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The Road to Global Closing: Drafting Local Transfer Agreements in Cross-Border Carve-Outs

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After months of planning, negotiation and drafting, the sale and purchase of a carve-out business with operations around the world often snaps into focus with the signing of a global purchase agreement. Press releases may be issued, the parties and their myriad advisers may rest briefly and even congratulate one another. But this milestone is really only something akin to two strangers, having met and measured the other's worth, agreeing to set off together, albeit on binding terms, for a far-off destination that they have only etched out in their minds and in their contract: a global closing.

The challenge in selling or acquiring a carve-out business is that the target business may be commingled around the world with other business units that the parent company intends to retain. As a result, the target business often needs to be separated, either at or prior to a global closing. This separation generally involves a combination of equity and asset transfers in jurisdictions around the world to effectively "package up" the target business for sale (in the context of a pre-closing reorganization), or to deliver the business directly to the buyer at closing (in the context of a direct sale). As such, getting to global closing in a carve-out transaction often requires successfully navigating a series of local closings around the world — a daunting task even before the world became a patchwork of different local and national lockdowns and work restrictions related to COVID-19.

In this article, we describe some of the key drafting considerations for local transfer agreements in the context of a global carve-out transaction, as well as issues that buyers and sellers should consider in connection with these agreements. It is worth noting at the outset that our specific focus in this article, preparation of effective local transfer agreements, is only one of several important legal considerations at the outset of the implementation phase in a carve-out transaction.

Template Agreements

The form agreements to be used for local asset and share transfers are often an afterthought in the negotiation and execution of a global purchase agreement. While not contentious (the key terms of the deal have already been agreed), these local agreements do require attention and the deal team should understand the range of country-specific issues that may be encountered as the forms are localized for use in target jurisdictions. Templates for these agreements may be agreed upon as exhibits to a global purchase agreement, or prepared after signing. In either case, the parties should expect that the forms will need to be further customized for use in each jurisdiction where assets or shares are being sold.

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The local agreements should represent a bring-down of the terms of the global agreement for local implementation. These templates should be brief and silent on risk-allocation issues already addressed in the global agreement. For example, representations and warranties and indemnification obligations should be addressed in the global purchase agreement and not replicated in, or contradicted by, similar provisions in the local agreements. Ideally, the local agreements should also contain a clear provision that the global agreement controls in case of any conflict.

While these may be sound first principles, there are a number of country-specific issues that can make the roll-out of uniform local transfer agreements more challenging. Below we will look at some common issues in the context of asset transfers, as well as share transfers.

Asset Transfer Jurisdictions. Where it is decided that specific assets related to the carve-out business need to transfer in multiple jurisdictions, the first question the parties may ask is why, should each local asset buyer and local asset seller not simply sign a short, bill of sale-type document that purports to transfer all of the relevant local assets and liabilities by reference only to the terms of the global agreement. Tempting as this may be, this type of agreement will not be acceptable in many jurisdictions and will lead to inconsistent changes and additions as the agreement is localized for use.

We find the better approach is to prepare a brief but comprehensive business transfer agreement or "BTA" at the outset that brings down key commercial terms of the deal that are relevant for the local transactions. By placing these terms into the context of local transactions, local BTAs can help streamline implementation and increase consistency across the different jurisdictions involved in a project.

- *Referencing the Global Agreement.* In drafting a template BTA, the parties may find that there are certain terms in the global purchase agreement that are relevant to the local transactions, but that would be too cumbersome to replicate or summarize in the local agreements. In this case, it is acceptable in most jurisdictions for the local BTA to incorporate certain terms of the global agreement by cross-reference.

  The right balance here is to draft an agreement that local advisers and/or third parties can review on its face and readily discern the key terms of the local transaction, but that also may refer back to the global agreement for certain complex or specialized deal issues. Once the form is set, centralized coordination and review of any local drafting changes is critical to ensure that the local agreements remain consistent with the global terms.

  There are, however, certain jurisdictions and types of transactions where making any reference to the global agreement is strongly discouraged. For example, in China, references to the global agreement in a local asset transfer agreement may prompt tax authorities to question whether the price allocation to the local transaction is reasonable or to request a copy of the global agreement for review.

  It is relatively easy to work around this issue at the global level. For example, the parties may choose to enter into a private side-letter agreement that confirms that any "non-reference" local transactions are nonetheless part of the global transaction and subject to the terms of the global purchase agreement. While the global purchase agreement itself should already contain language to this effect, a side-letter agreement can be used for added certainty and clarity.

- *Schedules*. In preparing the schedules for a local BTA, the parties will again need to balance the use of inclusive, "catch-all" language that refers back to the global agreement with the need to

more specifically describe the assets and liabilities that are actually transferring in a given jurisdiction. Generally, we do suggest specifically scheduling any important assets that need to transfer in a jurisdiction, *e.g.*, material contracts for the local carve-out business, while also deferring to the broader global definitions of transferring assets and liabilities as a backstop.

If the parties have access to a recent balance sheet for the carve-out business in a given jurisdiction, this can also be included in the schedules and referred to as *indicative* of the types of assets and liabilities that are intended to transfer in that jurisdiction as of the closing date.

Any local assets that are publicly-registered or that may be subject to specific local requirements (*e.g.*, shares of stock, intellectual property rights or permits), as well as any real property transfers, should also be clearly defined in the schedules. While these asset categories often require additional specific conveyance documentation, clear references in the schedules are helpful in order to demonstrate to third parties that the relevant assets are intended to transfer as part of the business and to make it easier for the parties to confirm consistency with their agreed upon global strategies for separation of real estate, IP and permits. An itemized list is also helpful for any tangible assets that may be transferring at a site, but a "catch-all" approach can generally be used here, if needed.

The acceptability of different drafting approaches for schedules does vary by jurisdiction. While most jurisdictions follow some form of the broad principle that an asset must be reasonably described or discernable in a contract in order for it to transfer, this principle is more narrowly interpreted and regulated in some jurisdictions. In Germany, for example, the principle of clarity (*Bestimmtheitsgrundsatz*) requires different levels of specificity depending on the asset category at issue.

Schedules are thus another area where local advice is required, but centralized coordination is essential in order to ensure that the commercial terms of the global deal are fully implemented in each jurisdiction.

- <u>*VAT*</u>. Developing a more robust local agreement can also help support characterization of the local carve-out transaction as a "transfer of a going concern" in value-added tax ("VAT") jurisdictions. The likelihood of obtaining tax exemptions that may be available for this type of transaction is maximized where a BTA is used to describe the business that is transferring, and often to include language that specifically describes the intended tax treatment.

Given the important link between the transfer documentation and the tax treatment in this area, it is critical for a deal team to connect its indirect tax and legal advisers in VAT jurisdictions early in the process, so that each team understands the timing for the respective work streams and the local agreements support the intended tax treatment in each jurisdiction.

Another area of confusion in VAT jurisdictions is that asset transfers in these countries often require preparation of an itemized invoice showing all of the assets that have transferred and the value allocated to each of them. It is important to keep in mind that in most jurisdictions this itemized invoice is not a corporate legal requirement, but is rather more like a tax filing in connection with the local transaction, and it is often due only after the transaction has already closed,

e.g., 30 days after local closing. Again, early communication and planning on VAT issues can help to avoid last-minute emergencies or confusion about the respective corporate and tax requirements for a transaction.

Share Transfer Jurisdictions. Where a seller subsidiary primarily operates the target business, and/or the seller has been able to transfer any non-target business assets out of the subsidiary prior to closing, the parties may opt for a transfer of ownership of the entity itself to the buyer. The structure of equity transfers in the context of a carve-out transaction will depend on a number of factors, including tax planning and timing.

In the context of a pre-closing reorganization, for example, the seller may reorganize target business entities into a new chain through a combination of share sales, contributions or distributions. Alternatively, the deal structure may contemplate a direct transfer of the shares of a target business entity to a buyer entity at global closing.

As with asset transfers, we recommend preparation of a template share transfer agreement that can be localized for use in each jurisdiction where shares are transferring. Many jurisdictions will recommend or require the use of a local-law governed share transfer form. For consistency across the deal and to maintain the priority of the global purchase agreement, these local forms should be used *in addition to* rather than instead of the global template agreement, wherever possible.

Ultimately, however, the transfer of legal title to shares will occur pursuant to the laws of the jurisdiction of the transferred entity. As such, it is critical to understand the local mechanics for these transfers, particularly where a local closing is time-sensitive or part of a series of transactions that need to occur in sequence.

- *Notarial Deeds and Meetings*. For share transfers in civil law jurisdictions, depending on the structure of the transfer, a meeting before a civil law notary and the execution of a notarial deed will often be required to complete the transaction. For example, a local notarial meeting is required any time the shares of a Dutch entity are transferred; the same is true in Germany. In Luxembourg, a notarial meeting before a Luxembourg civil law notary will be required to authenticate changes in share capital that may be necessary as a result of contributions into or distributions from a Luxembourg company.

  In the context of a global carve-out transaction, special attention needs to be given to civil law notarial requirements from a planning and documentation perspective. As the notary is most often a third party, scheduling a notarial meeting or formalizing a notarial deed may raise timing concerns related to closing deadlines or other sequential transactions. To avoid last minute delays, it is imperative that civil law notaries are given an opportunity to read and understand the local transaction documents in advance of any planned closing.

- *Beneficial Ownership*. In addition to notarial requirements, there are a number of other types of local requirements that can delay (sometimes significantly) the transfer of legal title to shares in a given jurisdiction. These include, among other things, locating or replacing physical share certificates, employee notification requirements, stamp duty assessments and public registration processes.

  Particularly at this moment in time, when courts and government offices may be intermittently closed or only working on reduced schedules, any public process that is required to complete or formalize transaction may be slowed down, or left in administrative limbo for months at a time. For this reason, it is important for

local share transfer documents to include language on the transfer of beneficial ownership at local closing, notwithstanding any possible delays in the formal transfer of legal title.

This language can be adapted from the provisions of the global purchase agreement on delayed assets, but these global provisions will likely need to be changed or supplemented in certain respects to specifically address rights pertinent to share ownership. Beneficial ownership is not recognized in all jurisdictions, but including a provision on beneficial ownership transfer in your template share transfer agreement can often help to avoid unnecessary delays or slow-downs in global transactions where a large number of share transactions need to occur in sequence or simultaneously.

Governing Law

Because the local transfer documents are only intended to implement the deal as agreed in the global purchase agreement, the local agreements should apply the same governing law as the global agreement, to the extent possible. Local advisers may have some objection to the application of, for example, Delaware law, to a transaction in their jurisdiction, particularly if they are less familiar with large, cross-border implementation projects.

And in many cases, there are valid reasons why local law must apply to some extent in order for the transaction to be valid, *e.g.*, a transfer of shares in the relevant jurisdiction. Many of these local concerns can be addressed through the inclusion of a proviso in the governing law section of the local agreement that stipulates that the governing law of the global purchase agreement applies, except to the extent that mandatory provisions of other jurisdictions apply to the sale and transfer of the assets or shares at issue.

Of course there are also certain documents that are, by their nature, necessarily governed by local laws, *e.g.*, notarial deeds or local forms for share transfers. This is why we recommend using a template transfer agreement or other link to the global agreement (*e.g.*, by side letter) for all local transactions in addition to any local, prescribed forms. Notwithstanding local requirements, the goal is always to ensure that local implementation remains aligned with the global deal to the fullest extent possible, including with respect to applicable law and resolution of disputes.

Valuations and Settlement

While valuations and the flow of funds for a carve-out transaction are largely outside the scope of this article (and relevant considerations will vary depending on the transaction structure) there are a few key points to keep in mind from a drafting and implementation perspective. Regardless of the transaction structure, it is always important for the parties and their legal advisers to (i) keep track of timing for valuations (*i.e.*, when the value for a local transaction is expected to be available versus when the value will first be needed in local implementation documents); (ii) understand how certain value(s) will need to be used and represented in the local documents; and (iii) understand how the value will ultimately be paid or settled for a transaction.

In terms of settlement, the parties may be interested in using a single payment between parent entities in respect of a global purchase price, or a series of payments between different affiliates that are not directly involved in the local transactions. Most jurisdictions will allow for payment in respect of a local purchase price to be made between parent entities or other affiliates, but there are some jurisdictions and transaction types that need to be settled locally.

In particular, asset transfers in certain jurisdictions with more restrictive foreign exchange controls, *e.g.*, India, China and Brazil, must be settled with local payments. In all cases, the language used to describe settlement of a local transaction should be checked with local legal advisers in the jurisdiction where assets or shares are being sold.

Conclusion — Getting to Closing

While smart drafting and centralized coordination of local transactions can help to avoid many of the common pitfalls in corporate implementation of a global carve-out transaction, every transaction presents unique issues and challenges. Among the recommendations we have outlined in this article, the importance of communication between the different internal and external teams working across a transaction cannot be overstated.

The most difficult obstacles that arise on the road to a global closing are rarely purely corporate, tax or regulatory issues. Rather, they are issues that may impact or be affected by each of these areas. A global purchase agreement provides a roadmap for implementation, but early and effective communication between the different functional teams working on a carve-out transaction is the best way to avoid surprises on the road ahead and to ensure that effective solutions are found in time to keep a deal from running off course.

Third Circuit Clarifies Requirements for Risk Factor Disclosures in Merger Proxies

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Securities transactions are subject to a three-tier system of enforcement: oversight by Congress, supervision by regulators such as the Securities and Exchange Commission ("SEC"), and pursuit of private causes of action by private plaintiffs and their attorneys. *Jaroslawicz v. M&T Bank Corp.*, 2020 WL 3278679, at *1 (3d Cir. June 18, 2020). On June 18, 2020, the United States Court of Appeals for the Third Circuit issued a decision concerning the third of these tiers and vacated the dismissal of a securities fraud claim brought pursuant to Section 14(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78n(a).

The Court focused its analysis on Item 105 of SEC Regulation S-K relating to risk factors and held that Item 105 disclosures must be specific, in plain English, and framed in the context of the disclosing entity's industry or business; mere boilerplate and generic discussions do not suffice. *Id.* at *9. The Court reversed a dismissal of claims based on alleged material omissions and affirmed dismissal of claims based on allegedly misleading statements of opinion in a proxy statement/prospectus filed on Form S-4. In so doing, the Court also took the opportunity to "reiterate the longstanding limitations on securities fraud actions that insulate issuers from second-guesses, hindsight clarity, and a regime of total disclosure." *Id.* at *1.

Background

On August 27, 2012, Hudson City Bancorp Inc. ("Hudson") and M&T Bank Corp. ("M&T") executed a merger agreement, pursuant to which M&T would acquire Hudson. *Jaroslawicz v. M&T Bank Corp.*, 2020 WL 3278679 (3d Cir. June 18, 2020). The merger agreement required approval by the shareholders of both banks. To provide the required notice, Hudson and M&T issued a joint proxy statement/prospectus (the "proxy") and filed a single registration statement on Form S-4 in accordance with SEC rules, which was required to include the information called for by Item 503 of Regulation S-K.[1]

On April 12, 2013, M&T issued a press release announcing that the Federal Reserve had raised "concerns" about "M&T's procedures, systems and processes relating to M&T's Bank Secrecy Act and anti-money-laundering compliance program" ("BSA/AML compliance"). *Id.* at 674. M&T explained that, to address these concerns, "the timeframe for closing the transaction will be extended substantially beyond the date previously expected." *Id.* As a result, M&T and Hudson

1 Item 503 has been recodified as Item 105. See *Jaroslawicz v. M&T Bank Corp.,* 2020 WL 3278679, at *1 (3d Cir. June 18, 2020).

amended their merger agreement and moved the closing out several months. *Id.* The shareholder votes, however, remained as scheduled and resulted in approval of the merger by both sets of shareholders. *Id.*

Over a year later, on October 9, 2014, the Consumer Financial Protection Bureau ("CFPB") announced that it had taken action against M&T for allegedly violating consumer disclosure laws by offering free checking accounts but then switching customers to accounts which carried fees (the "Consumer Violations"). *Id.* A year after that, on September 30, 2015, the Federal Reserve approved the merger. *Id.*

Following the merger, former stockholders of Hudson brought suit in the United States District Court for the District of Delaware, arguing that the two companies violated Section 14(a) by omitting from the proxy significant risk factors required under Item 105 and making misleading statements of opinion in the proxy. *Jaroslawicz*, 296 F. Supp. 3d. at 677. The plaintiffs argued that Hudson and M&T violated Item 105 by not disclosing that "the Merger would be delayed or denied (or that M&T would suffer sanctions) due to the Consumer Violations, and the substantial deficiencies in BSA/AML compliance." *Id*.

Further, the complaint alleged that the proxy was materially misleading or incomplete when it stated that: (1) M&T had "approved policies and procedures that are believed to be compliant with the USA Patriot Act" (the "compliance opinion"); and (2) Defendants "currently believe we should be able to obtain all required regulatory approvals" and complete the merger "in a timely manner" (the "timing opinion"). *Id.* at 678.

The district court stated that Item 105 requires the proxy to provide under the caption "risk factors" only a "concise discussion" of "the most significant factors that make the offering speculative or risky." *Id.* The Court commented that "it is undisputable that there can be no omission where the allegedly omitted facts are disclosed" (*Id.*) and found that the following excerpt from M&T Bank's proxy met such a standard:

> "M&T is subject to operational risk, which represents the risk of loss resulting from human error, inadequate or failed internal processes and systems, and external events. Operational risk also encompasses reputational risk and compliance and legal risk, which is the risk of loss from violations of, or noncompliance with, laws, rules, regulations, prescribed practices or ethical standards, as well as the risk of noncompliance with contractual and other obligations. . . . Although M&T seeks to mitigate operational risk through a system of internal controls which are reviewed and updated, no system of controls, however well designed and maintained, is infallible. Control weaknesses or failures or other operational risks could result in charges, increased operational costs, harm to M&T's reputation or foregone business opportunities."

Id. at 677-78.

Although the district court highlighted that there was no discussion in the proxy of risks related to the CFPB or the Consumer Violations, the Court found that "[t]o be actionable, a statement or omission must have been misleading at the time it was made; liability cannot be imposed on the basis of subsequent events" and that "[p]laintiffs have not plausibly alleged that either [the CFPB action or the Consumer Violations] posed a significant risk at the time the Proxy issued." *Id*. at 678.

The district court also rejected the allegedly false opinion claims consistent with *Omnicare, Inc. v. Laborers Dist. Council Const. Indus. Pension Fund,* 575 U.S. 175, 178 (2015). The Court commented that, instead of pleading particular facts about the compliance opinion as required by *Omnicare*, the complaint pleads hypotheticals like "[h]ad any of the defendants at that time performed adequate due diligence, they would have discovered. . . that M&T's 'Know Your Customer' obligations . . . were non-compliant."

Id. at 679. Regarding the timing opinion, the Court observed, "[t]aking context into account, no reasonable investor would have been misled by the timing opinion. Plaintiffs cherry-picked the phrase 'timely manner' out of a caveat about timing: 'Although we currently believe we should be able to obtain all required regulatory approvals in a timely manner, we cannot be certain when or if we will obtain them....'" *Id.* at 680.

The district court allowed the plaintiffs to amend the pleadings, but the plaintiffs asked for a final order of dismissal with prejudice to file an appeal. *Jaroslawicz*, 2020 WL 3278679, at *3. The Court granted the plaintiffs' request, and the appeal followed.

The Third Circuit Clarifies the Requirements of Item 105

The Third Circuit found that plaintiffs' complaint plausibly alleged that the anti-money-laundering deficiencies and consumer checking practices were known to M&T, and posed significant risks to the merger, before issuance of the proxy. *Jaroslawicz*, 2020 WL 3278679, at *5. The Court commented, "[i]n short, while Item 105 seeks a 'concise' discussion, free of generic and generally applicable risks, it requires more than a short and cursory overview and instead asks for a full discussion of the relevant factors. That, as we will see, is where the Joint Proxy fell, in a word, short." *Id.* at *7.

The Third Circuit began its discussion of Item 105 by highlighting guidance from the SEC and other circuits that it found illuminating. *Id.* at *5. In the SEC's Legal Bulletin on the subject, under the section titled "Risk Factor Guidance," the SEC explains that "issuers should ***not*** present risks that could apply to any issuer or any offering." *Id.* at *5 (citing SEC Division of Corporation Finance: Updated Staff Legal Bulletin No. 7, "Plain English Disclosure," Release No. SLB-7, 1999 WL 34984247, *1 (June 7, 1999) ("Legal Bulletin No. 7") (emphasis added).

The SEC guidance continues that Item 105 risk factors fall into three broad categories: (i) industry risks, which companies face by virtue of the industry in which they operate; (ii) company risks, which are specific to the company; and (iii) investment risks, which are specifically tied to the security that is the subject of the disclosure document. SEC Legal Bulletin No. 7, 1999 WL 34984247, at *5-6. "When drafting risk factors, [companies must] be sure to specifically link each risk to [the] industry, company, or investment, as applicable." *Id.*

The Third Circuit discussed two cases from other courts of appeal that it found instructive concerning the scope of adequate disclosures under Item 105. In *Silverstrand Investments v. AMAG Pharmaceuticals, Inc.*, the Court of Appeals for the First Circuit found that plaintiffs plausibly alleged inadequate disclosures under Item 105, where a pharmaceutical company's offering documents failed to mention almost two dozen "Serious Adverse Events" that it had reported to the Food and Drug Administration ("FDA") in clinical trials of its drug. 707 F.3d 95, 98-99 (1st Cir. 2013).

The First Circuit held that "a complaint alleging omissions of Item [105] risks needs to allege sufficient facts to infer that a registrant knew, as of the time of an offering, that ... a risk factor existed." *Id.* at 103. Given the many adverse reports the company submitted to the FDA, the Court concluded the allegations "more than suffice" to plead a plausible claim of undisclosed risk. *Id.* at 104.

In *City of Pontiac Policemen's and Firemen's Retirement System v. UBS AG*, the Court of Appeals for the Second Circuit found that plaintiffs' allegations did not plausibly allege inadequate disclosures under Item 105, where the company disclosed "multiple legal proceedings and government investigations" showing exposure "to substantial monetary damages and legal defense costs," along with "criminal and civil penalties, and the potential for regulatory restrictions." 752 F.3d 173, 183–84 (2d Cir. 2014). The Second Circuit found that "disclosure is not a rite of confession, and

companies do not have a duty to disclose uncharged, unadjudicated wrongdoing." *Id.* at 184 (internal quotation marks and footnote omitted).

By disclosing the possible problems that could flow from the multiple investigations, UBS was found to have complied with Item 105. *Id*. The Third Circuit observed that these two decisions could be reconciled, as each reflected the text of Item 105: the issuer in *Silverstrand* allegedly knew that the FDA would scrutinize the reported effects of its products—an obvious risk to their business—so failing to disclose that risk factor was enough to state a claim, whereas the issuer in *City of Pontiac* sufficiently disclosed the existence of "multiple legal proceedings," making the imposition of further disclosure obligations tantamount to creating an obligation grounded in guesswork. 2020 WL 3278679, at *7.

The Third Circuit in *Jaroslawicz* applied these decisions to find that "shortcomings in M&T's proxy become clear." *Id.* at *8. Starting with the alleged compliance omission, the Court highlighted that M&T knew that the state of its compliance program would be subject to extensive review from federal regulators and that failure to pass regulatory scrutiny could sink the merger. *Id*. at *8. The Court observed that this knowledge alone makes it clear that M&T had a duty to disclose more than generic information about the impending regulatory scrutiny. *Id*.

Because in "every case under the Bank Merger Act" the "[Federal Reserve] Board must take into consideration. . . records of compliance with anti-money-laundering laws," M&T's generic disclosures essentially only state that obvious regulatory hoops stood between the proposed merger and a final deal, but failed to disclose "just how treacherous jumping through those hoops would be." *Id*. "M&T offered information generally applicable to nearly any entity operating in a regulated environment. In fact, M&T said that: '[l] ike all businesses,' it was subject to regulatory risk.

Contrary to Item 105's directive, M&T's explanation of the regulatory review process offered no details and no more than '[g]eneric or boilerplate discussions [that] do not [explain] . . . the risks.'" *Id.* at *9 (internal citations omitted). The Court observed that "M&T should have 'specifically link[ed]' its general statements to 'each risk to [its] industry, company, or investment' using details that connected the pending merger review to its existing and anticipated business lines." *Id*. (citing Legal Bulletin No. 7 at *6).

The Third Circuit similarly held that M&T's disclosure about the problems surrounding its consumer checking practice were deficient under Item 105. *Id*. The Court stated that it is reasonable to infer that "the consumer checking practices cast doubt on M&T's controls and compliance systems, and posed an independent regulatory risk to the merger material enough that a reasonable shareholder would consider it important in deciding how to vote." *Id.* While not "hold[ing] that the regulatory enforcement actions by themselves required M&T to disclose these issues," M&T had an obligation to disclose because "M&T knew the regulators would be looking into its compliance program, and specifically its BSA/AML effectiveness. They said so themselves. And they knew the failure to obtain regulatory approval would be significant, possibly fatal, to the merger. Yet, . . . M&T offered little more than generic statements about the process of regulatory review." *Id*. at *10.

Regarding the misleading opinion claims, the Court agreed with the district court's dismissal. The Court stated that, "'to avoid exposure for admissions,' a speaker 'need only divulge an opinion's basis, or else make clear the real tentativeness of its belief.' Thus, even if a reasonable investor would have expected the banks to conduct diligence over a longer period, the Joint Proxy provided enough information to understand what the banks did, information enough to decide how to vote." *Id.* at *11 (citing Omnicare, 575 U.S. at 195). The Court observed that "the opinions flowed from the Joint Proxy's description of the increased scrutiny across the industry. Cautionary language surrounds the opinions, warning of the uncertainty of projections

about regulatory approval. Under Omnicare, these opinions inform, rather than mislead, a reasonable investor." *Id.* at *11.

Implications

The Third Circuit's decision in *Jaroslawicz* clarifies that Item 105 requires more than mere boilerplate or generally applicable language to describe risk factors. In reaching this conclusion, the court cited to written SEC Legal Bulletins as providing support that the risk factors must each be "specifically link[ed]" to the particular industry, company, or investment being discussed.

Companies drafting disclosures post-*Jaroslawicz* should ensure that their practices conform with the SEC's written guidance as articulated by the Third Circuit, as failure to fully discuss the relevant risk factors could result in a court finding—in the words of the Third Circuit—that the disclosures "fell short." This appears to be the case where, as in Jaroslawicz, the company possesses sufficient knowledge that a regulatory investigation is likely.

M&A Purchase Price Considerations in the Context of COVID-19

By Anne Cox-Johnson, Partner, and J. Hillyer Jennings, Senior Associate, of King & Spalding LLP

Much like everything else in the world, M&A transactions must adjust in order to account for the impact of COVID-19. Arguably the most important feature in any M&A transaction is the purchase price. Set forth below are several practical ways for parties to reach a successful agreement regarding the purchase price despite coronavirus-related uncertainty.

Post-Closing Purchase Price Adjustments

Most acquisition agreements contain provisions allowing for adjustments to the purchase price after closing, particularly in the form of net working capital adjustments. Net working capital adjustments work by allowing the parties to "true up" the net working capital component of the purchase price, which is typically estimated at the time of closing, with the actual amount of the target company's net working capital at the time of closing calculated after the closing date.

While determining and negotiating the mechanics of the net working capital adjustment, given the impact of COVID-19 on most (if not all) businesses, parties should ask themselves the following questions:

- Given the impact of COVID-19 on the target company, how should "target" or "peg" net working capital be determined? For example, taking an average of net working capital over the last 12 months may not be the best measure.
- When is the closing expected to occur? What impact will the timing of the closing have on net working capital? For example, parties may expect the prospects of a target company to be better if closing is expected to occur in three to six months as opposed to one month.
- Has a review of the impact of COVID-19 on the target company's working capital been undertaken? If so, what was the result of that study? Buyers now have the benefit of observing how a target company has been impacted over several months in the coronavirus world, and any company going through a sale process should be prepared to provide those results.
- How will parties determine inventory levels after closing? It is not unusual for an acquisition agreement to contain a requirement for the performance of a physical inventory in connection with the determination of net working capital. Given the impact of COVID-19 (and social distancing), is taking a physical inventory even possible? How will the parties deal with obsolete inventory?

- Consider whether the response times for providing the post-closing information (and any response thereto) in order to calculate the exact net working capital amount is adequate or if it is likely that more time will be needed.
- Is a collar on the purchase price adjustment to minimize dramatic swings during the crisis appropriate? Parties can incorporate a ceiling (an upper limit to any positive adjustment amount) and/or a floor (a limitation on the negative adjustment amount) to limit the risk for either or both parties.
- How will the parties take into account any loans that a target has received under the CARES Act and the Paycheck Protection Program (PPP)?

Earnouts

Given the impact of COVID-19 on the business of many companies, it is becoming even more common for buyers and sellers to have a disconnect on the perceived value of a business being bought/sold. How can parties bridge this valuation gap to get to a deal?

Earnouts may provide that bridge and are becoming particularly important, and increasingly more common, in acquisition agreements in the context of the COVID-19 outbreak, when the future performance of a business is especially hard to predict. Earnouts are payments with respect to a target company that are contingent on the target achieving certain post-closing milestones, which are often tied to revenue or EBITDA targets.

For example, if a target company achieves revenue of a certain amount during the year (or two) following closing, the buyer agrees to pay the seller additional consideration as part of the purchase price. This contingent consideration serves as a risk-allocation mechanism whereby the buyer and seller can bridge the gap between different expectations for the performance of the target business post-closing.

Given the uncertainty regarding business operations going forward, with the potential for rolling stay-at-home orders and social distancing measures for an extended period, the parties to an M&A transaction must pay even more attention to how an earnout is structured. Set forth below are areas to pay particular attention to when drafting an earnout provision:

- How will the target business be operated post-closing, including with respect to any limitations on how the business will be run after closing in a COVID-19 environment that could necessitate significant changes? How can the seller be assured that the target business will be operated post-closing in a manner to maximize the possibility that the earnout will be paid?
- How will the milestones be set, including both in terms of the appropriate threshold amount(s) and the timing of the measurement date(s)?
- If there is more than one possible earnout payment, how will the parties manage failure to attain a threshold in one year vs. overperformance in another year? Will proration or catch-up payments be permitted?
- What accounting methodologies will apply to the target company post-closing for purposes of the earnout? Will it be the accounting methodology used by the target company pre-closing or the accounting methodology used by the buyer post-closing?
- How will the parties treat any PPP loans received by the target company and the forgiveness thereof?
- What happens if the target company is sold during the earnout period? Does the new buyer assume the earnout? Does the first buyer have to pay all of the earnout at the closing of the sale to the new buyer?

Buyer Stock

Buyers can pay the purchase price in an M&A transaction to the seller in the form of (i) cash (which can be obtained by the incurrence of debt), (ii) stock of the buyer or (iii) a mixture of both. Due to COVID-19, debt markets are tighter, and many potential buyers are hoarding cash until their own operations and the economy as a whole return to some level of stability and predictability.

Given these factors, buyers may find it favorable to use stock as consideration for an acquisition in lieu of cash. From a seller's perspective, the buyer's stock provides upside potential if the buyer's value increases post-closing, as well as the potential for tax advantages over an all-cash acquisition. It is important to engage tax advisors/specialists when considering stock versus cash consideration, and the parties should consider the appropriate share valuation method (fixed, floating or hybrid) to address stock price fluctuations between signing and closing, particularly given the recent extreme market volatility.

Determining the appropriate value for stock consideration will depend on the buyer's prospects (including today in the context of coronavirus), so the seller should consider its expectations for the buyer's stock when negotiating the purchase price in a transaction involving stock consideration.

Distressed Sales

While the CARES Act has made certain changes to U.S. bankruptcy law that distressed companies can evaluate and consider, many companies may be better off pursuing a distressed sale instead of bankruptcy. The valuation of intangible assets such as intellectual property (*e.g.*, patents, brands and know-how) may have dropped significantly as a result of COVID-19's impact, particularly with respect to distressed targets, which may present an opportunity for a tax efficient transaction and a more attractive purchase price.

Depending on the company's asset composition, it may be better to structure the deal as an asset sale instead of a stock deal (or vice versa). These considerations will certainly impact the purchase price and may present options to a target company feeling cornered by the difficult economy, so it is imperative to engage qualified restructuring and tax advisors to advise in these situations. Buyers with available resources will also want to be equipped to take advantage of the opportunities in the market to acquire distressed targets at values well below pre-COVID-19 levels.

Conclusion

COVID-19 has made it even more difficult to value target companies, which is why post-closing purchase price adjustment mechanisms and earnouts are increasingly helpful tools to enable buyers and sellers to reach an agreement and consummate a transaction. Parties should not forget to consider buyer stock as an alternative to cash for the purchase price payment in these volatile times. Further, distressed sales may present new opportunities and options for buyers and sellers alike.

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