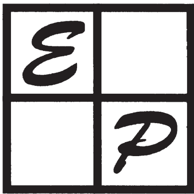

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Utilizing Social Media in Proxy Contests

By Steve Wolosky, Andrew Freedman and Ron Berenblat, Partners, and Kenneth Mantel, Counsel, of Olshan Frome Wolosky LLP

As shareholder activists fine-tune their communications strategies for the upcoming proxy season, we expect that many will view social media as an increasingly important means of getting their message out to shareholders.

Although a number of prominent investors have used certain forms of social media for years (*e.g.*, Carl Icahn's use of Twitter), we have only recently seen investors begin to engage with multiple social media platforms as part of a comprehensive digital and social media strategy for their campaigns. Noted examples include Elliott Management's successful campaign at Arconic and Pershing Square's recent election contest at Automatic Data Processing.

This article lays out the important legal issues and other information that investors should consider when evaluating whether and how to use social media in their upcoming campaigns.

Why Utilize Social Media?

Given social media's massive popularity as a news source,[1] the better question than "why utilize social media?" may well be "how can you not?" Still, a number of other developments have made social media platforms more appealing and important to shareholder activists.

First, with the help of advisors experienced with digital and social media communications, shareholder activists can use social media to target shareholders in an impactful, efficient and cost-effective manner. Potential advantages of utilizing social media in proxy campaigns include the following:

- Paid social media advertisements (often in conjunction with search engine marketing) can target an audience based on interest in the company, geography and other attributes, and ensure that messages will be prioritized and not immediately buried beneath other posts;
- Brief topical digital communications can quickly and directly address developments in the campaign and maintain contact with the target audience;

[1] See News Use Across Social Media Platforms 2017, Pew Research Center, September 7, 2017, http://www.journalism.org/2017/09/07/news-use-across-social-media-platforms-2017/

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- Links included in digital communications can drive traffic to campaign websites that provide dynamic and impactful content, including graphics and videos, helping to maximize engagement with the target audience and tell a more compelling story; and
- Data analytics can measure interest in particular content and help shareholder activists refine their communications to optimize results.

Second, companies increasingly are using social media platforms on a regular basis as part of integrated digital and social media marketing strategies and investor relations efforts. As a result, many companies are well-positioned to leverage an established digital and social media presence, as well as knowledge of their target audience, to help solicit votes in proxy campaigns. This requires shareholder activists to make up ground to build a social media presence and compete for the attention of a large audience of social media users.

Third, the publication of SEC guidance with respect to electronic communications and the SEC's track record of engaging with investors in a reasonable and constructive manner regarding applicable issues, based on our recent experiences, have given shareholder activists and their counsel comfort to move forward without fear of unexpected consequences from social media use in the heat of a proxy campaign. However, constant dialogue and coordination between shareholder activists and their legal counsel is necessary to ensure continuous compliance with SEC rules.

The SEC's Rules

The SEC has a number of rules governing communications that may constitute the solicitation of a proxy, which we refer to as soliciting materials. The SEC broadly defines "solicitation" to include the furnishing of any communication to shareholders under circumstances reasonably calculated to result in the procurement, withholding or revocation of a proxy, subject to certain exceptions.[2]

The term "communication" is interpreted broadly, and is considered to cover electronic communications made over social media platforms, so social media posts and advertisements generally are subject to the same rules as traditional written communications (*e.g.*, press releases, letters and newspaper advertisements).

The key solicitation rules applicable to shareholder activists utilizing social media include the following:

- Soliciting materials must be filed with the SEC on the date of first use;
- Soliciting materials disseminated before a definitive proxy statement is furnished to stockholders must include an appropriate legal legend; and
- Soliciting materials are subject to anti-fraud rules.

Same-Day Filing of Soliciting Materials

All soliciting materials must be filed with the SEC no later than the date they are first sent or given to shareholders.[3] This includes the text of any social media posts or advertisements, as well as transcripts of any audio or video content included in those communications.

The SEC's daily filing deadline is 5:30 pm Eastern. Due to the time involved in preparing and formatting an SEC filing once the soliciting material is finalized, which process often takes longer for graphic-intensive communications and audio or video content required to be transcribed, shareholder activists and their legal counsel must coordinate closely to ensure that soliciting materials are timely filed.

In our experience, shareholder activists can best avoid issues by creating, circulating and regularly updating a calendar of expected communications, and when attempting to respond to events in "real time", generally avoiding communications shortly before the deadline.

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[2] Exchange Act Rule 14a-1

[3] Exchange Act Rule 14a-6

Rule 14a-12 Legends

The general SEC rule is that no solicitation is permitted to be made unless the person solicited is or has been furnished with a proxy statement containing the information required under SEC rules.[4]

However, under Exchange Act Rule 14a-12(a), the SEC permits solicitations made before a proxy statement is furnished to stockholders if any such written communication includes the following information, which we refer to as the Rule 14a-12 legend: (i) certain information regarding the participants in the solicitation, or a prominent legend advising shareholders where they can obtain that information, and (ii) a prominent legend advising shareholders to read the proxy statement when it is available and that they can obtain the proxy statement, and any other relevant documents, for free at the SEC's website, and describing which documents are available for free from the participants.[5]

Depending on the shareholder activist's fund structure and the number of participants in the solicitation, the Rule 14a-12 legend can become lengthy. That tends not to be a problem for traditional written and digital communications, in which the Rule 14a-12 legend generally can be included at the end of the document in a manner that does not detract from its visual impact.

For social media communications, however, a social media platform's applicable space and character constraints (*e.g.*, Twitter's 140-character limitation) may make the legend obtrusive or impossible to include in full.

The SEC addressed this issue in a compliance and disclosure interpretation first published in 2014.[6] In that interpretation, the SEC acknowledged that limitations on the number of characters or amount of text that may be included in a communication on certain social media platforms make the inclusion of the Rule 14a-12 legend impossible.

In those instances, and those instances only, the SEC stated that the Staff would not object to the use of a hyperlink to the legend that prominently conveys that important or required information is provided through the hyperlink (often done by styling the hyperlink as "Important Information" or "SEC Legend"). Posts on social media platforms that do not have such limitations must include the full legend.

In our experience, the Rule 14a-12 legend typically does not impact social media communications as most often shareholder activists do not take their campaign to social media platforms prior to filing a definitive proxy statement. This is a strategically-driven approach that may evolve as the use of social media in activist situations becomes more commonplace. Nevertheless, shareholder activists have relied on the SEC's interpretation to utilize social media prior to filing a definitive proxy statement.

A question we have seen arise with respect to the SEC's interpretation is how it applies to character and spatial limitations for social media advertisements and search engine marketing that make the inclusion of a legend impossible.

For a printed newspaper or magazine, where sufficient space always can be purchased, the SEC has been clear that the legend is required in advertisement text no matter the cost. However, for advertisements on social media platforms and search engine marketing that would be otherwise effectively off-limits prior to the filing of a definitive proxy statement due to the inability to include the full legend, a reasonable argument can be made that the SEC should permit the advertisement with a hyperlink to the legend.

Anti-Fraud Rules

When utilizing social media during a proxy campaign, shareholder activists always should be mindful of the prohibition on making a solicitation containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact,

[4] Exchange Act Rule 14a-3(a)

[5] Exchange Act Rule 14a-12(a)(1)

[6] Compliance and Disclosure Interpretations, Securities Act Rules, Question 164.02, https://www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm

or which omits to state any material fact necessary in order to make the statements therein not false or misleading.[7]

The SEC has highlighted the following as examples of what may be deemed misleading: (i) predictions as to specific future market values; (ii) material which directly or indirectly impugns character, integrity or personal reputation, or directly or indirectly makes charges concerning improper, illegal or immoral conduct or associations, without factual foundation; and (iii) claims made prior to a meeting regarding the results of a solicitation.[8]

Compliance with the anti-fraud rules extends not only to communications via social media developed by the shareholder activist, but also to any third party information re-transmitted, endorsed or linked to in the shareholder activist's communications, as the SEC may attribute offending third party statements to the shareholder activist.[9] Therefore, shareholder activists generally should refrain from hyperlinking to third party websites and exercise caution when endorsing third party content.

[7] Exchange Act Rule 14a-9

[8] Note to Exchange Act Rule 14a-9

[9] Securities Act Release No. 33-8591 (July 19, 2005), "[W]hether information prepared and distributed by third parties that are not offering participants is attributable to an issuer or other offering participant depends upon whether the issuer or other offering participant has involved itself in the preparation of the information or explicitly or implicitly endorsed or approved the information."

Planning for M&A Cybersecurity Risks

By Jennifer Thiem and James Scheuermann, Partners of K&L Gates LLP[1]

A glance at any media outlet shows that cyber risk is pervasive and increasing, and that virtually no company is immune to a cyber incident. Almost all companies and associations collect and store some type of data, whether it is customer or employee data (such as personally identifiable information, personal health information, or cardholder data), intellectual property, confidential corporate information (such as historical financial data and projections, customer lists, or corporate strategies), or other confidential information (who is accessing which websites, consumer buying habits, and the like).

Similarly, virtually all companies communicate with their customers and vendors through emails, social media, or websites. And companies are increasingly purveyors of or reliant on devices connected through the internet of things or the industrial internet of things (industrial control systems), many of which lack adequate security. With a plethora of valuable targets and points of entry, cyber criminals, hacktivists, and nation-states do not lack for motives or opportunities to engage in cyber-attacks.

The costs associated with cyber incidents often are severe. For example, the costs associated with a data breach may include forensic and investigative activities, assessment and audit services, crisis management, notification of affected third parties, consumer class action or other litigation with customers, vendors, or business partners, regulatory investigations and fines, business interruption or contingent business interruption losses, and loss of reputation and goodwill.

As the threat of cyber-attacks increases, dealmakers would be prudent to familiarize themselves with a target's cyber risks and implement strategies, such as cyber representations and warranties in the definitive acquisition agreement and insurance for cyber risks, for minimizing that risk in order to protect buyers in the M&A setting.

[1] A special thank you to Richard Doelling, former K&L Gates lawyer and current General Counsel at MDK Hospitality, who contributed greatly to this article.

Steps Buyers & Sellers Should Take to Assess Cyber Risks

Understanding and addressing cyber risks in connection with an acquisition is important for both buyers and sellers. That, however, can be a difficult task. Cyber issues may be latent and the extent of potential damage often is difficult to quantify. Many data breaches, for example, are not discovered for many months or years after their inception. Parties run the risk of closing a deal well before an attack is discovered.

From a seller's perspective, an internal review of a company's vulnerabilities prior to going on the market is a beneficial initial step for several reasons. A would-be target company will strengthen its posture by having already identified and addressed weaknesses in its cybersecurity policies and procedures.

Reduced risk of a post-closing cyber-attack will be an attractive feature in the eyes of a buyer and likely will be reflected positively in the overall purchase price and in the terms of reps, warranties, and indemnification clauses.

Buyers can conduct due diligence to analyze the potential cyber risks associated with an acquisition target. Such due diligence may include a fulsome set of diligence requests regarding cybersecurity and require complete and satisfactory responses from the seller.

In addition to an examination of any known past breaches or other cyber incidents, diligence requests may include a detailed inquiry into:

– Identification of sensitive data and data assets;

– Location of sensitive data and data assets;

– Seller's cybersecurity infrastructure;

– Adequacy of the target's cybersecurity policies and procedures, including penetration testing, vulnerability assessments, and corrective follow-up; and

– Cyber-relevant terms of vendor and customer contracts, especially including indemnification provisions for cyber incidents.

Purchase Agreement Reps & Warranties and Indemnification

Buyers can also incorporate a robust set of reps and warranties regarding cybersecurity within the definitive acquisition agreement to supplement the diligence conducted. While reps are typically tailored to the specifics of the transaction, generally reps relating to cybersecurity will cover at least known incidents as well as the policies and procedures in place at the target company.

Additionally, the buyer, through its own research and diligence, will likely have a strong understanding of: (i) whether a cybersecurity industry standard exists for the target; (ii) any applicable privacy laws, such as the Digital Privacy Act or the Health Insurance Portability and Accountability Act (HIPAA); and (iii) the target's contractual obligations and protections relating to cybersecurity. Buyers can specifically track these considerations in the corresponding reps.

If the acquisition agreement contains an indemnity, buyers may consider, based on their diligence, how the cybersecurity reps should be treated related to other reps. For example, for unknown cybersecurity problems, buyers can push for the cybersecurity reps to be treated as "fundamental reps" so they are not subject to the same survival, caps and baskets limitations as non-fundamental reps.

And for either known or unknown cyber risks, buyers could negotiate for a "specific indemnity" which is subject to a separate set of limitations and methods of recovery.

Rep & Warranty Insurance as a Tool to Address Cyber Risks

An alternative risk-shifting mechanism that has recently become prevalent in M&A deals, especially in the middle-market, is representation and warranty insurance ("R&W insurance"). The rising use of R&W insurance is due, in part, to its increased scope of coverage as well as decrease in cost.

An R&W insurance policy typically covers the buyer for losses resulting from a seller's breach of reps and warranties in an acquisition agreement. Good diligence by the buyer may prove helpful as the underwriter will typically rely on the depth of the buyer's diligence, typically through review of the diligence memorandum, when crafting the policy.

R&W insurance is most commonly used in acquisitions of private companies and in "carveouts" (acquisitions of divisions or product lines of public or private companies). Nonetheless, R&W insurance can also be useful for acquisitions of public companies where there is usually no other means of recovery for a buyer for breaches of reps and warranties (because there is typically no survival of reps and no indemnity, due in part to the impracticability of trying to recover from a large group of shareholders).

R&W insurance policies, like all insurance policies, have their limitations. For example, they only insure against unknown claims. Further, like indemnification provisions, recovery will be limited to the extent of the policy limits. Moreover, many insurers are unwilling to insure against various types of risks (*e.g.*, certain environmental or tax risks), which may be expressly excluded from coverage.

Fortunately, policies can be negotiated extensively. Dealmakers will want to carve out an appropriate amount of time and resources to devote to negotiating the R&W insurance policy to ensure that the buyer has sufficient coverage for cyber as well as other risks.

Stand-Alone Cyber Insurance as an Alternative to R&W Insurance

If R&W insurance is not an option, or cybersecurity claims are excluded from the R&W insurance policy, another way to protect against the risks of cyber threats is through a stand-alone cyber insurance policy. That policy may be the seller's or the buyer's existing cyber policy, depending on how the acquisition and change of control clauses in those policies are worded and the size of the deal, or it may need to be an entirely new cyber policy.

If a new cyber policy is required, placing a cyber policy sometimes is an extended process, and so early planning and focus on this issue may be essential to a timely closing of the transaction.

Thorough Due Diligence is the Key to Effective Cyber Risk Management

The risk of a cyber incident occurring continues to increase, and the magnitude of the costs associated with a cyber incident is likewise on the rise. In the context of M&A, the basis for adequately accounting for cyber risk for buyers and sellers is conducting a thorough investigation into the target company's cyber history, and its cybersecurity infrastructure and policies.

Parties armed with this knowledge may then consider appropriate cyber reps, warranties, and indemnities in the definitive agreement as well as cyber risk management through R&W insurance and/or cyber insurance to reflect the risks discovered in diligence.

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True-Ups After *Chicago Bridge*: The Two Sides to Working Capital Adjustments

By Rob Little, Partner, and Eric Pacifici, Associate, of Gibson Dunn & Crutcher LLP

Buyers and sellers often agree that a target company's valuation assumes that the target will be sold on a cash-free, debt-free basis, with a normalized level of working capital. With respect to working capital, which is typically defined as current assets minus current liabilities, the buyer wants to ensure that the target has a sufficient amount of working capital to operate in the ordinary course after closing without requiring an infusion of capital.

Accordingly, the buyer and seller will typically agree upon a target for the amount of working capital the acquired company should have at closing. Prior to closing, the seller will deliver an estimate of the amount of working capital it believes the acquired company will actually have at closing. If the seller's estimate exceeds the working capital target, the seller will receive an amount equal to such excess as an increase in the purchase price.

If, however, the seller's estimate is less than the working capital target, the buyer will receive the shortfall as a purchase price reduction. In the period immediately following closing, the buyer will perform its own calculation to determine the amount of working capital the acquired company actually had at closing. If the amount resulting from the buyer's calculation differs from the amount of the seller's estimate, the purchase price will be further adjusted. This process is often referred to as a "true-up."

Purchase Agreements Often Unclear on a True-Up's Purpose

Occasionally disputes between the parties regarding the working capital calculation will arise in the true-up process. Often in these disputes the buyer's and seller's differing viewpoints regarding the purpose of the working capital adjustment are revealed.

On the one hand, sellers often argue that working capital must be calculated consistently with the methodology used to calculate the working capital target amount. In other words, the seller will argue that the purpose of the working capital adjustment is to compensate for deviations from the target working capital amount, and in order for such changes to be calculated equitably, the closing amount of working capital must be calculated using the same methodology that was used in calculating the working capital target amount.

On the other hand, the buyer may argue that the purpose of the working capital adjustment is to ensure that the acquired company is delivered at closing with sufficient working capital, and that determination should be made by calculating working capital in accordance with GAAP (*i.e.*, if the closing working capital amount, calculated in accordance with GAAP, results in a deviation from the target and the estimate, which were not calculated in accordance with GAAP, then the GAAP-compliant calculation should control).

Both of these divergent viewpoints sometimes make their way into the M&A purchase agreement in the form of convoluted and unclear language regarding how working capital is to be calculated. In contrast, at times, one side's preferred viewpoint may be reflected in the purchase agreement without the other side's realizing the full implications of the language.

Chicago Bridge: The Last Word on Working Capital Adjustments?

At first blush, a recent Delaware case, *Chicago Bridge & Iron Co. N.V. v. Westinghouse Electric Co. LLC*, 2017 WL 2774563 (Del. June 27, 2017), would seem to provide support for the seller's viewpoint. However, the case had highly unusual facts that ultimately limit its utility at the negotiating table for either the buyer or seller.

In the case, the Delaware Supreme Court reversed the decision of the Chancery Court, which had upheld the right of Westinghouse, as buyer, to use the post-closing working capital true-up process to claim that the financial statements of Chicago Bridge, as seller, were not based on a proper application of GAAP. The Delaware Supreme Court stated that the true-up process is a "narrow, subordinate, and cabined remedy" only intended to account for changes in the target's business between signing and closing of the transaction.[1]

[1] *Chicago Bridge & Iron Co. N.V. v. Westinghouse Electric Co. LLC*, 2017 WL 2774563 at *3 (Del. June 27, 2017) ("*Chicago Bridge*").

In October 2015, Chicago Bridge and Westinghouse entered into a purchase agreement pursuant to which Westinghouse agreed to acquire a wholly owned subsidiary of Chicago Bridge, CB&I Stone & Webster Inc. ("Stone").[2] Chicago Bridge agreed to sell Stone to Westinghouse for, *inter alia*, a purchase price of zero dollars and certain limitations on liability that were intended to give Chicago Bridge a clean break from the spiraling costs of the nuclear projects in which Stone was principally involved.[3]

The parties agreed that Westinghouse's sole remedy, in the absence of actual fraud, for Chicago Bridge's breach of the agreement's representations and warranties was to refuse to close the transaction.[4] In other words, for example, Westinghouse agreed that it would have no recourse for a breach of Chicago Bridge's representation in the purchase agreement that Stone's financial statements complied with GAAP.

Westinghouse also agreed to broad indemnification of Chicago Bridge for all future claims related to Stone and to obtain liability releases, for the benefit of Chicago Bridge, from the power utilities that would ultimately own the nuclear plants being built by Stone.[5]

The agreement also contained a post-closing purchase price adjustment true-up process whereby the parties would reconcile a working capital estimate with the actual working capital of Stone at closing.[6] This multi-step true-up process required Chicago Bridge to deliver an estimate of working capital to Westinghouse at least three days prior to closing and, subsequently, Westinghouse to deliver a similar statement to Chicago Bridge no later than 90 days after closing.[7]

The agreement required the statements to be "prepared and determined from the books and records of [Chicago Bridge] and in accordance with United States [GAAP] applied on a consistent basis throughout the period indicated and with the [agreed principles]."[8] At the conclusion of the true-up process, Westinghouse alleged that Chicago Bridge's historical financial statements, from which Chicago Bridge's true-up estimates were based, were not GAAP compliant and, as a result, Chicago Bridge owed it a working capital adjustment of over $2 billion.[9]

The agreement also contained a dispute resolution mechanism to address disputes in the true-up process which referred the parties to an independent auditor.[10] Prior to Westinghouse invoking the independent auditor to arbitrate its working capital adjustment claim, Chicago Bridge filed a claim with the Court of Chancery seeking a declaration that Westinghouse's claim was not appropriate for the true-up dispute resolution mechanism because it was based principally on the allegation that Chicago Bridge's historical financial statements were not GAAP compliant and, therefore, was barred by the limitation on liability contained in the agreement.[11]

The Court of Chancery held in favor of Westinghouse, holding that the dispute resolution mechanism established a mandatory path for resolving the parties' disagreements over the post-closing purchase price adjustment, including disagreements as to whether Stone's historical financial statements were GAAP compliant.[12]

The Delaware Supreme Court reversed the Court of Chancery's decision and held that the Court of Chancery must enjoin Westinghouse from submitting claims to the independent auditor or continuing to pursue already-submitted claims regarding Chicago Bridge's historical financial statements because such claims were barred by the limitation on liability contained in the agreement.[13]

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[2] *Id.* At *1.

[3] *Id.*

[4] *Id.* at *2.

[5] *Id.*

[6] *Id.* at *4.

[7] *Id.* at 7-8.

[8] *Id.* at *8.

[9] *Id.*

[10] *Id.* at *9.

[11] *Id.*

[12] *Id.; Chicago Bridge & Iron Co. N.V. v. Westinghouse Electric Co. LLC and WSW Acquisition Co., LLC,* 2016 WL 7048031 at *1 (Del. Ch. Dec. 5, 2016).

[13] *Chicago Bridge* at 16.

In his decision, Chief Justice Strine leaned heavily on the facts, including the limitation on liability, which he described as "unusual."[14] The opinion began with the declaration that "[i]n giving sensible life to a real-world contract, courts must read the specific provisions of the contract in light of the entire contract" and later stated that, although the true-up process has an important role to play, its role is "limited and informed by its function in the overall Purchase Agreement."[15]

Chief Justice Strine further justified his decision by arguing that a ruling to the contrary would "render the [limitation on liability] meaningless and eviscerate the basic bargain" struck by the parties.[16]

True-Ups After *Chicago Bridge*: Specificity in Drafting is Essential

This decision leaves open the question of whether the Delaware courts would view the true-up process contained in traditional agreements, where the buyer is not subject to a liability bar, in the same limited way. Some buyers will be tempted to argue that this case represents a narrow holding that does not preclude buyers in the traditional context from bringing claims regarding GAAP compliance in the post-closing purchase price adjustment true-up process.

In contrast, some sellers will be tempted to argue that Chief Justice Strine's pronouncement that the true-up process is only intended to account for changes in the target's business between signing and closing forecloses buyers from asserting that the working capital calculation was not performed in accordance with GAAP.

Certainly, the deal terms at issue in this case were unusual, and the imposition of a liability bar seems to have weighed heavily on the outcome. It is unclear whether a purchase agreement without a liability bar, and with unambiguous language subjecting the working capital calculation to a GAAP standard, would lead to a different result.

In any event, this case should serve as a reminder that, even in a traditional acquisition agreement, post-closing purchase price adjustments should be drafted with specificity and with the buyer's and seller's divergent viewpoints on the purpose of the working capital adjustment in mind.

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[14] *Id.* at *5-*6.

[15] *Id.* at *1, *11.

[16] *Id.* at *14.

Valuation Analysis: Key to Avoiding Failed M&A Deals

By Justin Johnson, CFA, Co-CEO and Senior Managing Director of Valuation Research Corporation

There are many reasons why companies enter into a merger or acquisition transaction. Regardless of the specific drivers, however, the common theme underlying all merger and acquisition deals is the expectation that the combination will increase shareholder value for the acquirer.

Ironically, it is estimated well over 50 percent of M&A deals fail – meaning they end up destroying shareholder value instead of creating it. This surprising statistic underscores the difficulty company boards face in determining whether or not a deal is worth pursuing. A greater emphasis on a disciplined and thorough valuation analysis is key to helping boards in their ability to identify and avoid bad deals or to guide them in negotiating and structuring deals that may make better financial sense.

This article will discuss what constitutes a disciplined and thorough valuation analysis and how such an analysis can help boards identify companies that could be successful acquisition targets.

Analysis of a Hypothetical Synergistic Deal

For our purpose, we will assume that a public company acquirer has identified a potential target. The target company operates in the same business as the acquirer and serves similar customers. The expected cost

savings from the business combination may be compelling due to an overlapping distribution network of both the acquirer and the acquisition target and because production and administrative staff redundancies can be eliminated from the acquisition target.

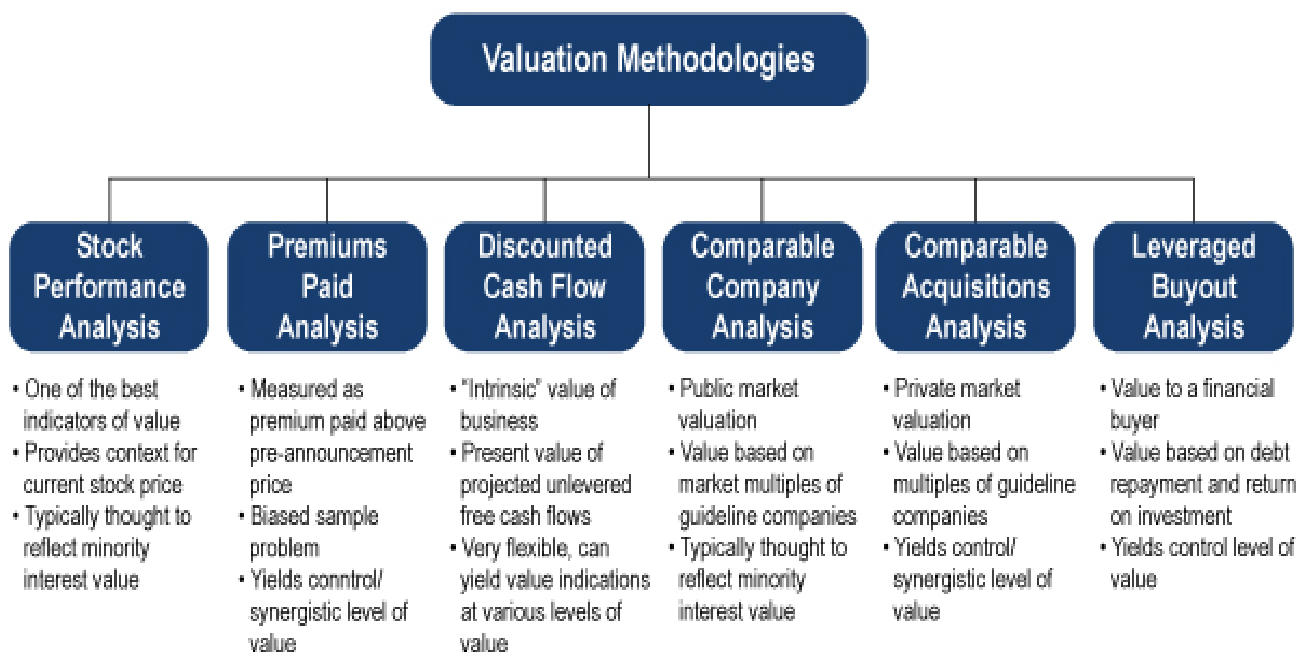
This is a classic example of a synergistic deal. Synergies refer to the ability of the acquirer to add the target company's revenue to its topline while at the same time eliminating many of the costs associated with achieving that revenue by eliminating duplicate operations and functions, increasing overall profit.

The first step in the valuation process is to establish the market value of the target company without regard to buyer-specific synergies. While acquirers are ultimately most interested in analyzing the valuation of the combined company, establishing the market valuation of the target on a stand-alone basis should be done first for two reasons:

- To provide the buyer perspective on a baseline valuation that the board of the target company might expect to realize in the transaction.
- To establish a reference point by which the buyer can analyze and evaluate how much additional synergy it brings to the table over and above a market level of synergy.

Establishing the Value of an Acquisition Target

There are several generally accepted approaches for establishing the value of an acquisition target (see the illustration below for an overview of commonly used approaches). The first two approaches are used primarily for publicly traded targets. For our purpose, we will assume the acquisition target is a private company and its value may be established using the other four approaches.



Comparable Companies & Acquisitions Analysis. One of the most common approaches relies on the trading multiples of comparable companies in the public markets. Care is required in the selection of public companies to ensure comparability of operations, size and/or growth prospects with the target company. Another common approach is to look at industry M&A deal multiples for similar targets. For this approach, it may be instructive to distinguish between financial sponsor deals and strategic deals. Strategic acquirers can and often do pay higher multiples for targets due to acquirer-specific synergies.

This approach yields a control/synergistic level of value. Value indications for these approaches should be based on applying observed market multiples to the target's standalone earnings before interest, tax, depreciation and amortization (EBITDA) (or other financial metrics that may be more appropriate) without factoring in any buyer-specific synergies.

Discounted Cash Flow Analysis. If a reliable long-term forecast is available for the target company, the financial advisor will often use a discounted cash flow (DCF) analysis to establish value. It is important to keep in mind, however, that such an analysis is only as good as the underlying financial forecasts used to perform the DCF model. For this reason, a DCF analysis is often underweighted and may even be omitted in some instances.

If the financial advisor does choose to conduct a DCF analysis, caution must be used in relying upon the financial projections prepared by the target company. One pitfall would be to take at face value any forecast that appears overly optimistic about future performance relative to historical performance. Careful due diligence should be conducted on such a forecast to determine if it is reliable.

In some instances, a "haircut" may be applied to the forecast to offset the optimistic nature of the long-term plan, while in other instances the financial advisor may develop a more reasonable set of projections by looking at the historical performance of the target as well as industry norms. In any event, the financial forecast should not factor in any buyer-specific synergies.

LBO Analysis. Last, if the target company is likely to attract financial buyers, then it would also be prudent to value the company using a leveraged buyout (LBO) analysis. This approach values the target by establishing what a financial buyer would be willing to pay for the company given the financing structure it may implement. In addition to its equity investment, a financial buyer will seek to use debt to finance the acquisition in order to enhance equity returns.

If a company is underperforming relative to the industry, the LBO model may also include some assumptions about reorganization to better align the target company's performance with the overall industry. The financial sponsor may also seek to use the target company as a platform from which to make add-on acquisitions to increase EBITDA and realize value through multiple expansion at exit.

Once all approaches have been performed, the financial advisor will triangulate the various pricing indications to establish an overall baseline valuation range for the target. This analysis provides a useful benchmark to the acquirer in determining a preliminary offer value.

Establishing Value for the Acquirer

The next phase of the valuation analysis involves assessing what the value of the acquirer will be pro forma for the acquisition. This analysis is different than the market valuation analysis because we are now conducting a review from the perspective of a particular buyer and what the value of the acquisition is to that specific buyer. This value may be different for each potential buyer in the market, with the most highly synergistic buyer able to offer the highest purchase price.

Identifying and Quantifying Synergies. In performing this valuation analysis, there are a number of factors that need to be carefully analyzed before determining the viability of the deal. If it is viable, then we determine how much the buyer can afford to pay for the target and still increase shareholder value. Some of these factors include the amount of expected synergies, the costs associated with realizing those synergies, the amount and type of purchase consideration, and the trading multiples for the acquirer's stock. We will address each of these factors in turn.

Money spent on outside advisors that perform due diligence on the target to estimate the potential synergies of a deal is usually money well spent. Management should be careful in relying on its own estimates of synergies. In many cases, the amount of synergies cannot be estimated with precision and may be a wide range.

Role of a Sensitivity Analysis. Because of difficulty in identifying and estimating potential synergies, it is recommended to run a sensitivity analysis to assess the impact of the transaction on the acquirer's stock price. This is best performed in a sensitivity table that varies both the amount of assumed synergies and the amount of purchase consideration, which provides the board with a visual tool to understand how much it makes sense to pay at varying levels of synergy.

With this analysis the acquirer should keep in mind that for many deals the amount of synergies actually realized is lower than projected. In addition, it may take longer than expected to realize those synergies and the associated one-time costs might be higher than expected. From the buyer's perspective, a good deal is one that is accretive to the acquirer's stock price even at the low end of the range of expected

synergies. An even better deal is one that still increases shareholder value despite synergies below the low end of the estimated range.

Conversely, deals that are only accretive at or near the maximum amount of projected synergies will likely end up destroying shareholder value. The same logic applies to the estimated one-time costs necessary to integrate the target's operation into the acquirer's and achieve synergies. Similar to the synergies themselves, these one-time costs may also be difficult to estimate with precision and their range may be wide and a sensitivity analysis around this assumption may also be required.

The idea behind the sensitivity analysis is to look at the financial impact of the transaction on a conservative basis. For example, if the scenario analysis shows that a deal increases shareholder value even if (a) actual synergies realized are at the low end of expectations, (b) one-time costs incurred to realize those synergies are at the high end of the range and (c) the purchase consideration is reasonable relative the market valuation of the target company, then the deal will likely end up good from the acquirer's standpoint.

Consideration of Other Potential Impacts on Value

It is also important to analyze the impact of the type of purchase consideration on value. How will the acquisition be financed? The purchase price can be financed with available cash, proceeds from newly incurred debt, with stock or with a combination of these. Use of debt will create a drag on future earnings in the form of interest expense. Interest expense is effectively another cost of realizing the transaction synergies that must be considered.

Stock v. Cash Consideration. If acceptable to the seller, using stock consideration may be advantageous to the buyer. But if stock is used, VRC advises placing selling restrictions on the shares until after the expiration of any transition services agreement so as to incentivize the sellers to ensure a smooth transition and to de-risk any transition issue. While the sellers must wait until they can convert their shares to cash, they will benefit in the run-up in the value of the stock assuming that transaction synergies are realized as planned.

Another factor that needs to be considered is the valuation multiple of the acquiring company. If historically it has been somewhat volatile, it may be advisable to run a sensitivity analysis on the pro forma value of the stock, assuming a range of valuation multiples for the acquirer that are consistent with its recent trading history. The lower the valuation multiple, the lower the increase in value from transaction synergies.

Ongoing Revenue Assumptions. There may also be other factors that need to be analyzed. For example, one assumption underlying most deals where the acquisition rationale is cost synergies is that the target's revenue will survive the acquisition without any loss of customers or decrease in the level of business from any given customer. However, in many acquisitions this does not prove to be the case.

The acquirer will need to evaluate whether incentives will need to be put in place with those at the target who have key customer relationships or directly with customers to ensure revenue is preserved and relationships transfer. This will be an additional cost that will be an offset to the synergies to be realized.

Having established both the market value of the target and the value of the target to the specific buyer, the acquirer is in a good position to negotiate with the seller. A buyer will typically be willing to pay up to the market level of synergies. The buyer should be careful paying for synergies beyond that point.

No board of directors goes into a deal with the intent to destroy value and yet that is what ends up happening in the majority of deals. In many instances, a greater emphasis on a disciplined and thorough valuation analysis as outlined above can make the difference in helping a board of directors in its ability to distinguish a good deal from a bad one.

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Founding Publisher: **Jesse M. Brill**. Formerly an attorney with the Securities and Exchange Commission and a leading authority on executive compensation practices, Mr. Brill is also the Founding Publisher of *The Corporate Counsel* and Chair of the National Association of Stock Plan Professionals.

Editors: **John Jenkins** and **Broc Romanek**, who also serve as the Editors of DealLawyers.com and TheCorporateCounsel.net. They can be reached at john@thecorporatecounsel.net and broc.romanek@thecorporatecounsel.net.