Baker & McKenzie

Structuring an M&A transaction: from the inside

M&A Masterclass - ACLA National Conference

Thursday 8 November 2012
Sunshine Coast, Queensland

James Halliday, Partner

Outline

1

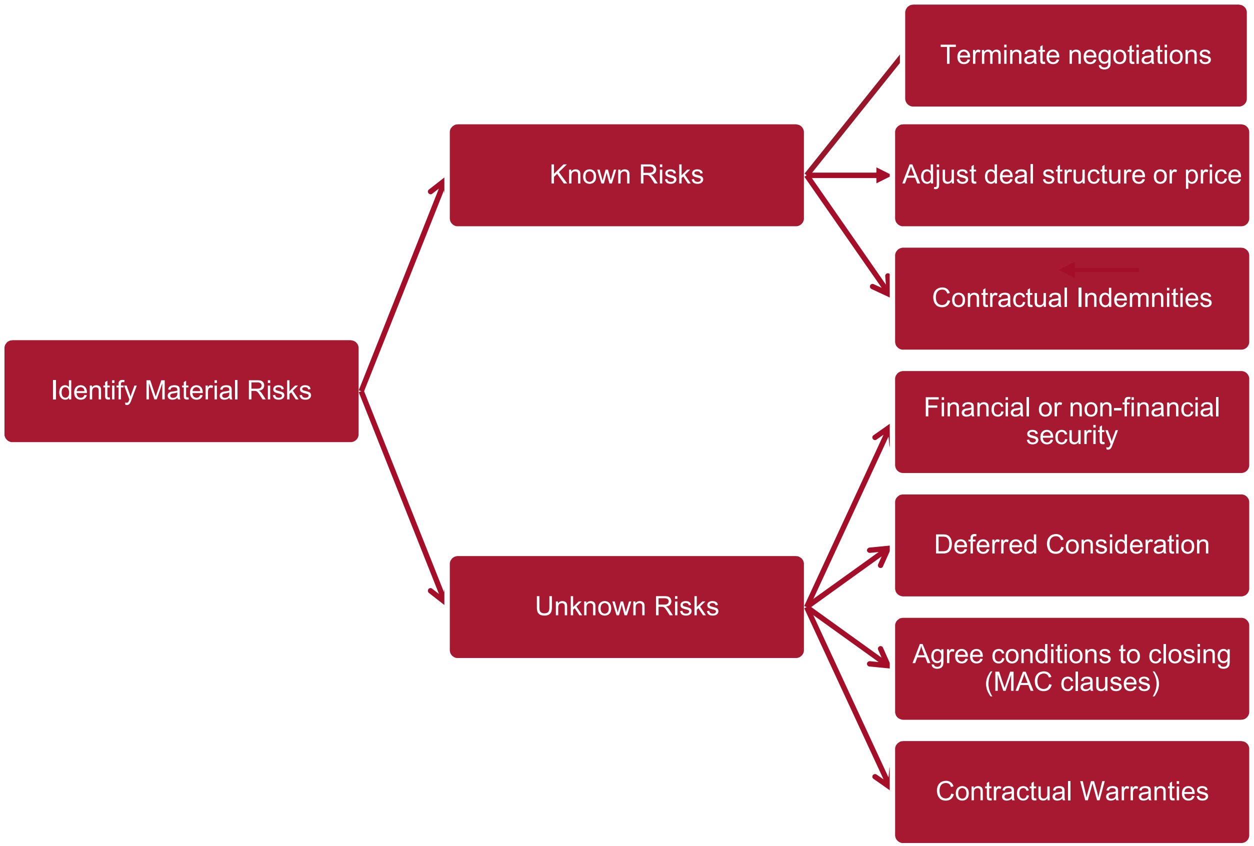
Why does deal structuring matter

2

Getting to the right transaction structure

3

Issues with common transaction structures.


Identify Material Risks
Known Risks
Unknown Risks
Terminate negotiations
Adjust deal structure or price
Contractual Indemnities
Financial or non-financial security
Deferred Consideration
Agree conditions to closing (MAC clauses)
Contractual Warranties

Case study

1

Facts

- Introuble Ltd is a mining company listed on the ASX
- Introuble's main business is the sale of iron ore to China
- Introuble's share price is under pressure. It decides to sell one of its better performing businesses to each cashflow pressures
- The relevant subsidiary is Courtingdisaster Pty Ltd. It owns an iron ore mine in the Pilbara and has valuable contracts with Chinese steel mills
- Introuble has recently announced to the ASX that Courtingdisaster has signed a long term contract with a major steel mill in China
- Introuble starts negotiations with a buyer, Overaeager Limited
- Because it is a distressed sale, there is only limited due diligence and Overeager relies upon the ASX announcement
- The sale contract contains the following condition precedent:

  "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 Courtingdisaster".

Case study

2	**Facts**	- After signing the agreement Introuble announces the deal to the market and its share price climbs 40% - The release does not mention any conditions to the sale agreement such as the MAC clause - Before completion: • The iron ore price drops 70% • It turns out the Chinese contract is non-binding and the counterparty does not want to proceed - Overeager gives a notice to Introuble, terminating the sale agreement
3	**Issues with contract**	- Can Overeager terminate the contract? - What other protections should a properly advised purchaser have included in the contract?
4	**Other considerations**	- What is the position of the directors of: • Overeager Limited • Introuble Limited

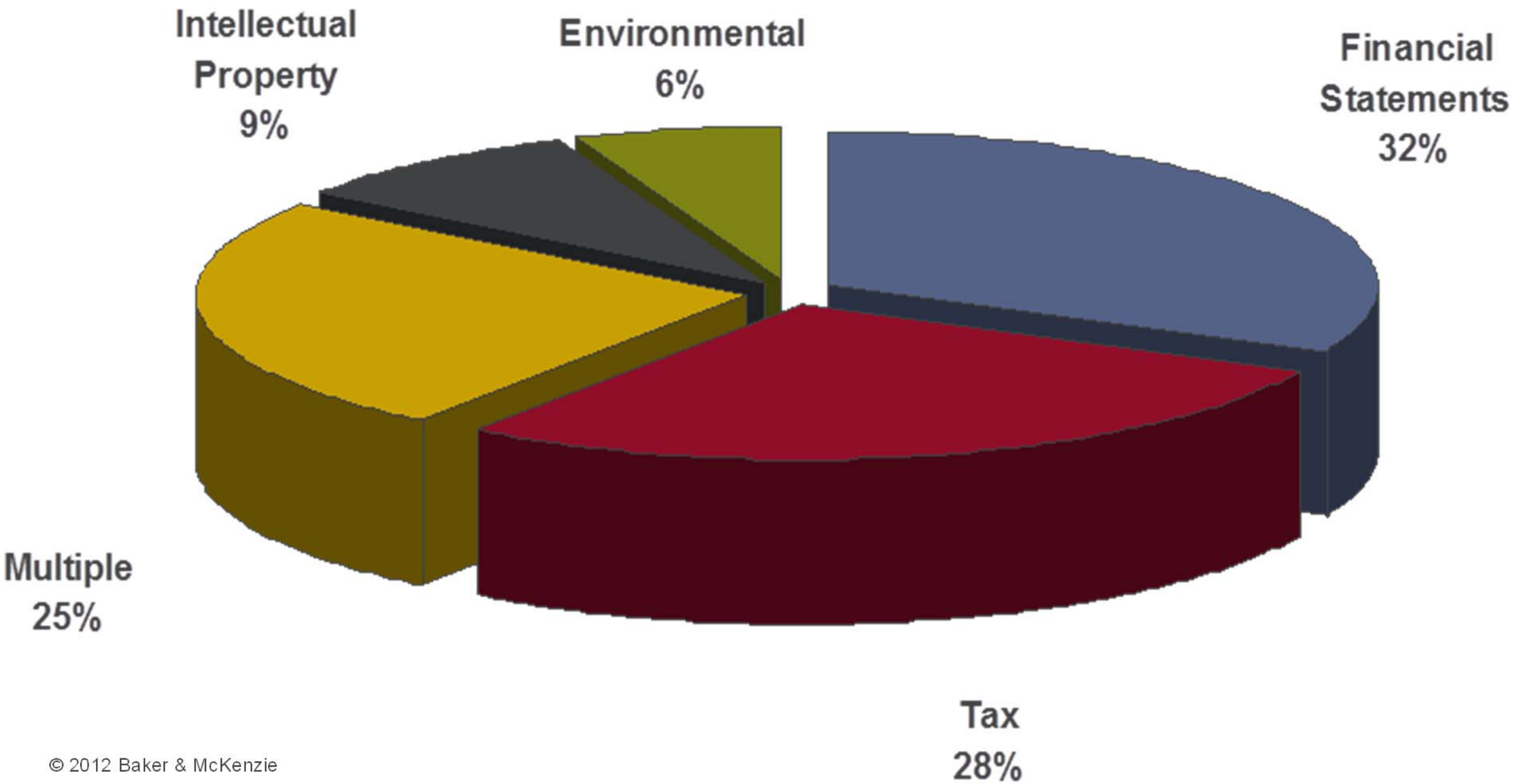
Why does deal structuring matter

Risks in M&A

(E&Y 11th Global Fraud Survey)

Types of Warranty Breaches (Insurance claims)

W&I claims experience



Claims history

1	**Claims notices**	- 16% of the policies issued in Australia are claimed upon (contrast 22% in North America) - Twice as many buy side policies are issued when compared to sell side polices - However, claims by buyers and sellers are roughly equal
2	**Claims timing**	- 66% of claims are notified within the first 12 months after inception - 85% are notified within 24 months after inception
3	**Claims paid**	- The number of claims paid is significantly lower than the number of claims notices received

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

Due diligence

Due diligence

1 **Why do it**

- DD is not a substitute for warranties and indemnities
- DD identifies go/no go decision points and price
- DD informs additional warranties and indemnities that are required
- It may lead to a different choice of transaction structure

2 **Issues in due diligence (non-tax)**

- Share Purchase:
  - must identify all liabilities, including tax and litigation
  - must identify whether the target company owns all the assets that are necessary to carry on the business after completion
  - must review change control clauses
  - must consider stamp duty issues
- Asset Purchase:
  - must identify whether the vendor is selling all assets that are necessary to carry on the business
  - need to review restrictions on assignment of assets
  - consider GST and stamp duty issues

Why do we do due diligence?

1	**Statutory duties**	- "Directors" and "officers" of the company must exercise the degree of care and diligence that a reasonable person would exercise in that position - bribery and corruption laws - continuous disclosure rules
2	**Who is a director**	- A person who is appointed as a director - a person who acts as a director - a person in accordance with whose instructions and wishes the directors or the company are accustomed to act
3	**Who is an officer**	- A director or secretary, or a person in accordance with whose obligations the directors are accustomed to act - a person who makes decisions affecting the whole or a substantial part of the business, or who can affect significantly the corporation's financial standing (e.g. general counsel, CEO, CFO)

Reliance on information

1	**When is reliance permitted?**	**A director may rely upon information or advice, provided it is prepared by:** ▪ **another officer or committee within authority** ▪ **an employee whom the director reasonably believes is reliable and competent** ▪ **a professional adviser within expertise**
2	**When is reliance reasonable?**	▪ **Reliance is reasonable if the director does so in good faith and following an independent assessment** ▪ **Reliance is taken to be reasonable unless the contrary is proved**

Vines v ASIC (2007 NSWCA)

Facts	Held
▪ AMP announced a bid for GIO ▪ GIO released a profit forecast which was allegedly overstated ▪ The profit forecast included information signed off by the CFO (Vines) in the due diligence committee ▪ Vines had taken advice from another executive without further inquiry, even though warning signs existed	▪ Held: ➢ Vines and others had contravened the duty of care and diligence ➢ The contraventions occurred because Vines: - failed to advise the DDC of the assumptions underlying the forecast; and - supported the integrity of the GIO profit forecast

Deal structuring to minimise risk

1	**Types of security**	- Bank guarantee or letter of credit - Parent guarantee - Charge over vendor’s assets
2	**Deferred consideration**	- Retentions - Earn Out*
3	**Conditions to closing**	- Obtain key consents from landlords, government agencies or counterparties - Establish a Newco and migrate assets of problematic entities - Material Adverse Change (MAC) clauses*
4	**Warranties and Indemnities**	- Cut through the boilerplate to identify key warranties* - Consider Warranty and Indemnity Insurance

Issues with earn outs

1	**General**	- Prevents a clean break - the buyer loses the opportunity to realise synergies during the earn out period - the target's management may become focussed on the earn out rather than the long term
2	**Risks for seller**	- Needs to ensure the target entity is isolated from the purchaser group - may encourage creative accounting by the buyer - there needs to be transparency and reporting obligations on the buyer - disputes are fairly common - seller should consider asking for security and interest on late payment - overlap with warranty claims (double recovery issues)
3	**How to manage the risks in the contract**	The contract should provide that, after Completion: - all transactions must be on arms' length and in the ordinary course - there should be reporting provisions on the buyer - the buyer should promise not to make any changes to the business strategy, or make acquisitions or disposals - the buyer must not divert business opportunities to the buyer group - the buyer must not make changes to accounting policies

Material Adverse Change clauses

1	**Frequency of MAC clauses**	- The great majority of public M&A transactions announced in 2012 included a MAC clause
2	**How are MAC clauses interpreted?**	- 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." (Tempus Group, 2001 UK) - Projected financial results cannot be a benchmark for MAC determination where the Sale Agreement expressly states no warranties are given regarding projections

Material Adverse Change clauses

3

Drafting considerations

1. The contract should include:
    a. explicit MAC events (particular occurrences that are important to the Buyer should be listed as MAC events)
    b. specific quantifiable materiality thresholds (e.g. fixed percentage or dollar reduction in net asset position or annual EBITDA) that are objectively clear
    c. (for buyer) Explicit MAC exclusions
2. The seller should focus on defining MAC events that are specifically related to the target's business
3. If the defined event is a generic one, it should have a disproportionate effect on the target
4. The timeframe for the MAC standard should be defined, and (if buyer) include events that are reasonably likely to lead to a MAC.
5. The contract should allocate the burden of proof (who determines whether a MAC event has occurred). The Buyer may want to shift burden of proof that no MAC has occurred to Seller (or request a certificate on closing).

Key warranties

1	**Core warranties**	These should confirm that: - the sale assets are unencumbered, and are owned by the target/sale company; - the accounting (and tax) position has been fully disclosed; - the assets are in good condition (change of control/assignment); - all liabilities have been disclosed.
2	**Due diligence**	The Purchaser should ask the Seller to : - confirm all materials provided in the DD are accurate and complete - confirm these materials are not misleading or deceptive; - clarify the status of forward looking representations; - confirm there are no material omissions in the DD.
3	**Reverse warranties**	- The Seller should ask the Purchaser to confirm it has carried out due diligence and is not aware of any breach of warranty.

Contact

James Halliday
Partner
+61 2 8922 5187
james.halliday@bakermckenzie.com