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NEGOTIATED ACQUISITIONS OF COMPANY SHARES AND ASSETS IN THE UNITED STATES—PITFALLS AND HOW TO AVOID THEM

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This article discusses how acquisition agreements are negotiated in the United States based on a study that my co-author Larry Glasgow and I have been doing for the past four years.[1] I call it "traps for the unwary, foreign acquirer of a United States business." In this article I will discuss considerations for the foreign acquirer, pre-transaction regulatory compliance issues, the Mergers and Acquisitions Deal Points Study, representations and warranties, and closing conditions.

CONSIDERATIONS FOR THE FOREIGN ACQUIRER

A foreign acquirer or seller must have the proper deal structure and understand how United States-Mexico tax treaties work, as illustrated by a hypothetical deal. Suppose a foreign company that owned a U.S. subsidiary was attempting to sell the subsidiary. The foreign company's in-house legal counsel believed the sale would be a simple sale of assets. However, under U.S. law, if you are a foreign shareholder, not a United States citizen, there are no capital gains if you sell shares of a U.S. company. If the deal were restructured into a share deal instead of an asset deal, the corporate-level tax would be eliminated, producing millions of dollars in savings from a real simple fix. If you are the Chief Financial Officer, that savings is your bonus. The structure of the sale and the tax plan are very important.

PRE-TRANSACTION REGULATORY COMPLIANCE ISSUES

The first pre-transaction regulatory compliance issue is the United States antitrust, pre-merger notification rules called the Hart-Scott-Rodino Act (HSR).[2] Depending on the size of the transaction, you may have to register with the proper agency. Generally, if you acquire shares or assets of a company within a certain range, usually over U.S. $50 million, you will have to file and get clearance from the Federal Trade Commission (FTC) and the Department of Justice. This allows them time to make sure there are no undue anti-competitive effects. There is one exception to the HSR filings that has been a high-profile problem. An HSR filing does not have to be made if the company shares are acquired for investment purposes, even over the U.S. $50 million range. Earlier this year Bill Gates went over the threshold and was fined several million dollars by the FTC. Bill Gates can afford

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1. Wilson Chu and Larry Glasgow, Truth or Dare: The Realities of Negotiated M&A Deal Points in the U.S. (This is an ongoing annual study that analyzes acquisition of private companies by the public acquirers.)

2. Hart-Scott-Rodino Act, Pub. L. No. 94-435, Sept. 30, 1976, 90 Stat 1383 (2005).

high-powered advice and was tripped up by this HSR filing. Even if foreign acquirers of U.S. companies are not familiar with these laws, they are still subject to them just as Bill Gates is.

The second compliance issue is Schedule 13-D filings. Under the United States Securities and Exchange Commission (SEC) rules, filing a Schedule 13-D with the SEC is required if acquiring 5% or more of a company's shares. A Schedule 13-D is a publicly available filing that contains various types of information, including who you are, where your money is coming from, and what you intend to do with this investment. Foreign investors need to be aware of this information-disclosure requirement and be very careful about going above 4.99%.

A third compliance issue concerns foreign ownership restrictions. Even though the U.S. economy is very open, there are restrictions on what foreign investors can buy. For example, broadcasting businesses, banking businesses, air carriers, even some coastal properties are subject to foreign ownership restrictions. There are complicated ways to structure around the foreign ownership restriction depending on the type of asset.

The Exxon-Florio filing is a fourth regulatory compliance issue.[3] Any foreign acquirer of a U.S. business is required to file the terms of the intended transaction with a multilateral agency to determine if the acquisition has national security implications.[4] There are two big problems with the Exxon-Florio filing. One, there is no definition of "national security." This creates uncertainty about what can be acquired. For example, a company may attempt to acquire some software that has encryption capabilities. That software may be deemed to have national security dimensions in one circumstance, and not in another. Two, if you do not complete the Exxon-Florio filing, the U.S. government can come in after the acquisition is done and void the deal. That may not be a bad thing for us lawyers—we get you coming and going—but a buyer does not want that.

A fifth type of regulatory compliance issue in acquisitions is the exchange of confidential information during the preliminary agreement stage. Typically an acquiring company will receive confidential information from the acquisition target to determine whether they want to buy it, and how much they want to pay. As part of due diligence in an acquisition deal, a U.S. acquisition target might give some information to the foreign acquirer, and it could be considered a "deemed export" in violation of U.S. export control rules. An exchange of information is called a "deemed export," which is treated like an "actual export." An actual export refers to exports of material goods, which are heavily regulated under U.S. export control rules.

The last regulatory compliance issue arises when stock is used as consideration. A foreign acquirer wanting to use stock as consideration has to register their shares with the Securities and Exchange Commission (SEC). In the United States, every offer or sale of a security must be registered with the SEC unless there is an exemption. The United States does have some private-offering exemptions, but they are very limited. That has an impact on the kind of stock that can be used for

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3. Omnibus Trade and Competitiveness Act, Pub. L. No. 100-418, 102 Stat. 1107 (1988) (amending Title VII of the Defense Production Act, 50 U.S.C. app. 2158 (1950)).

4. *See id.* § 5021 (requiring a non-U.S. corporation to file its intended merger, acquisition, or takeover with the Committee on Foreign Investment in the United States).

consideration because of the time and expense required to issue stock pursuant to a registration statement filed with the SEC.

M&A DEAL POINTS STUDY

This is the fourth year of the M&A Deal Points Study, and it has received much national and international acceptance. Larry Glasgow and I have been invited to present this study to the M&A group of Credit Suisse First Bank in New York. Because of this study, the American Bar Association's (ABA) Negotiated Acquisitions Committee asked us to head a new M&A market-trend subcommittee that will expand on what we have been doing in this area.

Most of the time when people define the acquisition agreement "market," it is an abstract idea based on personal or second-hand knowledge. No one had studied all the acquisition agreements to determine what the market is. Larry Glasgow and I did a study of acquisition agreements found in the SEC database. The SEC database contains acquisition agreements filed by public companies acquiring private targets in the middle market. The acquisition agreements ranged from U.S. $25 to $150 million.

Statistics can be interpreted in many ways. What we try to give is a bell curve average, which provides an objective standard to compare acquisition-negotiating points. Knowing the bell curve average does not prevent a particular negotiation from falling somewhere else on the curve. Rather, the average provides a starting point for negotiations.

REPRESENTATIONS AND WARRANTIES

Most U.S. acquisition agreements take one of three basic forms: stock deals, asset deals, and merger agreements. The components of an acquisition agreement include a section called "deal mechanics." That component determines who gets what, for what price. There are also closing provisions, representations and warranties, covenants, conditions, indemnification, and termination fees.

In a "U.S.-style" acquisition agreement, there are thirty pages of representations and warranties. Representations and warranties confirm certain facts and assumptions about the acquisition target so the buyer will know what it is buying. The first representation and warranty we looked at for our study was the very common "Seller's No Undisclosed Liability." It says that except as otherwise disclosed to the buyer, there are no other liabilities. A buyer wants to know that there are no other liabilities out there. A buyer's proposed form of representation and warranty is very broad because it addresses "Liabilities" defined with a capital L. It covers all liabilities: contingent, non-contingent, known or unknown, liquidated or un-liquidated, secured, unsecured, etc. On the other hand, a seller would prefer GAAP liability.[5] GAAP liability has its own assumptions of what a liability is, so warranty and representation provisions are limited to GAAP liability.

According to our study, 95% of the time the acquisition agreements had a "Seller's No Undisclosed Liability" representation and warranty. Out of this subset,

5. GAAP: Generally Accepted Accounting Principals

we studied how an agreement was divided between all liabilities and GAAP liabilities. Almost 80% of agreements had "All-Liabilities" representations and warranties, so they were more buyer-favorable. Many of our colleagues on the ABA Negotiated Acquisitions Committee were surprised that 20% of the time there were GAAP liability limitations. What can you do with this information as a seller? In negotiations, a seller can ask for GAAP liability limitations. If the buyer claims they have never seen such a limitation before and no one does that, the seller can use the study to prove that GAAP liability limitations are used 20% of the time. This creates a stronger negotiating position.

Another representation and warranty we studied was the "Seller's Full Disclosure Representation." It states that if the seller has failed to disclose anything, it would make all other representations misleading. The buyer wants the seller to guarantee that everything has been disclosed. Some sellers think that after thirty pages of representations and warranties, a guarantee that nothing is left out is overreaching. Before we did this study the conventional wisdom was that this provision was in all U.S. acquisition agreements. However, only two thirds of the deals we examined had this type of full disclosure representation. A seller now has grounds to argue it is not always standard operating procedure to have this representation.

Within the subset of agreements that had a full disclosure representation, we also studied how many times the representations were qualified by knowledge. A knowledge qualifier is when the seller represents that to their knowledge they have not forgotten to tell the buyer anything. The buyer wants the seller to say flatly that they have not forgotten to disclose anything. Around 80% of the time there was no knowledge qualifier in the full disclosure representations, so they are very buyer-friendly. Again, a seller now has grounds to argue it is not always standard operating procedure to have this qualifier.

CLOSING CONDITIONS

There are two types of closing provisions. Most agreements are delayed closings, where an agreement is signed one day and is closed another day. Between the signing and the closing, the parties get third-party consents, finish due diligence, or get merger clearance. Under the other type of closing provision, both signing and closing occur on the same day.

Closing conditions are requirements that have to be met before a buyer is required to close a deal. We call closing conditions "Buyer's Walk Rights." A very important walk right concerns the accuracy of a seller's representations. This condition provides that each of the representations and warranties made by the seller in an agreement shall be accurate in all respects as of the date of the agreement, and the date of closing. The accuracy condition is what I call the "Mother of All Walk Rights." It requires that all representations and warranties be true and correct. It takes those thirty pages of representations and warranties and turns each of them into an individual walk right for the buyer. A seller must pay attention to this powerful closing condition.

The accuracy of the representations is tested when the agreement is signed, and again on the closing day. For the seller, it is too demanding to represent that everything is accurate when they are an ongoing business subject to normal operational risks. They may have some problems between signing and closing and cannot bear the risk that absolutely nothing bad will happen. The seller wants the representations and warranties to be true and correct in all *material* respects. If the seller wants to take it one more step they will represent that an inaccuracy will not give rise to something that will have a materially adverse effect. This is a three-step representation. The representation has to be true and correct in all material respects. The material respects are then defined. Finally, the inaccuracy has to have a material and adverse effect on the buyer.