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Ensure That Artful Deals Are Painted With the Proper Strokes

▸Stradling Yocca shareholder Parker Schweich and CU Direct general counsel Erin Wilson discuss recent trends – and important legal considerations – in the high-flying world of mergers and acquisitions.

CCBJ: Please describe some of the recent trends you are seeing in M&A, and what are companies are trying to achieve through mergers, acquisitions and divestitures right now?

Parker Schweich: M&A has been extremely active this year, and that trend is continuing. There are a number of factors that probably have contributed to this: tax reform helped the economy; there's been an easier U.S. regulatory climate; there's a growing amount of cash available to buyers; credit is readily available and inexpensive; and sellers are seeing valuations continue to rise, so it becomes more attractive to sell their business.

On the buy side, deals are being done to acquire more customers, to solve any plateaus a company might be experiencing in its organic growth, or to expand or diversify products and services. Acquisitions of technology also have been playing a role. On the sell side, companies have been divesting business lines that aren't within their core competencies.

Erin Wilson: Another aspect of this is the consolidation of technology platforms, even among competitors. Basically, we're seeing companies consolidate their intellectual property under one platform. "If you can't beat 'em, join 'em" – that kind of thing. If companies are perceiving a possible issue with a competitor, they may go after an acquisition of that company. It can increase their customer base, increase revenue, and eliminate the competitive issues.

Schweich: On a cautious note, given the recent rise of uncertainty and volatility in the markets, companies are being more careful, both on the due diligence side and the integration side, in order to make sure that the growth projections will be met. There are indications that the economy is slowing down a bit, and companies want to make sure that their acquisitions are successful. So they're being a little more careful during the planning stages.

What are some key issues related to that due diligence you just mentioned, and how are transactions being impacted by the new privacy laws?

Wilson: As far as the new privacy laws, it's quite an interesting time, especially with the California Consumer Privacy Act (CCPA) now being used as a model for other states' privacy laws, along with the latest privacy regulations in New York. From my perspective, there is concern. And this goes back to due diligence, because of these new requirements. A company must be able to track every instance of non-public personal information, where it resides, how it's flowing, and the fact that consumers now have an opportunity to request that you remove that data if you do not have a legally required reason to have it. Again, these two issues go hand in hand. If you are acquiring or merging with an entity and those tracking processes are not in place, or they don't already have the ability to remove that information, you may be inheriting liability you didn't anticipate.

Schweich: We're also seeing an expansion of reps and warranties in that space, and possible standalone indemnification as well. Hand in hand with the privacy issues, there is also laser focus on cybersecurity because any companies that have personally identifiable information (PII) are targets. It's very important to confirm that they have the proper systems to protect against hacks or loss of PII.

More generally, there have been many hot-button issues in due diligence lately. Especially in California, there has been a lot of focus on the misclassification of employees as independent contractors. California recently passed legislation that makes it more difficult for companies to classify people who work for them as independent contractors. We've seen in the news the movement toward applying that law to ridesharing companies and the gig economy generally. As a result, from a due diligence perspective, making sure that workers are properly classified is something that everybody on both sides is focused on. And when technology is in play, intellectual property ownership and protection and open source issues are very important parts of the due diligence process – making sure the company owns or has a right to use the intellectual property and that it is protected, especially if that's driving the value of the acquisition.

Parker Schweich is a shareholder in Stradling's Corporate and Securities practice group and is a member of the firm's Mergers & Acquisitions, Public Company, and Emerging Growth practice groups. Parker helps clients raise capital, invest in or acquire businesses, achieve successful exits and navigate the complexities of corporate and securities laws. Reach him at pschweich@sycr.com.

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— ERIN WILSON

In the context of M&A, how should companies identify and mitigate risk? What are some examples of a successful risk mitigation strategy?

Wilson: Some companies have a much higher risk appetite than others, and some are very risk-averse and take a more conservative approach – so the strategies can vary quite a bit. We look at information depending on the structure of the deal. From my perspective, it's crucial to do a 30,000-foot look initially to identify the overarching risks. Once you identify them and see where there may be gaps or areas of higher risk, then you develop your risk mitigation strategy. If it's a rep and warranty issue, you may have a little leeway in how you structure the clauses. But there are some risks that are just so completely inherent that I advise caution. Sometimes something comes out during due diligence that you realize could cause so much liability that you may not have the ability to mitigate it.

Schweich: There's legal risk and then there's business risk, and we try to bring them into alignment. We help the company properly assess the legal risks, so that the company's management team and board of directors can decide if they are comfortable with the business risk of moving forward despite the legal risk – or if it needs to

be fixed. That's always a judgment call that needs to be made. The art of it is figuring out how to find the right balance.

In terms of mitigating risk, there is definitely a lot more negotiation of reps and warranties these days because both sides are usually very focused on how to either shift or share the burden of the risks that are out there. And of course there's the question of indemnification – who will bear the cost of that risk, and will there be any kind of contribution toward bearing that risk, whether through a deductible in the indemnification provision or otherwise? There also has been an increased use of rep and warranty insurance, and that has an impact on the negotiation of reps and warranties and indemnification.

On the business side, when making a decision about purchase price, companies look at the forward projections of the target. A way to mitigate the risk of those projections not coming true is to put part of the purchase price into an earn-out provision. If the target is confident it can hit those projections, and in fact does hit them, the sellers will get an upside benefit. By the same token, if the target doesn't hit those projections, the buyer is protected against that risk by not having to pay the earnout. However, earnouts can bring about litigation risk if the parties disagree on how the business has been run post-acquisition, so it is important for those provisions to be carefully drafted.

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As we reach a longer bull market, companies are being more careful, to make sure growth projections are met.

— PARKER SCHWEICH

Wilson: Another mitigation strategy is the use of a holdback, so that you have those funds available to address certain issues. One of the potential scenarios in these deals is that everybody gets their money and leaves the table, and then something bad happens. People don't like to hear this, but paper is paper. It costs you money to go and enforce that paper. If you have funds in escrow, with the terms of a holdback clearly defined, it makes it a bit easier.

What are some post-acquisition integration considerations and strategies?

Wilson: The best way to go about it is to begin structuring your post-acquisition integration plan while the transaction is proceeding. Processes are very helpful. If you have working processes that can be implemented within the newly acquired entity, that's assistive. Communication is key. In order to successfully integrate post-acquisition, you must have a communications plan that all parties can get behind.

When these kinds of mergers and acquisitions happen, it creates anxiety among the employees, who inevitably wonder if some of them are going to be let go. Your

communication strategies are key to the actual integration of both businesses. When I advise clients, I tell them to structure their communications to be as forthright as possible, but in a way that they're not going to end up stepping on their own feet later. You can lose trust if you tell your people, "Everybody is fine. Nobody is going to get laid off," because sometimes that does happen down the line. So you want to be very careful with what you say and how you structure those communications.

From an IT perspective, it's imperative that you have a technological map of where things are and where they need to be, so that your systems people have a very clear view of your expectations. There's nothing worse than having the IT teams proceeding in a way that's not aligned. Mapping technology and developing a process to get things integrated is important. That means keeping the relevant staff involved. Just including high-level managers is not necessarily the best strategy. You have to have your boots-on-the-ground people included, because oftentimes they're actually doing things in a way that management may not understand, especially if there's not a process document already in place.

Schweich: Along these lines, on the IT side, it's important to make sure that the systems are compatible. I've seen instances where integration has slowed down just because the two companies have completely different IT systems. There's migration that needs to be done, and the earlier the planning starts, the better.

Another consideration is whether the buyer is acquiring a business that has other geographic footprints outside of the ones the buyer already has. Some of those footprints might not fit with the buyer's business plan and might need to be divested or relocated. Other times, a particular geographic footprint might be exactly what the buyer is looking for, but the target doesn't have sufficient critical mass or resources in that geographic area for the buyer's future needs. Early planning for that kind of expansion post-acquisition is key as well.

Employee transfers and determining if there are any redundancies also are important, as well as determining how the organizational chart will look post-acquisition and whether it needs to be restructured. There also could be regulatory considerations, including potential antitrust concerns. If the companies are very large, they may need to figure out whether they will be required to divest some of their business lines.

What are some best practices for communications with employees and the public?

Schweich: Acquisitions are very sensitive projects. When it comes to communications, timing is everything. If information gets out prematurely, it could kill the deal or create other problems if competitors hear about it. The messaging and the timing are both critical. Both parties should be aligned about what the message is and what the timing of it will be, whether it's with employees, customers or the public.

Wilson: When dealing with customers or the public, some deals actually stipulate that both parties must have the opportunity to review and approve certain PR. You don't want to start off a new relationship with one party feeling like they came out looking less than stellar. But internal communications are equally sensitive, if not more so. You should work with your HR group and marketing group to make sure that you are communicating in a way that reaches employees and does not cause any undue angst. You want to make sure that this budding relationship gets off the ground with as few pitfalls as possible. ■