Exam in M&A Law

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Part I: Identification and Significance

MAC clauses are a common means of allocating the risks presented by adverse business or economic developments occurring between the signing and the closing of an acquisition agreement. A MAC clause aims to give the buyer the right to terminate the agreement before completion, or to provide a basis for renegotiating the transaction, if events occur that are seriously detrimental to the target assets/company. MAC clause is a part of Acquisition Agreement and may refer to a sharp decline in sales or a regulatory change. Usually involves the preparation of numerous "disclosure schedules" documenting assets, financial information, liabilities, etc.

Indemnification - a provision in an acquisition agreement which states that both parties (seller and buyer) agree to be liable to the other party for losses, damages and breach of representations and warranties. Indemnification provision in a sence is a risk allocating mechanism. There are potentially a conflict of interest between buyer and seller. The former wants to define indemnification broadly, while latter - as narrow as possible. Indemnification also typically includes of the following provisions: basket, survival period, caps, limitations based on knowledge. Efficiency of using indemnification clause is dependant on the interrelations with R&W and closing conditions.

LLC. It is essentially a corporation which is taxed like a partnership but without many of the S Corporation restrictions. A LLC has fewer statutory formalities than a corporation, but it does not provide the full range of exit strategies or liquidity options as does a corporation. It is not possible to grant stock option incentives to LLC employees in the same manner as a corporation. Further, an acquisition of an LLC generally may not be done on a tax-free basis and the expenses of formation are higher than for forming a corporation. LLCs are very often used in JVs and M&A deals, because it has pass through taxation status, flexibility in distributing income, etc.

Right of first refusal. Right to buy stock from the seller before the seller can sell shares to third parties. In fact is a call option for a holder. Rights of first refusal is often used in joint venture agreement: from one hand, it assures parties that they will have a choice of either working with a new partner or not (by accepting an offer). From the other hand,

Financial covenants - a covenant or obligation to meet or maintain certain financial requirements such as minimum working capital requirements, limitation of capital expenditures, EBITDA to debt, etc. Financial covenant may be written as a covenant relating to conduct of business in the master agreements. In this way they are used by buyer as a gap covenant - to assure that seller, for example, will not dispose of main assets of his company, etc.

Drop down is a technique, which can be used for structuring asset acquisition as a stock acquisition. It is used because asset acquisition has several shortcomings: impossibility of a transfer of some licenses and permits, additional liabilities to a buyer, which were not identified, documentation of each asset transferred, etc. Drop down implies that seller creates a newco, where he "drops down" assets together with certain liabilities. Then that seller issues equity, which can be sold to the buyer. In addition to that, creditors of a target company cannot claim on assets of a buying company, because the target company is a wholly owned sub.

Part II: Discuss the Quote

First Quote

> *What structuring considerations and deal structuring devices are considered crucial for maximizing the benefits from the deal and minimizing the negative consequences?*

In a negotiated deal, asset acquisition has several shortcomings: impossibility of a transfer of some licenses and permits, additional liabilities to a buyer, which were not identified, documentation of each asset transferred.

These shortcoming can be overcome by structuring an asset acquisition as a stock acquisition: seller creates a newco, where he "drops down" assets together with certain liabilities. After that seller issues equity, which can be sold to the buyer. In addition to that, creditors of a target company cannot claim on assets of a buying company, because target company is a wholly owned sub.

This stock acquisition can be structured as cash for stock or stock for stock. The latter has a tax free status, where the former implies taxes for selling company.

Fourth Quote

> *...The best way to create the document is to start with a letter of intent (LOI) instead of negotiating the international joint venture agreement immediately...*

Letter of intent (LOI) is a reflection of pre-contractual views of the parties. It is preferable to start with LOI, because it is generally nonbinding (except some provisions)[1] and provides a clear map of future actions and proposes the structure of a transaction.

In fact LOI is a first step in a transaction, which is not very costly to both parties: at this stage parties just agree on basic principles (price, how it will be paid, etc.) and make basic provisions in LOI to protect their time and money spend on the transaction. In addition, LOI may be a sign of good faith and a first step towards building trust between parties.

[1] Most LOI contain a statement that it is nonbinding, however it may be not enough, because court, analyzing the circumstances of negotiations, may determine whether parties had intensions to contract.

After the LOI is signed, parties can engage in a more deep and long process of crafting a master agreement, having an option (LOI) to exit the transaction without significant losses.

Starting directly from JV agreement may result in a loss of time and money to both parties if somewhere in the middle of a process they will find out that they do not agree on basic principles.

Moreover, LOI can give one party an advantage, which could not be achieved in JV agreement. For example, a buyer can insist on (and include) "no-shop" provision that precludes the seller from negotiating with other potential buyers. That will give him a valuable option for a period of time.

Part III: Case Studies and Direct Questions

Alcatel Acquires Its Joint Venture, Shanghai Bell

What possible economic reasons motivated Alcatel to consider acquiring Shanghai Bell? Alcatel decided only to acquire 50 percent plus one share in the "acquisition" which in essence is still a joint venture. What is your opinion of this decisions?

As it was mentioned in the text the main reason for a merger was a wiliness of Alcatel to consolidate Shanghai Bell. However, there are might be also additional economic reasons for that, such as:

Restructuring industry value chain. China is a growing market with a taught competition. But Shanghai Bell product portfolio consists mainly of fixed lines, which prices have fallen 10 times in 5 years. Consolidation of all twelve Alcatel's JVs in China into ASB (Alcatel Shanghai Bell) will create a newco with a diversified portfolio of products. This in turn allows ASB to provide clients with a much wider range of products and services in accordance with "one-stop-shoping" principle. That might be a good way to sustain (or even increase) margins and boost sales in China.

Economy of scale. Pooling old JVs into one company under a global brand can create significant economies of scale in production, R&D, marketing spending, etc.

Intellectual property rights. China is an emerging market with not perfect IP laws in the world. If Alcatel plans to increase significantly R&D expenses in China, it should have a better protection of IP rights, which are crucial for telecommunication market. It may be reasonable to assume that a JV in China does not provide adequate protection of IP rights, so Alcatel shall prefer to acquire it's JVs.

Strategic response to competition. ASB can use it's market power and connections in China's government bodies to block the entry of new competitors, bound their ability to win the governments offers for building telecommunication infrastructure, etc.

> *Alcatel decided only to acquire 50 percent plus one share in the "acquisition" which in essence is still a joint venture. What is your opinion of this decisions?*

There are a number of reasons why 50/50+1 is a good idea: unwiliness of a government to have a foreign company with a higher stake, Alcatel's weak financial situation and a split between ownership and decision making control.

First of all, given the nature of the deal with Shanghai Bell, when government body was not willing to sell it's stake in the company, Alcatel could face the same problem with the other JVs in China. Aggressive attempts to acquire larger stakes could lead to a conflict with a China's authorities. Moreover, China's government could force Alcatel not only to pay higher price for it's stake, but also to take liabilities to invest certain amounts of money.

The latter proposition tightly interacts with the second argument - Alcatel's weak financial situation. With a recession in telecommunication market and, as a consequence, falling profits, sales and a share price Alcatel's management could hardly afford spending more funds on investment and acquisitions of JVs in China, because management have had to pay dividends: investors typically do not appreciate dividends cuts (especially in recessions). In table 1 one can find the dynamic of Alcatel's dividends per share in euro[2]: in 2001 Alcatel had cut total dividends by 67%, so Alcatel had a limited possibility to finance M&A deals.

Table 1. Alcatel's Dividend Payment

Year	1996	1997	1998	1999	2000	2001
Dividend paid	0.30	0.35	0.40	0.44	0.48	0.16
Tax Credit	0.15	0.18	0.20	0.22	0.24	0.08
Total Dividend	0.45	0.53	0.60	0.66	0.72	0.24

Third possible argument favors an idea that there is a split between ownership and decision making control. China is an emerging market and doing business in China is different from doing business in France. Having a larger stakes in companies does not guarantee that Alcatel will have more decision making control - government authorities (as a shareholder) can always use it's political power to achieve it's goals. Given that higher stake does not transform into more control, buying a larger stake may result only in more risk for Alcatel.

Moreover, not equal ownership can create additional worries from the China's part - not equal ownership may be seen as a sign of a distrust or

[2]Source - company website: `http://www1.alcatel-lucent.com/finance/dividend/`

anything similar: this perception may be a reason for a non-cooperative behavior. Working in China without a Chinese partner may be a really bad idea.

The Renault-Nissan Alliance

> *... a draft ... to the Board of Directors ... in which you set out your views with respect to the following issues: (1) ownership and control, (2) the influence of contractual arrangements on maintaining and building trust between the two companies, and (3) exit mechanisms*

Ownership and Control. Assuming, that Nissan is as interested in a JV as strong as Renault is and trust is an important factor of success - it seems that the most appropriate ownership and control structure is 50/50 with equal contributions of money and technologies. This structure from the beginning will assure respect and trust between partners. However, decision-making mechanisms and conflict resolution mechanism are important as well.

Creating in advance a governance structure with a transparent (and clear for everybody) decision-making map, that will clarify which decisions-makers (JV CEO, JV Board, steering committee, etc.) will be involved in which JV's decisions. Assuming that both parties wish to develop Nissan-Renault alliance further, it might be also worth thinking of creating coordination (steer) committees which will try to focus on how to exploit possible synergies in cost-reduction, technology transfer, distribution coordination, entrance of new markets, etc. reporting directly their initiatives to the JV's board.

Creating ex ante conflict resolution mechanism insures that there is less possibility for opportunism in future. Making provisions on deadlock, capital expenditure (investment plan) disagreement, transfer pricing, arbitrage procedures etc., also helps to eliminate conflicts in future.

Trust. Using contractual arrangements can structure the incentive of both partners in a way of reducing risk of opportunistic behavior, hidden actions, etc. However, using too tie provisions can be seen by Nissan as a sign of a distrust. So, we should be very careful trying to balance these two options.

Moreover, credible good faith intentions, which are also proved by specific action from both parties, are as crucial for creating and maintaining trust as contractual arrangements. For example, "gift-contra gift", when parties exchange "gifts" step by step, may be one of a way to build trust. The first action from the side of Renault - to invest money in a distressed Nissan is a good example of a "gift".

Designing exit mechanism is a complicated issue: in the very begining, even the act of a suggestion of exit clause may undermine trust and Nissan may percept it as a sign of a bad faith. For this, reason it will be wise to appoint a separate team to negotiate exit clause after general principles were discussed by business team and agreed from both sides. The design of exit clause is also a controversial issue, because we need to know ex ante at least who we are (seller or buyer near the exit time), when (which events trigger exit)[3], how the exist should be done once exit clause triggered and exit price[4]. Moreover, a good exit provisions combined with other clauses (generally well structured JV agreement) may be seen as a way to overcome problems associated with asymmetric information (hidden actions, ex post opportunism, etc.) and lack of coordination.

Assuming that both Renault and Nissan[5] cannot sustain competitiveness in the global market without each other and the fact that significant part of JVs investments are idiosyncratic[6] the expected life time of a JV should be large enough to profit from these idiosyncratic investments. This is why I believe currently both Nissan and Renault have equal probability to be a seller or a buyer. This is why putting a call or put provision might not be a good idea, because we can with equal probability suffer losses and benefit.

Moreover, it seems for me that we need also to discuss a possibility of an acquisition: if the JV will be successful - sooner or later it will become superior to both Nissan and Renault, so the only way to go further - acquisition when Nissan or Renault acquires the JV and the other party as well.

[3]That might be a breach of contract, inability to reach some business goals, etc.

[4]It might be a fair price provision which implies that an independent advisor will value the stake in the JV or a "buy-sell" provision (e.g. "Russian roulette") or any other

[5]Renault and Nissan are equal JV's partners - both provide financial investment and technology for the JV, both control patterns, etc.

[6]For example, investment in harmonization of platforms, dual usage of factories, some JVs R&D cannot be that profitably exploited by third party.

Project Dragonfly

> *What is the function of (a) Representations and Warranties, (b) Conditions to Closing, and (c) Indemnification provisions, and how do these provisions work together (please give examples)?*

R&W. Representations and warranties are provisions made in an agreement by either party that refer to past/present facts or matters that are important to the agreement. From a perspective of a buyer, R&W are seens as a way of allocating and reducing future risks.

Conditions to close. Provisions in an agreement that specify the conditions which seller has to meet in order to close the deal.

Indemnification provisions. Indemnification section provides such a mechanism, that if one party of the agreement experience losses, which result from the other's party misrepresentation, failure to comply with covenants in the agreement, actions, events (or caused by the other party) for which agreement specifies responsibility and liability, etc.

Interrelations. For example, if a buyer suffered damage after closing resulting from a breach of any covenant or R&Ws proved to be wrong as of singing (or closing) date, than the buyer can waive indemnification rights.

Suppose, the buyer's closing conditions include R&Ws true as of a closing date, while R&W are made of a signing date. If before closing a new fact arises, creating losses, a buyer can terminate agreement (as R&W are not true as of a closing date) or/and waive indemnification rights.

> *Are the provisions (Representations and Warranties, Conditions to Closing and Indemnification) in this agreement "buyer-favourable" or "seller-favourable", and why?*

In order to answer the question we need to know the context of this deal: who are parties, what their negotiation power, goals, characteristics are. This share purchase agreement is very general, sometimes omitting (explicitly) clauses like termination, break up fees, etc.

But in the end, I think this is a buyer-favorable deal, because the purchase agreement is very general and gives the buyer an opportunity to walk away from the deal: there is no explicit termination clause and termination fees. Given such an agreement, buyer can be negotiating analogous deal with other company and use this fact to negotiate price with the IBL Microprocessors N.V. So the seller has no protection from this "walk-away" behavior. Moreover, seller's business operations are restricted for a period since signing (conduct of business covenants).

However some clause might be found seller favorable: narrow definition of seller's R&W, no ear outs, very narrow definition of material adverse effect (MAE), relatively short survive period of R&W and short non-solicitation period (12 months).

MAE definition. Material Adverse Effect is very narrowly defined (See definition) and has a lot of widely defined exceptions:

- "any change in economic or business conditions or industry-wide or financial market conditions generally"
- "any change in local, regional, national or international conditions affecting the Business"

Using words "any" and "conditions generally" may have unpleasant consequences for a buyer if he want to prove there was a material adverse effect. In fact, a MAE definition here does not assume industry risk.

Seller's R&W are quite narrow defined (section 15.1, schedule M), including only basic clauses. However, buyer's R&W are also very general (Schedule N).

Indemnification. Time limitations for claims (survival period) are also quite tight - 12 months (16.2).

There are both clauses for aggregate minimum (EUR 250,000) and minimum claims (EUR 100,000) such that "Purchaser only be entitled to recover losses in excess of such threshold" (EUR 250,000, 16.5). Aggregate liability of a seller is limited by only 25% of a purchase price (16.6)

Contingent liabilities are almost absent and have a very wide definition of exceptions (16.7): "Seller shall not be liable in respect of any: ... "any loss of production, loss of profit, loss of revenue, loss of savings, loss of contract, loss of goodwill or loss of claim or any indirect or consequential losses" (16.7.3).

Closing conditions generally favors a buyer and are very general: R&W are true as of signing and closing date, fulfillment of covenants, no action initiated by the third party or governmental a agency to prevent the consummation of the agreement, etc. However, I also could not find the usage of MAE: in fact, there is no explicit usage of MAE in conditions precedent to purchaser's obligation to close.