KIRKLAND & ELLIS

KIRKLANDPEN
Private Equity Newsletter

June 17, 2014

Taking Stock - Value Protection in Stock and Mixed Consideration Deals

PENpoints

Deals involving stock consideration raise additional issues regarding value protection for target shareholders (and sometimes the buyer) during the signing-to-closing period.

As private equity sponsors contemplate exiting investments and strategic buyers ramp up their M&A activity, the use of acquirer stock as acquisition currency has become more common, particularly in light of an increasingly bullish outlook in the C-level suite and higher and more stable stock market valuations.

One key issue faced by parties in deals involving stock consideration is value protection for target stockholders (and sometimes the buyer) during the period between announcing and closing a deal, as the buyer's stock will certainly fluctuate in value prior to closing a deal.[1]

Fixed Value Deals

One way to provide the target company stockholders with certainty of value in a stock deal is to structure the per target share price based on a fixed dollar value, with the number of acquirer shares to be issued in satisfaction of that dollar value to float between signing and closing. For example, if an acquirer agrees to pay $100 in acquirer stock per target share and such stock is valued at $50 per share at closing, then the acquirer will pay two shares of acquirer stock for every one share of target stock. If the acquirer's stock price drops to $25 per share, it will instead pay four shares of acquirer stock for every one share of target stock.

One potential pitfall inherent in a fixed value structure is that, absent additional protections, the acquirer is at risk of suffering the dilutive effects of issuing more stock than originally anticipated if its stock price drops between signing and closing. This dilutive effect cannot only make a deal less attractive to the buyer but also have other negative consequences (such as by resulting in enough shares being issued to require buyer stockholder approval under stock exchange voting requirements or by causing sufficient dilution to trigger change of control provisions in debt, incentive equity or other key agreements). On the flip side, an exchange ratio that varies based on value could also cause issues if an acquirer's stock price increases meaningfully, such as by causing the number of shares to be issued to fall below thresholds required to achieve a desired tax treatment.

In order to ensure that the number of shares to be issued by the buyer in a fixed value deal remains within a range acceptable to both parties, dealmakers can craft a combination of caps, floors and/or collars on the number of shares to be issued. The exact terms will depend on the value risk(s) being addressed. For example, in the case of a deal struck for $100 of consideration payable in buyer stock, the parties could agree to cap the number of buyer shares to be issued per target share at four (i.e., the maximum number of acquirer shares issuable regardless of how far the acquirer's stock price falls). If the buyer's stock price falls below $25 per share, the target's stockholders would absorb the corresponding loss of value. In this circumstance, the target may seek to negotiate a "walk-away" (termination) right if the buyer's price drops below the cap.

Fixed Exchange Ratio Deals

In a fixed exchange ratio deal, the parties agree upon a specific exchange ratio at which the target's stockholders exchange their shares for buyer stock at closing. This approach has dominated stock deals in recent years. Because the number of buyer shares issuable does not float, if the buyer's stock price moves up during the period between signing and closing, the buyer is effectively paying more in dollar value at closing. By contrast, if the buyer's stock price moves down during that period, the buyer is effectively paying less in dollar value. Under this construct, either party's stockholders could find themselves on the losing end of the value equation and, to the extent stock price shifts cause the resulting value to move meaningfully, it can have impli-

INSIDE KIRKLANDPEN

cations for either board's recommendation in favor of a deal from a fiduciary perspective and even the banker's fairness opinion.

To mitigate these risks, parties to a fixed exchange ratio deal can also employ a cap, floor and/or collar to prevent the buyer from overpaying if its stock price runs up, or to prevent target stockholders from being underpaid if the buyer's stock price goes down (noting that these protections appear less often than in fixed value deals). For example, in a stock deal with a fixed exchange ratio of two buyer shares for each target share, where the buyer's stock is trading at $100 per share at announcement, the implied purchase price at that time is $200 per target share. If the buyer wants to protect against overpaying, it can negotiate for a cap on the value of shares to be issued of 10% over the purchase price — to the extent the buyer's stock trades above $110 per share during a pre-closing reference valuation period, the exchange ratio would start adjusting down so the target's stockholders receive a maximum per share price of $220 (a corresponding provision could increase the exchange ratio if, for example, the price fell by more than 10%).

Additional Considerations

The formulation of consideration and associated value-protection has additional complexities if a deal involves a mix of cash and stock consideration with an election mechanism where the target stockholders can choose to receive more stock or more cash (usually subject to proration if too much of one or the other is chosen). If the stock portion of the consideration is based on a flat fixed exchange ratio, the election between stock and cash can become less about investor preference and tax issues than about market dynamics. If the market price for the buyer's stock moves, it will likely mean that the stock consideration will be worth more (or less) than the comparable fixed cash price on offer in the election. In such a case, the election could be rendered somewhat illusory as the overwhelming majority of target stockholders are simply going to choose the more valuable currency.

* * * * * * *

The simplified examples above illustrate the incremental deal complexities introduced when buyer stock is added as consideration. These discussions have become even more interesting with a noticeable trend (a departure from historical norms) of acquirers' share prices often rising after announcement of a strategic acquisition. Recognizing that a significant majority of stock deals continue to be done with a fixed exchange ratio, most often without collars or other protections, the initial choice between a fixed exchange ratio and a fixed value deal is one made within the framework of each deal's dynamics. For example, a fixed value formula would seem out of place in a "merger of equals" with its spirit of combination, while a fixed exchange ratio may be viewed as unacceptably risky in an industry with high market price volatility. However, this choice is not necessarily binary and value protection alternatives should be considered, where appropriate. Combinations of caps, floors, collars and/or walk-away rights can be used to introduce elements of one of the approaches into the other; value can be partially protected in a fixed exchange ratio deal and the variability of the exchange ratio can be partially limited in a fixed value offer.

1 Value protection can be an important consideration even in certain cash deals – for example where ticking fees may be useful to incentivize a quick closing or address opportunity cost concerns in a deal featuring a fixed cash price per share (see recent *M&A Update*).

If you have any questions about the matters addressed in this *KirklandPEN,* please contact the following Kirkland authors or your regular Kirkland contact.

Daniel E. Wolf
http://www.kirkland.com/dwolf
+1 212-446-4884

David B. Feirstein
http://www.kirkland.com/dfeirstein
+1 212-446-4861

Joshua M. Zachariah
http://www.kirkland.com/jzachariah
+1 212-446-6450

PENbriefs

Foreign Fund Investors in Defense and National Businesses Subject to New Regulations Imposing 30-Day Advance Review

The Defense Security Service ("DSS") imposes ownership and control restrictions on a U.S. business with access to classified information under national security clearances if its parent entity or investors pose concerns regarding Foreign Ownership, Control or Influence ("FOCI"). For a transaction involving a private fund buyer, DSS reviews the participation of "foreign interests" — e.g., foreign limited partners, non-U.S. fund entities or foreign lenders — when analyzing FOCI risks.

DSS recently published its first set of regulations regarding Facility Security Clearances ("FCLs") to provide that a U.S. company "determined to be under FOCI is ineligible for an FCL unless and until security measures have been put in place to mitigate FOCI." Thus, DSS "will invalidate any existing FCL" upon closing on a sale, merger or other transaction involving significant foreign participation unless (1) the buyer has submitted to DSS a proposed "FOCI Action Plan" and DSS has found the Action Plan acceptable and (2) the company agrees to adequate interim protections. Previously, DSS would allow a target company to keep its FCL after closing if its buyer submitted a "Commitment Letter" and was "negotiating" a FOCI Mitigation Plan "in a timely manner" after closing. DSS is now ending that practice.

Under the new rules, a proposed FOCI Action Plan must be submitted before closing. DSS commits to provide "feedback" within 30 days. When planning an acquisition, a buyer will need additional time to develop its Action Plan and to negotiate adjustments in response to DSS feedback. Without adequate time to resolve issues, a target could lose its FCL, preventing it from receiving classified information, working on classified matters, or obtaining new classified contracts after closing.

The new rules also formalize the relationship between DSS reviews and reviews by the Committee on Foreign Investment in the United States ("CFIUS"). The new DSS process now officially overlaps with the CFIUS process, which can take up to 90 days, and the 60-day period for Export Control notices that may be required by the Department of State under the International Traffic in Arms Regulations ("ITAR").

The table below summarizes the relevant national security reviews and time periods for the acquisition of a defense and national security business.

Requirement Pertaining to Foreign Investment	Pre-Closing Review Period
CFIUS Initial Review upon filing CFIUS may require additional period of investigation Possible review by President	 30 days 45 days 15 days
ITAR Notice of foreign ownership or control in advance of sale or transfer of company holding Export Control licenses or registrations	60 days
DSS - new FOCI Rules Submission and negotiation of "FOCI Action Plan" and proposed "FOCI Mitigation" instruments and formalities	At least 30 days to receive "feedback" from DSS after submission.

As a practical matter, the new 30-day DSS timeline should be considered the minimum for planning purposes. Additional time may be needed to prepare and make adjustments for the FOCI Action Plan and to confirm DSS approval before closing. To learn more, see our recent *Alert*.

If you have any questions about the matters addressed in this *KirklandPEN*, please contact the following Kirkland authors or your regular Kirkland contact.

Robert Ryland
http://www.kirkland.com/rryland
+1 202-879-5086

Boyd Greene
http://www.kirkland.com/bgreene
+1 202-879-5209

EPA's Continued Regulatory Barrage on Fossil Fuel-Fired Electric Generation

The U.S. Environmental Protection Agency recently unveiled proposed rules intended to reduce greenhouse gas emissions from existing fossil fuel-fired electric generating units, as well as performance standards for modified and reconstructed fossil fuel-fired electric generating units. To learn more, see our recent *Alert.*

DC District Court Upholds New HSR Rules Expanding Reporting Requirements for Pharmaceutical Patent Licenses

The federal district court for the District of Columbia recently upheld amendments to the Hart-Scott-Rodino Antitrust Improvements Act applying the Act's reporting and waiting period requirements to certain transfers of exclusive pharmaceutical patent rights, resolving a challenge to the new rules filed by a pharmaceutical trade association. To learn more, see our recent *Alert*

PENnotes

Private Equity Forum (Fifteenth Annual)
New York, New York
June 30 - July 1, 2014

The Practising Law Institute will host its "Private Equity Forum (Fifteenth Annual)" on June 30-July 1 in New York. A distinguished panel of experts will discuss recent regulatory developments affecting the marketing of private equity funds in the United States and Europe; negotiating with investors; current issues in private equity M&A; ethical issues; compliance programs for private equity firms that are registered investment advisers; and recent enforcement and other regulatory issues. Kirkland partner Mark Mifsud will lead a panel called "Recent Regulatory Developments Affecting the Marketing of Private Equity Funds" covering the recent Reg D developments and AIFMD. For more information, click here.

Private Equity Practice at Kirkland & Ellis

Beijing
Chicago
Hong Kong
Houston
London
Los Angeles
Munich
New York
Palo Alto
San Francisco
Shanghai
Washington, D.C.

Kirkland & Ellis' nearly 400 private equity attorneys have handled leveraged buyouts, growth equity transactions, recapitalizations, going-private transactions and the formation of private equity, venture capital and hedge funds on behalf of more than 400 private equity firms around the world.

Kirkland has been widely recognized for its preeminent private equity practice. The Firm was named "Private Equity Group of the Year" in 2012, 2013 and 2014 by *Law360* and was commended as being the most active private equity law firm of the last decade in *The PitchBook Decade Report*. In addition, Kirkland was awarded "Best M&A Firm" and "Best Private Equity Firm" in the United States at *World Finance*'s 2012 Legal Awards and was honored as the "Private Equity Team of the Year" at the 2011 *IFLR* Americas Awards.

In 2012, 2013 and 2014, Chambers and Partners ranked Kirkland as a Tier 1 law firm for Investment Funds in the United States, UK, Asia-Pacific and globally. The Firm was ranked as the #1 law firm for both Global and U.S. Buyouts by deal volume in Mergermarket's *League Tables of Legal Advisors to Global M&A for Full Year 2011, 2012 and 2013*, and has consistently received top rankings among law firms in Private Equity by The Legal 500, the Practical Law Company and IFLR, among others.

The Lawyer magazine has recognized Kirkland as one of its "Transatlantic Elite" every year since 2008, having noted that the firm is "leading the transatlantic market for the provision of top-end transactional services ... on the basis of a stellar client base, regular roles on top deals, market-leading finances and the cream of the legal market talent."

KIRKLANDPEN

KIRKLAND & ELLIS

EDITORS
Jack S. Levin, P.C.
Margaret A. Gibson, P.C.
Norbert B. Knapke II

SUBSCRIPTIONS
To subscribe to *KirklandPEN*, please email
kirklandpen@kirkland.com
+1 (312) 862-3356

www.kirkland.com