Doing Deals 2017:
The Art of M&A
Transactional Practice

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The Art of Cross-Border Deal Structuring: Debunking Myths for Foreign Acquirors of U.S. Targets

Wilson Chu
Soren Lindstrom
McDermott Will & Emery LLP

Wilson Chu is an M&A and corporate partner in the Dallas office of McDermott Will & Emery LLP and the creator of the American Bar Association’s M&A Deal Points Studies. Soren Lindstrom is an M&A and corporate partner in the Dallas office of McDermott Will & Emery LLP. The authors gratefully acknowledge the assistance of our colleagues, Diego Gomez-Cornejo and Thaddeus Chase.

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There has been a significant uptick in U.S.-targeted acquisitions in recent years as foreign buyers set their sights on the United States for growth and diversification. Foreign investors continue to perceive the U.S. economy as strong and stable and U.S. targets are benefitting from the bullish global M&A climate. In spite of the increase of deal flow stateside, there are still many myths about inbound M&A that are believed by even the most experienced foreign buyers around the world. Understanding the intricacies of the U.S. legal landscape, cultural nuances and trends in market practices will help you make your next inbound transaction a successful one. Below we debunk our top ten favorite myths about acquiring a U.S. company.

1. **THE U.S. TARGET HAS A STATUTORY DUTY TO DISCLOSE ALL MATERIAL FACTS TO THE BUYER**

Generally, there is no statutory duty of the seller to disclose all material facts to the buyer in an acquisition of a private U.S. company for cash. Except for a few limited exceptions, a private U.S. company does not have any statutory duty to disclose material facts to a prospective buyer nor can the buyer rely on statutory implied warranties. For example, there are no implied statutory warranties with respect to any aspect of the business or financial statements of the U.S. target. Since the general U.S. law of contract provides the parties with very generous flexibility to negotiate the terms of the transaction, the buyer, consequently, must seek to cover all material risks by negotiating robust representations and warranties about the target’s business, financial statements, legal status, etc. as well as related provisions providing for indemnification by the U.S. target to the extent such representations and warranties turn out to be inaccurate. The buyer could also try to negotiate a “catch-all” representation and warranty by the target providing that neither the representations and warranties nor the related disclosure schedules of the target contain any misstatement of a material fact or omit to state a material fact necessary to make the statements made thereon from being misleading. For obvious reasons, the target will often object to such type of broad “disclosure representation.”
2. AS LONG AS WE SECURE A “MATERIAL ADVERSE CHANGE” (MAC) CLOSING CONDITION, WE CAN ALWAYS WALK AWAY IF THINGS GO WRONG

Don’t count on it! The U.S. courts have yet to let a buyer in an M&A transaction walk away solely by finding that a “material adverse change” (MAC) to the target and its business had occurred. Accordingly, a typical MAC condition provides little protection for the buyer. Instead, the buyer should seek to negotiate specific thresholds for when a MAC has occurred or, even better, separate closing conditions in addition to the traditional MAC clause. Such specific MAC thresholds or closing conditions could, for example, be a diminution of target’s revenue or earnings of more than a certain dollar amount or the loss of three of the target’s ten largest customers. The MAC thresholds or closing conditions should be tailored to the deal and to any specific concerns the buyer may have about the target.

3. OF COURSE IT’S CUSTOMARY TO QUALIFY SELLER’S reps BY EVERYTHING IN THE DATA ROOM

Under more English and continental Europe M&A practice, it is increasingly common for seller to sweepingly qualify its representations and warranties by any information fairly disclosed to buyer in its due diligence and in the due diligence materials in the data room. When counsel for a U.S. target vigorously asserts that such global qualification is also common U.S. practice, you should simply reply: *Au contraire, mon cheri*. Instead, the prevailing U.S. practice formulation is: “Except as set forth in the correspondingly numbered Section of the Disclosure Schedules, seller represents and warrants to buyer that…” Under this framework of specific qualifications, it is common for a U.S. target to attempt “blanket cross-referencing” to expand the scope of a particular disclosure to cover other representations to which its application is, for example, “reasonably apparent.” Cross-referencing (deemed or specific) as well as other issues such as disclaimers, materiality and knowledge qualifiers are commonly negotiated. “Whatever’s in the data room” notions, however, are not.

4. DON’T WORRY ABOUT WHAT THE AGREEMENT SAYS, YOU CAN ALWAYS SUE FOR FRAUD

Not true, especially if the definitive acquisition agreement contains a non-reliance provision along the lines of: “Buyer has not relied on seller with respect to any matter in connection with buyer’s evaluation of the Company other than the representations and warranties of seller specifically
set forth in Article [ ] of this agreement.” With this type of clause, buyer would be prevented from winning a fraud claim based on statements made by seller that are not contained inside of the four-corners of the written agreement (i.e., no fraud liability for extra-contractual statements). This works because reliance under U.S. law is an essential element of a fraud claim. So when buyer disclaims reliance on extra-contractual statements, then it cannot hold seller liable for them, and buyer would be limited to proving fraud arising from the statements contained within the “four corners” of the agreement. Non-reliance clauses are often the subject of spirited negotiations. Buyers will typically resist giving a non-reliance clause on the grounds that it effectively gives the seller a “license to lie.” On the other hand, seller will typically insist on such a clause so it knows for certain that it will be liable only for the representations and warranties within the four-corners of the agreement. Thus, the battle lines are drawn, with buyer forewarned that not all fraud is treated equally.

5. WE CAN’T USE MY COMPANY’S STOCK AS CONSIDERATION TO ACQUIRE A U.S. COMPANY

Not true if the target company is privately held (i.e. its stock is not publicly traded), but the use of buyer’s stock as consideration in the acquisition will implicate the U.S. federal securities laws (if only cash is used, the U.S. securities laws would not be implicated). To avoid triggering a time consuming and costly registration process with the U.S. Securities and Exchange Commission (SEC) and subsequent SEC reporting obligations, the buyer must issue its stock to the target’s stockholders in a “private placement” to “accredited investors” (basically, high net worth and sophisticated investors). If the buyer’s stock is issued in a private placement, no SEC filings would be required (other than possibly a post-closing formality notice under Regulation D). However, a private placement will require the buyer to take steps to limit resale in the United States of its stock used in the acquisition and will cause the target’s stockholders to be concerned about their ability to sell the stock.

6. YOU DON’T NEED NO STINKIN’ PRO-SANDBAGGING PROVISION

Buyer’s first draft would typically include a clause providing that buyer’s right to seek indemnification for misrepresentations by the U.S. target is not limited by any knowledge of buyer. This clause is commonly referred
to as a “pro-sandbagging” clause. The battle lines are drawn when seller insists on an “anti-sandbagging” clause that prevents buyer from seeking indemnification when it closed the deal over a representation that buyer knew was inaccurate. After typically protracted negotiations, the parties sometimes settle by “going silent” and not contractually agreeing one way or another. The question then becomes whether “going silent” is a win for buyer or seller. The answer depends on applicable U.S. state law and, in particular, whether buyer is required to prove reliance. For example, in Delaware (by far the most pervasive state corporate law), silence is generally considered a “buyer win” because buyer is not required to prove reliance on the representation. On the other hand, being silent under California law generally is considered a “seller win” because buyer must prove reliance. Combined with the uncertainty of litigation, buyer is better off insisting on an express pro-sandbagging clause on the basis that buyer is simply seeking to preserve the benefit of the bargain contained in seller’s representations and warranties for which buyer paid a king’s ransom in purchase price.

7. BEING A FOREIGN COMPANY, WE DON’T NEED TO WORRY ABOUT THE U.S. FOREIGN CORRUPT PRACTICES ACT (FCPA) WHEN BUYING A U.S. COMPANY

Wrong. The overarching purpose of the FCPA is to prohibit bribery of foreign officials. The life of the FCPA has over the last decade been marked by a dramatic increase in enforcement actions by the U.S. Department of Justice and the SEC. Violations of the FCPA are punishable by steep civil and/or criminal penalties and can result in severe harm to the reputation of a business. (In 2008, Siemens AG paid a $450 million criminal fine for violating the FCPA and $350 million in disgorgement of profits.) FCPA problems come in many shapes and sizes, but there are common warning signs that should alert a buyer, for example: the U.S. target company (a) conducts business in foreign jurisdictions where corruption is prevalent, (b) operates within an industry that historically is susceptible to corruption or (c) derives a substantial amount of business from government contracting. If a foreign buyer encounters warning signs in connection with a contemplated acquisition of a U.S. target, it should conduct a thorough FCPA due diligence investigation and seek to negotiate adequate protections in the definitive acquisition agreement.
8. IF WE ACQUIRE A U.S. COMPANY, WE WILL BE SUED LIKE THERE’S NO TOMORROW

Not necessarily. In fact, recent studies seem to suggest that is not the case. According to a 2015 study by SRS|Acquiom of 720 M&A transactions, only 9% resulted in arbitrated or court litigated indemnification claims. Proper counseling is key, and it is therefore critical to engage U.S. counsel who understands the custom and practice of U.S. M&A transactions so that the buyer will be afforded proper protections in the definitive acquisition agreement and any related escrow arrangement.

9. YOU MUST DO AN ASSET DEAL IF YOU WANT STEPPED-UP BASIS FOR U.S. INCOME TAX PURPOSES

A basic tenet in U.S. acquisition structuring is “BASS”: Buy Assets, Sell Stock. Buyers typically want the step-up in tax basis (for depreciation and other tax deduction expenses) to reflect the purchase price in an asset deal (i.e. purchase of substantially all of target’s assets). Selling stockholders in an asset deal, however, would be subject to double-taxation (target pays tax on the sale of the assets and its stockholders pay tax on sales proceeds received). One effective method to bridge this buy-asset v. sell-stock gap is through the use of an election under U.S. Internal Revenue Code Section 338(h)(10) in connection with a taxable stock sale. Under a 338 election, the stock transaction is treated as an asset deal for tax purposes, and the buyer’s basis is accordingly revalued (i.e. stepped-up) to reflect the purchase price. The disadvantage of a 338 election is that it triggers a taxable gain on the deemed asset sale for which target and buyer typically agree to share. Once this sharing is negotiated, the road is paved to with an easier-to-execute stock deal that makes both sides happy.

10. THE ABA’S M&A DEAL POINTS STUDY IS MARKET

Close, but not always. While one of the authors has a proud parent’s love for the ABA’s M&A Deal Points Studies that benchmark commonly negotiated issues in M&A deals, experienced deal lawyers know that these studies are not all-things-to-all-deals. The studies, which over the years have consistently earned their gold-standard status as the most reliable M&A market-checks, yield varying findings that depend on a variety of factors, including (a) the source of the deals it analyzes (the agreements are publicly available, which means they were filed with the SEC
because they meet applicable materiality hurdles for the public buyer), (b) purchase price amount (caps and baskets as percentages of deal size do not necessarily stay the same for every purchase price), and (c) nature of the deal (e.g., leveraged buyout or growth equity). The studies look at each data point but cannot cross-correlate every data point to each other, so they do not depict the inevitable horse-trading that occurs in every deal. The better view of the Deal Points Studies is that they provide a robust and authoritative framework of market practices so a foreign buyer can gain an informed view when tailoring its negotiations to the specifics of the U.S. deal.