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A GUIDE FOR NON-U.S. FINANCIAL INVESTORS EYEING PRIVATE M&A IN THE U.S. MARKET

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Non-U.S. financial investors looking to the U.S. market to deploy dry powder need to prepare for two critical matters: transaction terms that are unique to the U.S. market, and the heightened regulatory hurdles in the current legal U.S. M&A landscape. Although the M&A market faced stiff headwinds during Q1 through Q3 of 2022 and may continue to do so in the coming quarters, the U.S. financial market remains the premiere destination for non-U.S. financial investors to deploy their capital and seek alpha. To achieve their investment objectives, non-U.S. financial investors should engage their external legal advisors to ensure they can fully take advantage of the unique conditions and address the particular challenges in the current M&A legal market in the United States.

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Acquisition Structures

Transaction Structures

Non-U.S. investors should consider several factors when selecting their choice of acquisition structure. These are typically the characteristics of target entities, including their respective entity type – under local law, entity classification – for U.S. tax purposes, jurisdictions of organization and the nature of their capital structures.

For example, an acquiror of assets in a pure asset sale generally does not inherit the U.S. tax basis of the seller in the assets being acquired. This means that the acquiror generally is able to obtain a "step-up" in the tax basis of the acquired assets to equal their fair market value. This increase in tax basis can be a valuable tax asset to an acquiror because the incremental tax basis (i) may generally be depreciated or amortized over time – generating valuable tax deductions, and/or (ii) may reduce an acquiror's tax liability related to a future sale of such assets. In contrast, stock sales or mergers generally do not allow for tax basis step-ups in depreciable assets because the target in those cases continues to own the same assets following closing.

Under U.S. tax law, if a non-U.S. investor holds a direct interest in a U.S. business entity that is treated as a partnership for U.S. tax purposes, which includes many LLCs, the non-U.S. investor will generally be required to file a U.S. federal income tax return, and, if applicable, state income tax returns, and pay U.S. income tax at the ordinary income tax rate on its allocable share of the partnership's income. To avoid these unattractive results, it is common for non-U.S. financial investors to acquire their interests in a target indirectly through an entity known as a "blocker" which is taxable as a U.S. corporation. This protects the non-U.S. financial investor from having to file U.S. tax returns themselves, when they would otherwise be required to because of the underlying target structure. The use of a blocker also ensures that the blocker itself, rather than the non-U.S. financial investor, pays the U.S. generated tax on operating income of the target. However, the use of a blocker can lead to potential U.S. tax friction on exit structuring. In particular, a prospective acquiror will often wish to acquire partnership interests directly – as opposed to shares of the blocker – in order to access a basis step-up in the partnership's assets. By contrast, the seller will frequently wish to sell blocker shares in an attempt to avoid double taxation – U.S. corporate level taxes that would arise in the event the blocker were to sell its partnership interests. If the embedded tax liabilities are material, exit structuring tension will frequently affect the economic terms of the transaction as a whole. Early engagement with tax and legal advisors is crucial to navigate these complexities.

Merger Structures

While stock or asset sales are common structures globally, in the U.S. a statutory merger regime also exists whereby entities can be merged with the acquiring entity, leaving one surviving entity on closing. This has several benefits, including that it generally requires only the approval by a majority of shareholders to close the sale without needing unanimous consent of all shareholders, provided the requisite number of shareholders approve the sale – as determined by the target's bylaws and applicable law. Mergers afford the seller a "clean break" because sellers are not party to the merger agreement, and thus sellers can avoid being directly liable for losses arising from breaches of representations and warranties and covenants, and for purchase price swings. Notably, the most common private merger structure is a reverse triangular merger whereby a parent entity, the indirect acquiror, forms a merger subsidiary, the direct acquiror, which is then merged with and into the target with the target surviving the merger. Such a structure enables the indirect acquiror to acquire

certain assets of the target – which under different acquisition structures – would trigger third party consent rights that if not obtained, for example, can lead to the termination of material contracts of the target.

A non-U.S. financial investor transacting as the acquiror under a merger structure will need to get comfortable that the sellers have followed the appropriate requirements – under the applicable state's merger statute and the target's governing documents – to pursue a sale by way of merger, particularly in a complex shareholding structure where there could be the possibility of challenge from dissenting shareholders. Moreover, a non-U.S. financial investor will need to diligently consider potential avenues of recourse for sell-side liabilities, such as a downwards purchase price determination post-closing and if there have been breaches of covenants or representations and warranties – for example the use of escrows, deferred consideration mechanics and representation and warranties insurance come into focus.

Consideration Structures

Deferred Consideration

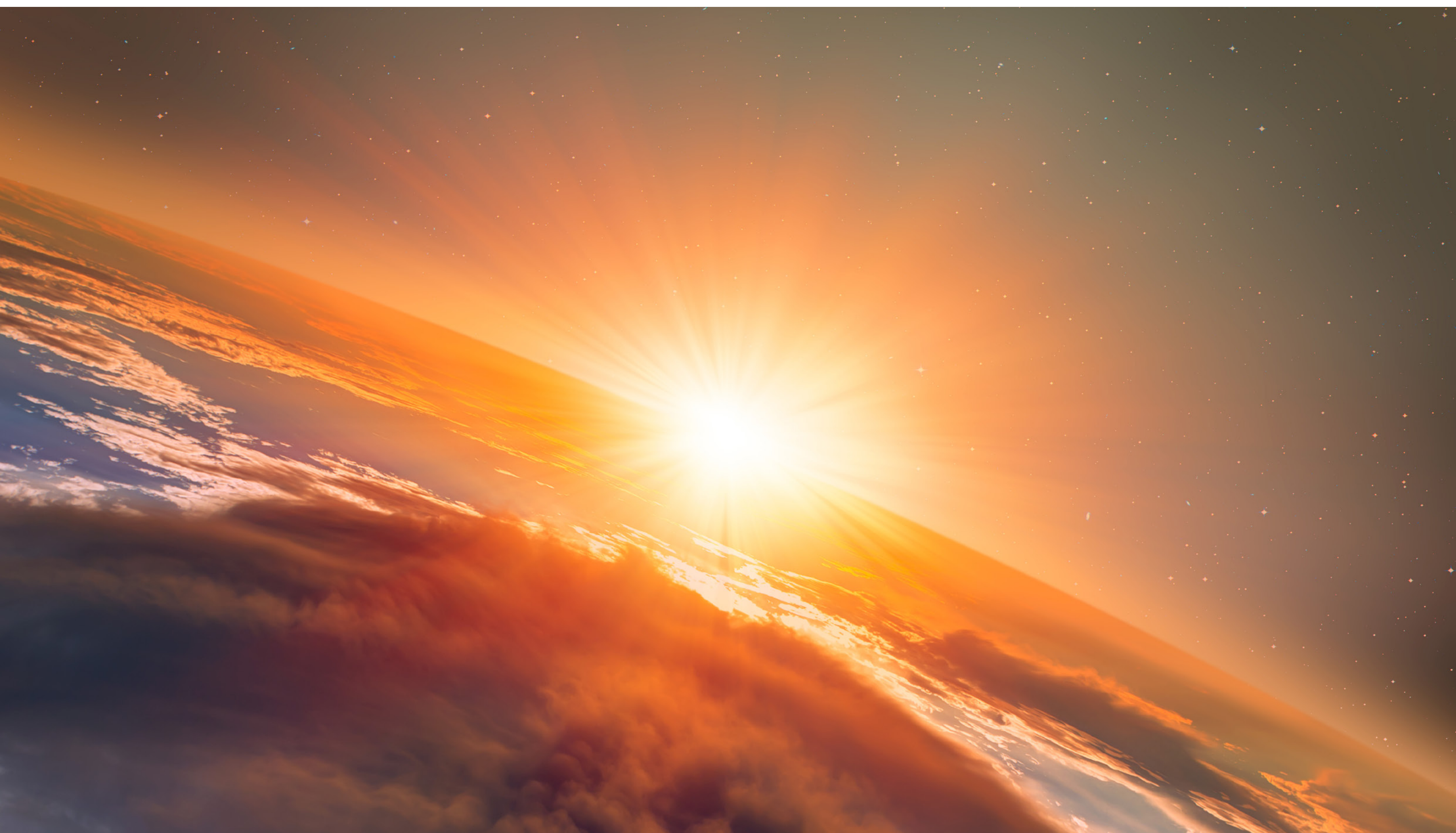
Given the prevailing economic uncertainties, acquirors operating in the U.S. market are increasingly looking to defer the payment of deal consideration over time so that the target's business case presented by the sellers can be adequately tested in the years immediately following closing. Deferred payments typically are structured as earn-outs which are tied to an agreed upon financial metric of the target business – e.g., EBITDA, revenue, etc. – and have successive earn-out periods, routinely spanning a one-year period, ranging between two through five years post-closing of the transaction. Sellers will typically negotiate for earn-out amounts to be paid on a sliding scale in lieu of a payment of the full earn-out amount if a target is met or exceeded. In such a case, the parties agree threshold and target figures, and if the yearly result falls between the two figures, a corresponding percentage of the earn-out amount is payable to the seller, although, some sellers will also seek a catch-up payment to the extent targets in prior years are not met but are then exceeded in later earn-out periods. Non-U.S. financial investors can utilize this deal consideration structure to limit the amount of committed capital needed to fund the closing payment, avoid or diminish the amount of debt financing needed to fund the acquisition – which in the current environment is increasingly expensive, keep existing management engaged on growing the business, and, due to the contingent nature of an earn-out mechanic, reduce the risk of overpaying for a business.

Rollovers

Non-U.S. financial investors should be aware that in the United States, founders and management who already sit in the equity structure of the target pre-closing are typically expected to roll a portion of their equity interests into the post-closing capital table. Not only does this reduce the amount of upfront cash consideration required to be funded by the financial investor, it also entwines the founder/manager into the future success of the target's business. Founders, and those members of the management participating in the equity structure, find rollover equity attractive because (a) they not only receive partial liquidity at closing but they are also able to participate in the growth of the target's business post-closing, and (b) they are able to defer taxes on the portion of their equity stakes rolled into the post-closing equity structure. Similar to a non-U.S. financial investor's benefits for deferred consideration, rollovers limit the amount of committed capital needed to fund the closing payment, avoid or diminish the amount of debt financing needed to fund the acquisition, and, most importantly, keep the founders and those members of management who participate in the equity structure of the target fully invested in the future growth and success of the target's business post-closing. Note, achieving a tax neutral rollover for U.S. resident equity holders, when rolling into a non-U.S. equity structure can be difficult and so this consideration structure needs to be carefully examined at the early stages of a transaction to ensure that there are no misconceptions between the parties as to what can be achieved; for example, when rolling a U.S. based management team's equity into a European portfolio company's existing equity structure.

Management Incentive Plans

In instances where a limited number of a target's management participate in the equity structure of the target, such as only the executive team, the creation of a broader management incentive program (MIP) post-acquisition may be important. Similar to rollovers, a MIP scheme provides a target's management an equity stake in the future of the target's business. Notably, MIP schemes are highly customizable programs that can include a requirement for certain contingent items to be met – such as a certain number of years of employment or achievement of financial performance metrics – prior to equity being vested. MIP schemes also contemplate a manager forfeiting equity previously issued based on certain behavioral triggers, such as a termination for cause or a breach of restrictive covenants. MIP schemes are routinely funded by financial investors, but over the past few years founder-led businesses have had an appetite to roll a portion of the deal consideration into funding MIP schemes – often with the financial investor agreeing to fund a corresponding amount of capital. MIP schemes are implemented to incentivize a target's workforce post-closing. Establishing MIP schemes on a tax-efficient basis is critical. U.S. target businesses may also have existing arrangements for management that will need to be terminated or assumed by the financial investor upon closing. Costs associated with the termination, cash settlement or other treatment of a target's equity or other incentive awards should be considered when a non-U.S. financial investor is negotiating MIP schemes for retained members of management and the economics should be considered when determining the purchase price for the target. Note, contrary to the approach outside of the U.S., here management does not typically invest their own money in exchange for the issuance of incentive equity, instead profits interests or option schemes, which do not require pre-funding, are more commonplace and are viewed as both more tax efficient and more aligned to the philosophy that management in the U.S. aren't typically asked to dip into their own pockets in order to participate in the scheme.



Regulatory Considerations

Antitrust

The years of lenient antitrust policy in respect of financial investors' acquisitions in the U.S. market are coming to an end. In particular, the Biden Administration through appointments of certain key personnel to the Antitrust Division at the U.S. Department of Justice and the U.S. Federal Trade Commission is increasing the focus on private equity to prevent it from "rolling up" – i.e., consolidating – large portions of American businesses. The stance taken by the Biden Administration is a result of financial investors having taken ownership of portions of the U.S. economy by deploying trillions of dollars of capital across a plethora of sectors. In light of the current antitrust headwinds, non-U.S. financial investors, as part of the investment thesis, should strategically address potential antitrust issues not only for the buyout stage, but also in future business plans for the target and when putting together exit strategies.

There are a number of ways that non-U.S. financial investors can mitigate antitrust risks when investing in a U.S. business. Non-U.S. financial investors should more heavily scrutinize the inclusion of a hell or high water provision in the acquisition agreement to protect its affiliates and other investments. For example, limiting a hell or high water to the target's overlapping assets may traditionally have been seen as a tolerable risk profile to accept with a slim chance of such divestiture materializing; however, this may now be problematic if the transaction is a bolt-on to an existing portfolio company operating in the same sector. On this basis, non-U.S. financial investors should proactively look at potential overlaps of the target business and its other investments and put together a plan for carving out of the transaction perimeter, or divesting immediately after closing, those assets/business units of the target that could heighten antitrust concerns, or at least value those overlapping assets and decide whether the transaction is still attractive in the event the acquiror is forced to leave those assets behind. Most importantly, non-U.S. financial investors should be sensitive about the information contained in press releases regarding an investment and the future business plans of a target; such press releases should be reviewed by external antitrust counsel.

There are also certain ways non-U.S. financial investors can mitigate antitrust risk simply through internal communications among deal team members and investment committees. At the very least, deal teams should treat each and every transaction – regardless of deal value – as if the transaction will trigger an antitrust filing. Acknowledgements can be made to investment committees in respect of potential future bolt-on M&A opportunities for a particular investment, but a defined list of an M&A pipeline and highlighting material growth through acquisitions should not be amplified in internal communications and materials, including by referencing the plan to undertake numerous bolt-ons for values that would not trigger U.S. antitrust filings or that would otherwise lead to material market consolidation. In contrast to the position in many non-U.S. jurisdictions, when filing for HSR clearance with the DOJ/FTC, generally speaking, they require submission of board/investment committee and other internal investment-related materials such as market reviews commissioned by the financial investor and as such the authorities are able to more heavily scrutinize the underlying investment thesis. This can lead to second requests and difficult assessments for the non-U.S. financial investor where the underlying materials appear anti-competitive in sentiment or fact.

CFIUS

The Committee on Foreign Investment (CFIUS) is an interagency committee authorized to review transactions involving the acquisition of control of, and certain non-controlling investments in, a U.S. business by a non-U.S. person to determine the effect of a transaction on the national security interests of the U.S. Industries that have historically drawn the greatest scrutiny from CFIUS include defense, aerospace, computers and electronics, heavy machinery, software publishing, utilities and mining. More recently, however, transactions involving critical technology, critical infrastructure and the personal data of U.S. nationals (referred to as "TID U.S. businesses") are of heightened interest to CFIUS, with semiconductors and 5G technology being examples.

The CFIUS landscape has changed rapidly in recent years, including with respect to new regulations implementing the U.S. Foreign Investment Risk Review Modernization Act of 2018 (FIRRMA) that took effect on February 13, 2022. Non-U.S. financial investors should note that under the new regulations, non-controlling investments – in addition to controlling investments – by non-U.S. investors are subject to CFIUS review if certain criteria are met, such as an investment in a TID U.S. business. However, such non-controlling investments may qualify for an exemption if they involve an "exempted foreign state" or an "exempted foreign investor". In addition, the CFIUS regime now includes mandatory filing requirements for certain transactions, namely those involving a substantial non-U.S. investment in a TID U.S. business and those involving a U.S. business that touches on critical technologies for which a U.S. regulatory authorization would be required for the export, re-export, transfer or retransfer of such critical technologies to certain non-U.S. entities involved in the transaction or in the non-U.S. financial investor's ownership chain.

It would be prudent for non-U.S. financial investors – as early as possible in the transaction timeline – to conduct an in-depth risk analysis on its potential acquisition of a U.S. business with a view to determine whether a mandatory filing is required and to understand the likelihood of CFIUS scrutiny. Further, if as part of its business plan a non-U.S. financial investor is targeting a series of investments in the U.S., then it should work with its external counsel to put together internal policies and other knowledge materials to educate its deal team members and investment committees.

Representation & Warranty Insurance

Current Market

Representations and warranties insurance (RWI) shifts the risk of loss from a seller to the RWI insurer for a premium – often a cost borne by the acquiror or split between the parties. Routinely, in transactions where the seller is a financial investor or in auction processes more generally, bidders will need to accept a non-survival deal – where none of the representations and warranties of the target or covenants survive closing and no corresponding indemnities are provided to the acquiror – if they want to make an attractive bid for the target. For transactions where the seller is accepting a survival and indemnity mechanic, RWI is also still attractive as it could serve as an extension of the survival period of the commercial representations and warranties of the target since the RWI policy may offer longer survival periods than what is contained in the acquisition agreement. On the heels of a record number of transactions in 2021, and a record number of claims being brought and paid out on under existing policies, there has been a hardening in the RWI market, which has resulted in increased pricing, more detailed diligence by insurers and their advisors and more deal specific policy exclusions. In some cases, particularly in the payment processing sector or where an audit of the target business is unavailable, underwriters are refusing to provide coverage. Non-U.S. financial investors should pay close attention to those specific exclusions and the sectors in which finding coverage is difficult. It is critical for non-U.S. financial investors to carefully manage the tension between being competitive vis-à-vis other bidders, while adequately safeguarding the risk profile, in an auction process where the seller is requiring RWI to be obtained.

Key Differences in U.S. and RoW Deal Terms

Purchase Price Adjustments

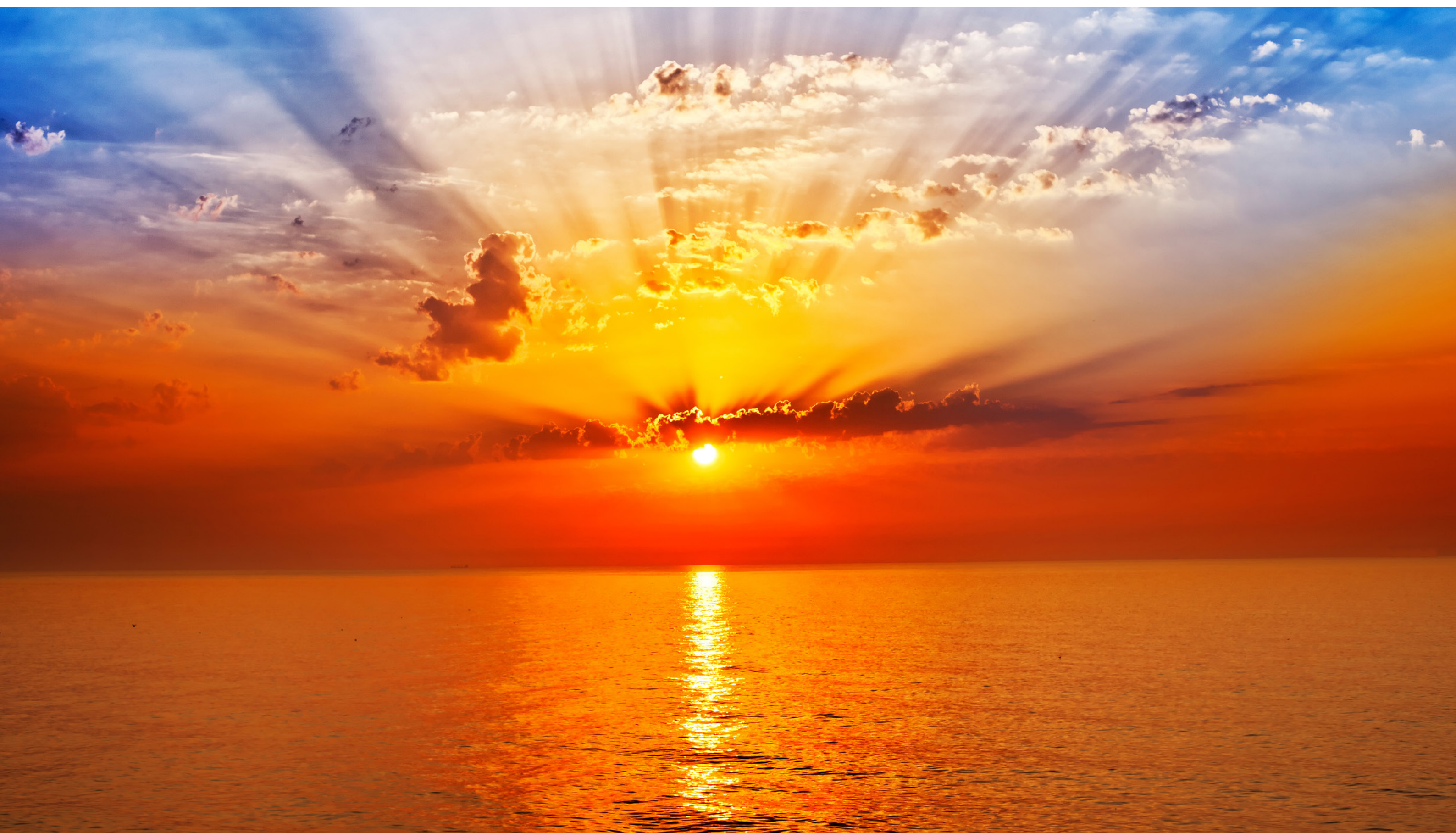
One of the key differences that non-U.S. financial investors should understand when investing in the U.S. market is how the market addresses valuation mechanics in private acquisition agreements. In Europe, for example, it is customary to have a locked box structure where the acquiror assumes the economic risk at signing. Under a locked box mechanic, the purchase price is based off of historic accounts and the purchase price is fixed at signing and is only adjusted for leakage – i.e., value extracted between the locked box date and closing for the benefit of the sellers; typically, there are no other post-completion adjustments made. In the U.S., however, a working capital adjustment is nearly always utilized and the acquiror assumes the economic risk from closing. A working capital mechanism works such that the acquiror purchases the target business valued at the base consideration – on a cash-free/debt-free basis – which is then adjusted for working capital normally off of a target net working capital peg, cash, indebtedness and other transaction specific items – e.g., including transaction expenses. Often caps and collars are applied in the aggregate to the purchase price adjustment or sometimes solely in respect of changes in working capital. In terms of process, sellers deliver an estimated closing statement in the days leading up to closing and acquirors deliver a closing statement post-closing – often between 90 – 120 days after closing. If there is a difference between the parties' valuations and there remains a dispute after a negotiation period, then the dispute is submitted to a neutral party for resolution, such as an international accounting firm. In a volatile market, non-U.S. financial investors can benefit from the U.S. model by ensuring their economic risk is assumed at closing and not at signing, which shifts some of the economic risk of the interim period to the seller – though it does not address the valuation multiple upon which the equity value was derived.

Conditionality

The U.S. model includes certain conditions/termination rights not commonly found in the rest of the world. For instance, U.S. acquisition agreements include a material adverse change/effect condition whereby an acquiror need not close an acquisition if there is a negative effect on the business that resulted in, or is reasonably likely to result in, a change in the operations of the business or its performance that is material and durationally significant; although the occurrence of a MAC is difficult to prove. Further, U.S. acquisition agreements include a bring down – i.e., reconfirmation – of the representations and warranties of the target at closing, both fundamental and commercial subject to different standards; whereas in other parts of the world there is no termination right for breach of a commercial warranty, although a failure of a fundamental warranty – which are typically brought down at closing – could frustrate closing. U.S. acquisition agreements also include a condition that the seller complied with its covenants in all material respects, but such a condition is not commonly found in other parts of the world. In times of heightened uncertainty, non-U.S. financial investors can benefit from the greater conditionality captured in the U.S. contractual model which provides an increased chance to terminate a transaction during the interim period where there are materially adverse changes to the target (*albeit* difficult to do so) than under other contractual models across the globe.

Debt Financing/Reverse Termination Fees

Financing conditions are rare in acquisition agreements, both in the U.S. and the rest of the world. However, U.S. style financings typically consist of debt commitment letters delivered at signing, with the full form documentation being agreed upon prior to completion. Contrast this with the rest of the world, which typically has a "certain funds" approach, which often sees full financing terms agreed at signing, leaving less room for debt financing for the transaction to fail. Thus, non-U.S. financial investors using U.S.-style debt financings should not be surprised to see a seller expect a reverse termination fee (RTF) be paid by the acquiror if the financing fails between signing and closing. Although RTFs provide a seller with greater certainty over the amount of damages it will recover should the debt financing become unavailable to the acquiror, it also serves as a limit on the acquiror's liability. Financial investors routinely push for the RTF to (a) act as the break fee payable where the acquiror fails to close the transaction when the closing conditions have otherwise been satisfied – i.e., because the debt financing is unavailable – and (b) cap all damages in all instances – including for willful breaches – where the acquiror's breach of the acquisition agreement causes a condition to fail which is unrelated to the debt financing failing. Sellers may instead negotiate hybrid approaches to the foregoing, such as seller (i) taking the RTF in the case of a financing failure or where certain actions taken by an acquiror frustrates the closing conditions and (ii) in addition to taking the RTF, having the ability to sue for damages above the RTF amount in an instance where the acquiror willfully breached the acquisition agreement to frustrate the closing conditions – all aimed at avoiding the acquiror treating the acquisition agreement as an "option". RTFs are a unique feature of the U.S. M&A market and one that is used by sophisticated parties to transfer closing risk. Given the current state of the debt financing markets, non-U.S. financial sponsors should expect tougher negotiations around debt financing representations and warranties, covenants and RTF constructs.



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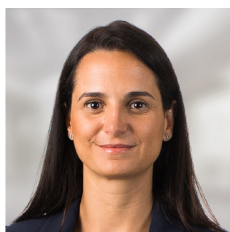

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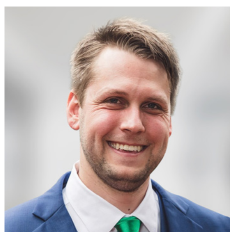

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