KIRKLAND & ELLIS LLP

KIRKLAND **M&A UPDATE**

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Taking Stock — Value Protection in Stock and Mixed Consideration Deals

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

As confidence in M&A activity seems to have turned a corner, the use of acquirer stock as acquisition currency is a serious consideration for executives and advisers on both sides of the table. A number of factors play into the renewed appeal of stock deals, including an increasingly bullish outlook in the C-level suite and higher and more stable stock market valuations, as well as deal-specific drivers like the need for a meaningful stock component in tax inversion transactions (see recent *M&A Update*).

In this light, it is a useful time to discuss a key issue that arises in some deals involving stock consideration – specifically, value protection for target stockholders (and sometimes the buyer) during the period between announcing and closing a deal. Value protection can be an important consideration even in certain cash deals – for example where ticking fees may be useful to incentivize a quick closing or address opportunity cost concerns in a deal featuring a fixed cash price per share (see recent *M&A Update*). But value protection is naturally a greater focus of negotiations in a stock deal because the consideration being offered, the buyer's stock, will certainly fluctuate in value prior to closing a deal.

Fixed Value Deals

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

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

In order to ensure that the number of shares to be issued by the buyer in a fixed value deal remains within a range acceptable to both parties, dealmakers can craft a combination of caps, floors and/or collars on the number of shares to be issued. The exact terms will depend on the value risk, or risks, being solved for. Just to give a simple example – going back to the case of a deal struck for $100 of consideration payable in buyer stock, the parties could agree to cap the number of buyer shares to be issued per seller share at four (i.e., the maximum number of acquirer shares issuable regardless of how far the acquirer's stock price falls). If the buyer's stock price falls below $25 per share, the potential dilution facing its stockholders will be capped, with the target's stockholders absorbing the loss of value if the buyer's price falls below that threshold. In this circumstance, the target may also seek to negotiate a walk away right so that if the cap is triggered, and the buyer's price drops too far, the target can terminate the agreement as opposed to being forced to accept meaningfully reduced value in the form of a capped number of acquirer shares.

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Fixed Exchange Ratio Deals

A fixed exchange ratio deal, in contrast to a fixed value deal, defines a specific exchange ratio at which the target's stockholders exchange their shares of target stock for shares of buyer stock at closing (noting that this construct has dominated most stock deals in recent years). Because the number of buyer shares issuable does not float, if the buyer's stock price moves up during the period between signing and closing, the buyer is effectively paying more in dollar value at closing; by contrast, if the buyer's stock price moves down during that period, the buyer is effectively paying less in dollar value. Under this construct, either party's stockholders could find themselves on the losing end of the value equation and, to the extent stock price shifts cause the resulting value to move meaningfully, it can have implications for either board's recommendation in favor of a deal from a fiduciary perspective and even the banker fairness opinion.

Similar to the "bells and whistles" that can be used to dress up the consideration formula in a fixed value deal, a cap, floor and/or collar on the purchase price can be used to prevent the buyer from overpaying in a fixed exchange ratio deal if its stock price runs up, or to prevent the seller from being underpaid if the buyer's stock price goes down (noting that these protections appear less often than in fixed value deals). Again, to give but one simple example – assume that a buyer is negotiating a stock deal with a target for a fixed exchange ratio of two buyer shares per target share, where the buyer's stock is trading at $100 per share, implying a spot purchase price value at announcement of $200 per seller share. If the buyer wants to protect against overpaying, it can negotiate for a cap on the value of shares to be issued of 10% over the spot price – to the extent the buyer's stock trades above $110 per share during a pre-closing reference valuation period, the exchange ratio would start adjusting down so the target's stockholders receive a maximum per share price of $220 (a corresponding provision could increase the exchange ratio if, for example, the price fell by more than 10%).

Additional Considerations

It is worth noting that value protection can extend beyond the formulation of per share consideration. For example, where there is a discrepancy between timing and/or amount of the two parties' regular dividend payments, failure to properly address equalization of the dividends during the pre-closing period (usually based on the agreed exchange ratio) may result in value discrepancies arising between announcement and closing (with the disparity increasing if the timeline to closing is elongated).

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

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

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