Bridging the Purchase Price Gap in Business Acquisitions

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Many transactional attorneys and other dealmakers have experienced the frustration of being part of a proposed acquisition in which the buyer and seller are close on price but cannot seem to come to a final agreement. In fact, in today's environment of tight credit, depressed valuations, and conservative decision-making, buyers and sellers in many would-be business acquisitions are frequently finding it even more difficult than usual to come to terms on a purchase price.

There are a variety of ways that the gap between what a buyer can pay (or is willing to pay), and what the seller is willing to accept, can be bridged without requiring the payment of more cash at closing. These "bridging provisions" could include an earnout provision in which the seller gets a certain part of the post-closing financial performance of the acquired business, letting the seller keep a piece of the equity of the company being acquired, granting the seller a piece of the equity of the acquiring company, or any combination of the foregoing. Other bridging provisions are also often available depending on the parties and circumstances of the transaction. Now more than ever, getting a deal done may very well depend on the parties' ability to creatively craft and implement such bridging provisions.

This article will identify and briefly discuss various types of bridging provisions that could make all the difference in reaching a deal. Although many of these bridging provisions can be used in acquisitions of either public or private companies, the practicalities of dealing with public companies may limit a dealmaker's ability to use or combine some of these provisions. Additionally, it is important to remember that accounting and tax considerations may also play a significant role in the ability to utilize and combine these bridging provisions. Therefore, it is always important to include tax and accounting professionals in the process as you develop your strategy for closing the purchase price gap.

Earnouts and Other Types of Contingent Consideration

The use of contingent consideration is a common way to bridge the gap between a seller's purchase price expectation and what a buyer is willing to pay for the seller's business. Generally speaking, "contingent consideration" is a seller's contractual right to receive additional consideration in the future based on the occurrence or non-occurrence of specified events or circumstances.

Earnouts are a common type of contingent consideration frequently utilized to bridge the purchase price gap. In an earnout, the sellers may be entitled to receive additional consideration depending on the post-closing financial performance of the acquired business. For example, an earnout might entitle the seller to receive 50

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percent of the net income of the acquired business during each of the two years following closing. Another earnout might entitle the seller to 10 percent of the acquired company's incremental sales over and above an agreed-upon baseline. Earnouts can be based on any number of financial measures, including revenue, net income, earnings before interest, taxes, depreciation and amortization (EBITDA), or some adjusted version of any of the foregoing. There is virtually no limit on the number and variety of formulas and measures that can be negotiated into an earnout.

Experienced dealmakers rightly approach earnout provisions with a high degree of trepidation, as the structuring, negotiation, and drafting of earnout provisions can involve a complicated web of practical and business considerations. A seller agreeing to an earnout should be concerned with how the buyer plans to operate the acquired business during the earnout period because the buyer's conduct during this period may materially decrease the seller's earnout payments below expectations. For example, in an EBITDA-based earnout, what will prevent an acquirer from doubling the advertising and marketing expenses of the acquired business in an earnout period when the fruits of the advertising campaign will not be realized until subsequent periods for which the seller is not entitled to an earnout payment? What will prevent a buyer from diverting customers from the acquired business to other business units owned by the buyer? How can the seller get comfortable that excessive intercompany management fees or overhead will not be charged to the acquired business? What other unforeseeable future events could decrease the amount of the earnout?

A seller who intends to utilize an earnout is well advised to contemplate the range of future possibilities that could jeopardize the amount of its earnout payment and to communicate such range of possibilities with counsel so that appropriate earnout protection provisions may be drafted. These protection provisions, designed to preserve the seller's ability to earn a maximum earnout payment, could include, at the most basic level, a requirement that the buyer preserve the current business of the target until the earnout period expires. More specifically, the seller might negotiate provisions that restrict, or at least normalize or exclude from the earnout calculation, excessive intercompany charges or intercompany management fees or other specified expense items. The seller may also negotiate restrictions on certain management changes or other material changes in the acquired business that could undermine the ability of the acquired business to meet earnout targets. Although an earnout will require a seller to have a high degree of trust in the buyer, it is also important that the seller be prepared to bargain for earnout protections to preserve the seller's expectations for the deal.

Although earnouts are one of the most popular forms of contingent consideration, they are by no means the only type of contingent consideration available to bridge the purchase price gap. The parties may provide that the occurrence of a particular event or circumstance triggers a payment of contingent consideration. For example, in the case of a target that has products under review by the Food and Drug Administration, the target's stockholders may get an additional one-time payment upon approval of the product.[1] In targets with contingent liability concerns, the parties may provide that a contingent payment is due upon the resolution of a

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contingent liability of the target. Alternatively, the parties could provide that a contingent payment is due upon the future sale of the acquired business by the buyer for a profit, the sale of certain assets by the buyer, or the occurrence of various other business or operational milestones that materially impact the value of the acquired business.

Equity Retention or Equity Rollover in Acquired Business

In some cases, the purchase price gap can be bridged through the buyer's purchase of less than all of the equity of the target, with the target's stockholders retaining the balance of the equity. This may be an attractive alternative if the buyer is unable to finance the purchase of all of the target's equity at a price agreeable to the sellers. Under this alternative, the equity purchased in the deal can either be acquired from all of the target's stockholders on a pro-rata basis or it could be acquired disproportionately in order to, for example, entirely cash out certain stockholders and leave principal stockholders with a continuing equity interest.

One of the frequent challenges in a retained-equity deal is getting the target's stockholders comfortable that their retained minority equity will continue to have value in the future. How will the target's stockholders get comfortable that the buyer will operate and grow the business in a way that will enable them to get value out of that interest? What if the target is merely one of many subsidiaries of a large publicly held buyer, in which case the target's stockholders will end up owning nothing more than a minority interest in an entity whose securities may never be liquid? What if the buyer can decrease the value of this interest through transfer pricing with its other subsidiaries? What if the target is used by the buyer to absorb the costs of its other business units or if the target's business is effectively diverted to other business units?

For these reasons, savvy sellers will negotiate covenants that protect them against such possibilities. They may also want to negotiate special rights, such as liquidation preferences, dividend preferences, or perhaps put rights that are triggered upon the occurrence of specified events or at a certain time after the closing. Sellers may also negotiate for certain consent rights that require minority stockholder consent before certain corporate actions or transactions can occur. In addition, sellers can negotiate for a non-compete from the post-closing parent company guaranteeing that the parent's other subsidiaries will not cannibalize the acquired business. These are only a few examples of possible protections that wise sellers can negotiate to support the value of their retained interest.

In private equity-led acquisitions, the sponsor will usually expect members of the target company's management to "roll over" some portion of their equity into the entity that will own the acquired business after the closing. The rollover of equity into the acquisition vehicle is favored by sponsors because it provides an incentive for management to make the acquired business profitable, thereby aligning management's interests with those of the sponsor. In these deals, the purchase price gap can sometimes be bridged by increasing the amount of equity that target management is "rolling over." However, due to a number of factors, management may not always be able to defer the taxes on the rollover equity that they receive

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because the structure of the transaction may not accommodate such deferral. Accordingly, it is very important to have competent tax counsel involved in these discussions.

Distribution of Equity in Buyer

One of the main disadvantages of retained equity is that the acquired company may be only one of multiple companies owned by the buyer and a retained minority position in a subsidiary will usually be less liquid than equity in the subsidiary's ultimate parent company because the parent company is typically the entity that is publicly traded or sold. Accordingly, stock in the buyer's ultimate parent entity, or stock in the buyer if it is the ultimate parent entity, may be more desirable than retaining equity in the target company, particularly if the parent company's stock is publicly traded. The parties can agree to bridge the purchase price gap either wholly or partially with shares of parent company stock. The target stockholders could even receive a preferred class of parent company stock that may give them certain preferences over the parent company's common stockholders.

The main risks for sellers in utilizing parent company equity to bridge the purchase price gap is the risk that the parent company equity cannot be quickly converted to cash and the general market risk associated with owning stock in the current economy. If the seller wants any protections against these risks, the protections would need to be specifically negotiated. For example, the target stockholders may negotiate for registration rights that would enable them to dispose of their shares at some point in the future if a public market for the parent company stock exists.

The main difficulty with utilizing stock consideration to bridge the purchase price gap is that, unless the transaction can be structured as a "tax-free reorganization" under the Internal Revenue Code of 1986, as amended, then the target stockholders will have taxable income in the year of acquisition based on the fair market value of their stock. To make matters worse, the stock received in the acquisition may not be liquid in the hands of the target stockholders because there may not be a public market for such stock, making it more difficult for the target stockholders to readily sell the stock to pay their taxes. Even if the parent company's stock is publicly traded, unless the shares are issued to the target stockholders in a transaction that is registered with the Securities and Exchange Commission, the stock will be "restricted stock" in the hands of the target's stockholders, meaning their ability to resell the stock will be limited. [2]

Seller Finances Portion of Purchase Price

In some cases, if the buyer cannot finance the entire purchase price, the seller may act as the buyer's lender in the transaction and finance a certain portion of the purchase price. In such a transaction, the buyer would deliver a note to the seller setting forth the repayment terms. The items to be negotiated in such a situation are the typical items in any debt transaction, including due date, payment schedule, interest rate, and security interest. If the seller is seeking some form of security interest from the buyer, the seller should determine if the buyer has existing lending relationships because the consent of the buyer's lenders may be required before the

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buyer can incur additional debt. In addition, the buyer's lenders may have a first priority security interest in the assets of the buyer, relegating the seller to a subordinate or unsecured position. In such cases, the buyer's lender will often require the seller to enter into a subordination agreement providing for the subordination of the seller's rights of payment to that of the lender. To mitigate these risks, a seller may want to negotiate certain rights, such as the ability to accelerate the obligations due under the note or to receive punitive interest upon the occurrence of an event of default, the ability to take over management upon non-payment of amounts due under the note, or the ability to convert the obligations due under the note into equity of the buyer.

Other Methods to Bridge the Purchase Price Gap

Depending on the companies involved and other deal-related circumstances, there are a variety of other possible methods to bridge the purchase price gap. For example, if the purchase price gap is partly a function of the buyer's inability to get comfortable with certain due diligence issues, contingent liabilities, or possible regulatory concerns, there are several insurance products available that could insure the buyer against such risks. For example, "representation and warranty" insurance can often be tailored to suit the circumstances of the transaction.[3] Even though the cost of these products can be considerable and the payment of the premium is often another point to be negotiated by the parties, under the right conditions, these policies can be critical to bridging the gap.

Sometimes a purchase price gap may be due to the existence of target businesses or assets that the buyer does not want to acquire or are perceived to be of nominal value by the buyer. Under these circumstances, the parties may consider a carefully crafted disposition of these assets or businesses prior to closing, whether by spin-off or some other transaction form. Although these dispositions sometimes involve complex tax issues and could preclude the ability to receive tax-free reorganization treatment on buyer stock received in the acquisition, they can be a great bridging tool under the right circumstances.

A buyer and a seller who are trying to get past a purchase price differential might also consider whether some additional business transaction or relationship between the parties might bolster the deal value sufficiently to bridge the gap. For example, if the buyer owns intellectual property that might be useful in the seller's other businesses, the buyer might offer the seller a license of such intellectual property for use in the seller's retained business. The parties might consider entering into co-marketing agreements where the parties market or distribute each other's products on a post-closing basis, or they might consider a supply relationship where one party supplies the other with a needed product.

Conclusion

There are virtually an unlimited number of ways that bridging provisions can be crafted and combined to close the purchase price gap between a buyer and seller. Some of these provisions can complement and be used in conjunction with each other. For example, the parties may agree to pay a certain portion of the purchase

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price in the form of an earnout paid in buyer stock and another portion in the form of a buyer note. In other cases, however, the use of one bridging provision may, as a practical matter, preclude the use of another. An example of this might be use of a cash earnout that precludes tax-free reorganization treatment in an otherwise stock-for-stock transaction.[4]

The ability to use certain types of bridging provisions may also be dependent on, or alternatively precluded or limited by, various company-specific or deal-specific factors, including the number of stockholders, whether the stock utilized as consideration in the deal is a publicly traded security, the target's debt structure, the relevant industries, and regulatory considerations. When coupled with tax and accounting issues, these issues and circumstances can present a formidable web of complexity. Thus, while negotiating and structuring a purchase price bridge will often involve a great deal of creativity, such creativity should always be tempered by a healthy dose of wariness.

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[1] For example, on June 2, 2009, a wholly owned subsidiary of ev3 Inc., a Delaware corporation, merged with and into Chestnut Medical Technologies, Inc., a California corporation. Pursuant to the terms of the merger agreement, ev3 made an initial closing payment of approximately $75 million to Chestnut and agreed to make an additional payment of up to $75 million in cash and ev3 common stock if, on or before December 31, 2012, the FDA issued a letter granting pre-market approval for the commercialization of Chestnut's Pipeline Embolization Device. See ev3 Inc., Current Report (Form 8-K), Item 1.01 (June 2, 2009).

[2] "Restricted" securities are securities that are acquired in a private sale that is not registered with the SEC. To sell such securities, a stockholder must usually comply with Rule 144 of the Securities Act of 1933, which allows public resale of restricted securities if certain conditions are met, including a condition that the stockholder hold the restricted securities for a certain period of time.

[3] Representation and warranty insurance, depending on the specifically negotiated policy terms, can cover losses arising from specified breaches of representations and warranties in the acquisition agreement, such as representations and warranties regarding environmental or regulatory risks.

[4] Tax-free reorganization treatment generally limits, among other things, the amount of non-stock consideration paid in a transaction. In some cases, a cash earnout could cause the cash portion of the consideration to exceed this limit.

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