• MAE/MAC is not established as a result of short-term events, even if significant

• In order to be a MAE/MAC, the event must be:
  – “Durationally significant”
  – “Substantial” in degree and duration
  – “Persist significantly into the future”
  – Material when viewed from “the longer-term perspective of a reasonable buyer”
  – Not a “short-term hiccup in earnings”
MAE/MAC: A changing landscape?

• Osram Sylvania Inc. v. Townsend Ventures, LLC
  - Holdings in Osram:
    • Osram had adequately pleaded breach of the MAE representation
    • Financial manipulation prior to execution of agreement can lead to a MAE
    • Short-term billing practices could have been an MAE on long-term performance
    • Failure to meet sales forecasts could conceivably be a MAE
    • Short-term changes in financial results could constitute an MAE against the backdrop of allegations of fraudulent misconduct
    • Billing and shipping excess products without proper credits or discounts could materially harm the Company’s financial condition when excess products are returns and revenues are reduced
MAE/MAC: A changing landscape? (cont.)

- Distinctions between Osram and the Hexion line of cases:
  - The Hexion line of cases were all an attempt by the buyer to walk away from the deal before closing, while Osram is a post-closing indemnification claim
  - Osram was a motion to dismiss, while the Hexion line of cases are rulings on the merits
  - Osram involved allegations of manipulation
MAE/MAC: Lessons of Osram

• Establish precise, objective triggers in purchase agreement rather than relying on ambiguous phrase “material adverse effect” or “materiality”

• Include within the MAE definition short-term and forward-looking features or, as a seller, make clear that failure to meet forecasts is not an MAE

• Carefully review carve outs to definition of material adverse effect
MAE/MAC: Sample Carve-outs to Definition

• Carve outs related to changes in the economy
  – Change in economy or business in general
  – Change in industry conditions
  – Change in securities markets
  – Change in trading price or trading volume of target stock
  – Change in interest rates, exchange rates

• Carve outs related to changes in legal developments
  – Change in laws or regulations or interpretation of laws
  – Change resulting from bankruptcy or actions of bankruptcy court
  – Changes in applicable taxes/tax law, GAAP

• Carve outs related to hostilities and calamities
  – Acts of war or major hostilities
  – Acts of terrorism
  – Acts of God
  – Changes in political conditions
  – National calamity or international calamity impacting the US
MAE/MAC: Carve outs to Definition (cont.)

• Carve outs related to employee matters
  – Employee attrition
  – Lay offs
  – Change in relationship to any labor organization or unions

• Carve outs related to changes in ordinary course of business
  – Reduction of customers or decline in business
  – Commencement of a proceeding in bankruptcy with respect to a material customer
  – Adverse effect relating to seasonal reduction in revenues

• Carve outs related to other changes
  – Developments arising from any facts that were expressly disclosed
  – Effect of announcement of the transaction
  – Failure to meet revenue or earnings predictions
Earn-Outs
Earn-Outs: What is an Earn-Out?

- Portion of consideration in an M&A transaction payable to a seller in the future, the amount of which is contingent upon the future performance of the target business and/or based on the achievement of certain milestones.
Earn-Outs: What is Market?*

- Comprise about 10-15% of aggregate purchase price
- Medimmune acquired Spirogen for $200 million up front and $240 million subject to earn-out

*From American Bar Association, Private Target Mergers & Acquisitions Deal Points Study (Including Transactions Completed in 2012.) (Study of publicly available acquisition agreements for transactions completed through 2012 that involved private targets being acquired by public companies. Hereinafter referred to as the “ABA Deal Points Study.”)
Earn-Outs: Flexible Structuring Alternative

• Allow a deal to move forward when the parties cannot agree on the value of the target
  
  • Especially when future is highly promising but necessarily uncertain

• For this reason, earn-outs are especially common in Life Sciences transactions*
  
  • 82% of Bio/Pharma deals included earn-outs
  
  • 84% of Medical Device deals included earn-outs

*From 2012 Shareholder Representative Services Life Sciences M&A Study
Earn-Outs: Litigation Concerns

• “[A]n earn-out provision often converts today’s disagreement over price into tomorrow’s litigation over the outcome.” Vice Chancellor Laster, *Airborne Health, Inc. v. Squid Soap, LP*

• Most disputes are a result of seller thinking buyer manipulated target’s performance to reduce / avoid earn-out payments or disagreement over calculations

• When earn-out is missed, litigation ensues 50% of time

• Pays to be very careful

• No time for lawyers to sit back and say it’s a “business issue.”
Earn-Outs: Key Issues

• What is the earn-out metric?
  • Revenue
  • Net income
  • EBITDA
  • "Adjusted" EBITDA
  • "Proforma" revenue or EBITDA
  • Other metrics – e.g., dollar volume of orders for future business; FDA approval for drugs; minimum number of new customers; orders from existing customers for new projects; or launch of new products
• Each has advantages (and disadvantages)
  • "GAAP" metrics (revenue or net income) are audited and less controversial to calculate
    • But fail to reflect cash flow, which is likely important to buyer
  • EBITDA metrics reflect cash flow
    • But not GAAP numbers and arguably easier to manipulate
    • As metrics become more subjective, potential for controversy may increase
  • Non-financial metrics go to key operational issues
    • But may be subjective and raise definitional issues
  • Buyers and Sellers may have different perspectives
Earn-Outs: What is Market?*

2012 Earn-Out Metrics

- Earnings/EBIDTA: 30%
- Revenue: 32%
- Combo: 3%
- Other: 30%
- Not Determinable: 5%

*ABA Deal Points Study
Earn-outs: Key Issues

• Whatever metric you pick, pay close attention to how you want it computed
  • Frequent cause of litigation
  • Sample computations sometimes included in agreement
  • Show to your accountants, bankers, etc. for fresh, independent perspective
• Aspirational statements may create problems
  • “Actively” promote products
• Unrelated business events can impact earn-out
  • Run different scenarios
Earn-outs: Other Important Terms

• All or nothing? Or graduated?
  • “All or nothing” may incentivize seller to “just miss” the earn-out target
  • Graduated more common

• Length of earn-out period
  • Range from 1 to 4 years
  • Most end after 3 years
  • Should be selected with metrics in mind

• Interplay of earn-out and escrow
  • May earn-out payment be offset for indemnity claims?

• Security for payments
  • Require buyer to grant security interest in assets
  • Require buyer to put potential earn-outs in escrow
Earn-Outs: Post-Closing Covenants are Critical

- Sellers seek protective covenants given potentially perverse earn-out incentives
  - Good faith and fair dealing
  - Require target business to operate “consistent with past practice” (27%)*
  - Restrictions on disposing a portion of the target business: Maintain sales force or cap exp at a certain level
  - Run business to maximize earn-out (8%)*
  - Additional protection if change in management (e.g., liquidated damages or acceleration of payments)
  - Acceleration on a change of control
- Big Issue: How does seller know what’s going on?
  - Are sellers (with earn-out rights) employees post-closing?
  - Quarterly, 6-month or annual reports
  - In person meetings
- Frequent topic of litigation

*ABA Deal Points Study
Earn-Outs: What will the courts do?

- Apply the “plain language” of the agreement
- Unlikely to rescue sophisticated party that failed to negotiate contractual protection
- May be unwilling to re-write to avoid “unfair” or “windfall” results
- Best case is bad faith or deliberate efforts to reduce earn-out
- Will not imply duty to “maximize” earn-out
  - If that’s what you want, say so
  - 8% of agreements have this requirement
- Clear, concrete obligations may be most successful for sellers
  - “Spend $1 million/year on marketing”
- Keep in mind that courts will require (1) breach of covenant and (2) showing that breach caused missed earn-out payment
To Recap:

• Earn-outs are a valuable tool . . .

• . . . but are fraught with peril for both buyers and sellers

• Litigation frequently ensues over whether target reached and post-closing behavior of seller

• Courts apply your agreement and unlikely to “imply” duties

• Be specific in agreement and make sure your computations are tight and easy to follow
  
  • Vague statements may conclude a difficult negotiation but only make litigation inevitable
Dispute Resolution: Courts vs. Arbitration
Dispute Resolution: What’s Market?*

- Purchase agreements enable buyers and sellers to elect court proceedings or arbitration for the resolution of disputes
- 15% of deals in 2012 provided for arbitration or mediation.
  - Binding arbitration (86%)
  - Mediation (5%)
  - Mediation then binding arbitration (9%)
- Mediation is becoming more common
  - Obligates parties to work through issues prior to a binding proceeding
  - Some believe that mediation rarely resolves the dispute but only prolongs the process and adds unnecessary expense

*ABA Deal Points Study
Dispute Resolution: Considerations

• The right answer varies from deal to deal and depends on various factors
  • What are the possible litigation venues?
  • Do you want a quick resolution or would you prefer to wait?
    • Timing incentives vary – If no escrow, Sellers may want to delay resolution of disputes to retain funds
  • Is confidentiality important to you?
  • Are you looking for a decision that has precedential value in other cases?

• Arbitration is typically faster and cheaper than court proceedings
  • Mandated discovery proceedings and jammed dockets may slow court proceedings

• Jurors (and even judges) may lack requisite sophistication
  • Especially when complicated commercial issue is involved
  • Sellers may prefer a “home town” judge and jury
  • But identity of a court is a key issue --- Delaware Chancery Court or local court in commercially remote place?

• Often helpful to consult with experienced litigator
Dispute Resolution: Tailoring your arbitration provision

- Picking arbitration doesn't end the analysis
- Parties may design arbitration clauses to fit their deal
- Parties may designate required qualifications of arbitrators
  - Former federal or state judge
  - Investment banker or accountant with experience at national firm
  - "C-level" executive
  - Qualifications may vary with issue
    - Accountant for working capital or earn-out issue
    - Judge or lawyer for representations
    - Business person for business issues
- May specify time limits for selecting arbitrators and issuance of decision
- May propose special rules for discovery and motions
- May waive right to appeal
- These designations may enhance the attractiveness of arbitration as compared to court proceedings
Dispute Resolution: Downsides to Arbitration

• It is easier to make a baseless claim in arbitration, and an arbitrator may not have procedural ability to dismiss a baseless claim
  • Short time periods may mitigate
• Arbitrators do not necessarily have to follow the law. May make decisions based on what is “fair” or issue a compromise result
  • "Ball player" provision may avoid "split the baby" problem and promote settlement
• Arbitrators are not always lawyers
  • For example, this could present issues in complex securities law disputes
  • As noted above, parties may prescribe qualifications
• ADR includes significant costs as well
  • Parties must compensate arbitrators, and such costs are rising
Dispute Resolution: Pre-closing problems

- Arbitration may not be as good for pre-closing problems
- Courts more suitable for injunctive relief
  - E.g., to require party to close a transaction
- "Third" arbitrator may take too long to appoint
- Courts offer immediate injunctive relief
- Parties should bear in mind when opting for arbitration
  - May exclude pre-closing issues from arbitration clause
To Recap:

• 15% pick arbitration

• My view: parties sometimes don’t think about it correctly: don’t pick arbitration often enough, and don’t design their provisions optimally when they do

• Arbitration allows you to pick your judges, location, time periods and even decision matrix
  • “Ball player”

• Courts provide one party with “home court” advantage, but the judge you get may not have the background to fully understand all issues involved
  • Del. Chan. Ct. is superb but one party may not want to travel to Wilmington

• If you choose arbitration, think about pre-closing issues
Competitive Market Effects on Auctions
Current Status of the Markets

• “Seller’s market”
• Fewer targets
• Competitive
  - Strategic buyers with large cash reserves and synergistic opportunities are often participating in M&A auctions in a big way and paying substantial premiums over what some private equity buyers can justify paying
  - Readily accessible financing market driving up pricing
  - Some larger private equity funds pursuing smaller “middle market” deals
  - Many private equity buyers are responding to this competitive market by evaluating more deals and participating in more auctions (especially in early bidding rounds)
• Very “managed” process by investment bankers with limited (or no) exclusivity or tight timelines and milestones that must be met to maintain exclusivity
Trends to Get the Upper Hand in a Competitive Auction

• Providing certainty of closing with minimal closing conditions and/or no financing condition

• Pursuing a simultaneous sign-and-close

• Avoiding buyers who may present regulatory risk or added time to close (e.g., lengthy foreign anti-competition filing process) – absent a significant premium

• Specialization of private equity buyers:
  – Making investments or developing in-house operations teams in specific sectors, thus squeezing out other private equity funds without the same specialization and competing more effectively against strategic buyers

• Getting to know management teams up to a year before the auction begins

• Offering buyer favorable terms on “pricing-like” items (limited or no escrows, lower indemnity caps, higher deductibles, shorter survival periods)

• Using representation and warranty insurance to sweeten bids
Considerations

• Diligence – balancing early-stage diligence to signal interest with time/cost associated with full diligence

• Reverse break-up fees:
  – Concepts from public company deals are moving into private company deals, including reverse break fees
  – Reverse break fee would be payable by buyer if deal does not close for certain reasons, including failure to obtain financing, even if no financing condition
  – Because private equity funds use “newcos” as buyers and often seek outside financing, reverse break fees are much more prevalent in private equity deals
Key issues for private equity/venture capital/controlling stockholders
Key Concerns In Change of Control Transactions Involving Controlling Stockholders and Private Equity and Venture Capital Funds:

- Business Judgment Rule Standard of Review (burden of proof on plaintiff)
- Entire Fairness Standard of Review (burden of proof on defendants); Concerns are:
  - Fair Process
  - Fair Price
- Strict Scrutiny Standard of Review (somewhere in between)
- See Prior Trends and Developments in M&A (Part I): Public Company Targets for further discussion on these standards of review
Change of control transaction in which common stockholders received no consideration

Preferred stockholders received almost all the consideration ($52.8 million of their $57.9 million liquidation preference)

Management received $7.8 million of bonuses through a management incentive plan adopted to promote a sale
In re Trados Holdings and Other Findings

• Board owes fiduciary duties to all stockholders; Board members do not owe different, or conflicting, fiduciary duties to different classes of company stock

• Board failed to give any consideration as to what was in the best interest of the common stockholders

• 7 of 8 directors had conflicts of interest arising out of affiliations with venture capital funds that invested in preferred stock:
  – 3 employees of the venture capital funds
  – 2 appointed by venture capital funds
  – 2 management directors who participated in management incentive plan
  – only 1 independent director

• Court found conflict of interest in the record relating to venture capital funds’ desire to exit the investment and move on to other investments

• Court determined that more rigorous entire fairness standard of review applied based on conflicts of interest at the Board level

• Under the entire fairness standard, a deal is entirely fair even if it would provide no consideration to the common due to liquidation preference rights of the preferred where the common stock had no economic value
Other Recent Cases re Controlling Stockholder Buyouts

- Recent Cases Where Controlling Stockholder Buyout Held to Business Judgment Rule Standard:
  - In re MFW Stockholders Litigation (Del. Ch. 2013), affirmed Kahn v. M&F Worldwide Corp. (Del. 2014)
    - At the outset, controlling stockholder (43%) conditioned consummating any going-private transaction upon the transaction being approved by (i) an independent special committee and (ii) a vote of a majority of the disinterested stockholders

- Recent Cases Where Controlling Stockholder Buyout Subject to Entire Fairness Review:
    - Controlling stockholder (53%) did not agree up front that the deal would be conditioned upon either approval by a special committee or a majority vote of the minority stockholders
    - Other bad facts include: (i) controlling stockholder offered $2.10 per share without a majority-of-the-minority approval condition, and finally agreed on a price of $2.05 per share with a go-shop and a majority-of-the-minority condition and (ii) lead special committee director was not independent or disinterested due to long-standing relationships with family members of controlling stockholder and the director’s solicitation of a post-closing consulting agreement with controlling stockholder

- See prior Trends and Developments in M&A (Part I): Public Company Targets for further discussion of these cases
Practice Tips in Light of *Trados*

- From the outset, private equity funds/venture capital funds/controlling stockholders should have contractual exit rights that place sale decision in the hands of the investors (e.g., drag along rights) and avoid board fiduciary duties (although some practical limitations).
- From the outset, consider choice of business entity (e.g., Delaware LLC law permits modification and elimination of most fiduciary duties).
- Disclosure of conflict of interest (to the Board and to the stockholders voting on the transaction).
- Conflicts of interest will most certainly exist with employees of private equity/venture capital funds that serve on the board.
- Realization that “outsiders” who have other relationships with the private equity/venture capital fund (e.g., nominated by private equity/venture capital fund to serve on other boards or other overlapping relationships) will likely not be found to be independent.
- Conflicts of interest may exist at a very low threshold (e.g., one of the “outside” directors in the *Trados* case only received a few hundred thousand dollars of benefit from the transaction).
- Actively consider the interests of common stockholders and the ways in which the process might mitigate the conflict.
Practice Tips in Light of *Trados* (cont’d)

• Actively consider the manner in which management bonuses impact the decision to sell and the process (e.g., courts generally look unfavorably on incentive plans that reward management when the common stock is “out of the money”)

• Even if all investors hold the same class of stock (and receive the same per share price), consider whether any interests driving the sale process may create a conflict of interest (e.g., private equity/venture capital fund’s near-term desire for liquidity)

• Board process is important, including executive session without private equity/venture capital fund director (if available)

• Board documentation of the reasons for decision to sell, including rationale for the sale timing, and deliberations memorialized in the minutes

• Financial advisor presentations on merits of liquidity event at such time

• Fairness opinions (if possible, from a bank engaged by an independent/special committee)

• An unconflicted controlling stockholder may participate but, to avoid the appearance of adversely influencing the sale process, such person should not lead the sale process (if possible and practical)
Strategic Decisions in Light of *Trados*

- Pro rata consideration to stockholders?
- Independent Committee (if available and practical), with own advisors?
- Majority of the minority vote?
Questions?

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Thank You