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CROSSING THE BORDER:
Key Legal Considerations in Acquiring a U.S.-Based Company

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Key Legal Considerations in Acquiring a U.S.-based Company

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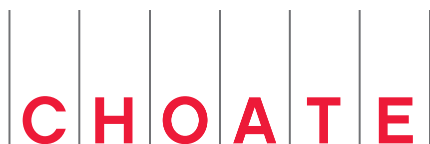

CHOATE HALL & STEWART LLP

INTRODUCTION

This article is intended to guide Irish-based businesses seeking to acquire a business located in the United States, whether an entire company, an operating business unit or select assets. Companies based in Ireland that have achieved a level of commercial success at home often turn their focus to expanding to the United States in order to maximize the value of their franchise. The three main ways for an Irish company to accomplish this are to (a) build a presence organically from scratch (i.e., "greenfield"), (b) leverage its assets through a strategic alliance, and (c) acquire a business.

Although acquiring a business is sometimes perceived as the most risky of the three approaches, this view is not necessarily true. Building operations in the United States by greenfield can be very time consuming, and the success of the effort is dependent on hiring good key managers in the United States. This, unfortunately, is particularly problematic to an Irish-based company because it can be challenging for an expansion-stage Irish company to assemble a high-quality management team in the U.S., and the hiring of an unqualified executive can set back the U.S. expansion significantly. Moreover, in competitive industries most companies need to move at a quicker pace than growth-by-greenfield allows.

While relying on a strategic partner to capture the U.S. market can serve to leverage your assets and gain market share rapidly, partnerships also are not risk-free and have to be actively managed. Strategic alliances need to be carefully structured in order to ensure that the licensor is appropriately compensated for its franchise while the distribution partner is economically incented to promote sales, that intellectual property and developments are protected, that the technology developer has exposure and reach into customers, and ultimately, that the Irish company maintains its independence and strength in the marketplace. An inherent risk of this growth strategy is that it places a company's success in the hands of a third party, with its own changing and unpredictable business, strategic and political ebbs and flows.

In contrast, an acquisition allows an Irish company to obtain revenue, an experienced management team and staff, valuable intellectual property, a customer footprint, and, at times, cash, all in one transaction. Moreover, this can be accomplished in an aggressive timeframe, rather than over the course of years. Finally, because extensive due diligence can be conducted prior to completing the transaction, an acquiring company can reshape the target business and minimize certain risks that it could not otherwise avoid in hiring new employees or partnering with a third party. For all these reasons, acquiring a business may be the right answer to the "buy or build" question confronted by an Irish company looking to expand into the United States.

Understanding the challenges an acquisition may present, of course, is essential for a successful transaction. These challenges include identifying a worthy target, structuring and completing the acquisition in an advantageous manner, and carefully integrating the new business. Based on our experiences working with Irish companies acquiring businesses in the U.S., an Irish acquirer would be well served to consider the points below as they work to shape a successful transaction.

DISCUSSION

Be Confident, Opportunistic, and Aggressive – Proper Mindset is Vital.

In order to lead a global market, an Irish-based company will almost certainly have to conduct one or more acquisitions at some point in its lifecycle. Consequently, it is important that the management team understand this in advance and continually be on the look-out for quality targets to acquire. Successful companies regularly update a landscape analysis, think outside the box, network across their industries and competitors, and cultivate and pace a number of possible business relationships. Although a strong management team would be wise to incorporate such a transaction in their long-term business plan, quality opportunities rarely present themselves in accordance with the timing of these plans. Because of this, a company needs to be opportunistic and act when the right opportunity presents itself, not just when the business plan calls for action. Although a company may believe it is not yet ready to be an acquirer, an attractive seller will always find a buyer, and it may be important for a growing company to act sooner rather than later, whether to take advantage of a unique opportunity or to prevent a competitor from seizing the opportunity. First-time management teams face a learning curve in acquisitions. Those burgeoning teams, however, often find that they are more capable in assessing and managing a combination than their target-company counterparts, despite the name recognition and market share those targets may have achieved.

In Planning for the Process, Allow Sufficient Time and Commit the Necessary Resources.

Acquiring a business requires extensive time and resources, often more than is initially expected. It is not uncommon for a deal, from the time of the first conversation to completion, to take twelve months or more. In addition, the process will serve as a significant drain on the resources of the management team, as they will have to conduct the transaction and may also need to obtain equity or debt financing to fund the transaction. Consequently, between their regular responsibilities of running their business and the work required to make a transaction successful, the management team can expect to work almost two full-time jobs when the process hits the critical stages. Because of this, a company will need to plan well in advance and should consider whether they need to supplement their management team through additional hires to support key functional areas and provide leverage to senior executives, or through the engagement of a consultant with meaningful experience working on acquisitions.

Find the Right Target…Use Your Full Network and Your Professional Advisors.

One of the most important considerations in a successful acquisition, of course, is acquiring the right target. Unfortunately, this can be one of the most difficult parts of any acquisition, and a company based in Ireland seeking to acquire a U.S.-based company has further challenges because it resides outside the geographic market. Because of this, it is vital that a company use all of the appropriate people in its network, including lawyers, financial advisors, accountants and industry connections, to help identify and qualify an attractive target. A company should also consider whether it is appropriate to engage a corporate finance firm to identify targets, or short of a formal engagement to make its interests known to reputable investment banks active in the industry. Of course, a company also would be well-served to work closely with Enterprise Ireland in identifying a target as they can provide invaluable assistance.

There are a number of steps a management team can take to increase the chances of identifying a high-quality target. These include getting to know the key personnel at other companies in the relevant industry. In addition, an opportunistic company should consider whether large corporations in the industry have "orphan technology" or are looking to divest certain business units; oftentimes these companies themselves have acquired other companies and have assets that are not core to the combined business. In addition, a good business case frequently can be made to acquire a strategic partner, and numerous benefits can be obtained by acquiring a competitor. Once a short list is established, a buyer should again utilize its broad network to evaluate the business and financial case of the possible transactions, as well as its ability to complete a deal on favorable terms.

Enter Into a Mutual Confidentiality Agreement, but Pay Close Attention to the Terms.

A confidentiality agreement is the mechanism used by a company, when it discloses certain information to a third party, to protect itself from misuse of disclosed confidential information by the recipient. This agreement is typically entered into before meaningful discussions begin. Because the potential target in an acquisition is the side that primarily is disclosing information, it is the party that has the strongest interest in ensuring such an agreement is in place. However, oftentimes it is appropriate for the confidentiality agreement to be mutual in nature, as a buyer will also be disclosing sensitive information about its own business and financial affairs as a condition to the target's commitment to considering engaging in an acquisition transaction. This concern on the part of the buyer is heightened in scenarios where it proposes to deliver equity to the target as all or a portion of the consideration for the transaction.

Confidentiality agreements typically contain provisions that go beyond the protection and use of confidential information, and a buyer should be sure to take special care in reviewing these points. These items include non-solicitation or no-hire clauses, standstills and restrictions on the ability to contact employees, customers and suppliers of the seller. Because of all this, the same form may not be desirable or appropriate for all deals and parties, even if the proposed deal is of a similar nature to a previous one. Business people at times view NDAs as one-size-fits all, but important variances lead to trouble if the deal does not go forward.

Tremendous Value Can Be Lost, and Significant and Unnecessary Deal Costs Can Be Incurred, Based on the Letter of Intent.

A letter of intent (a "LOI") is a preliminary agreement entered into by a buyer and a seller summarizing the negotiated and agreed-upon terms of the transaction. Although these agreements are generally non-binding, they often do contain certain provisions that are binding. Moreover, the expectation is that both sides will adhere to its terms unless a party can demonstrate that subsequently acquired information requires a revision of one of the agreed-upon points.

Because of this, a prospective buyer would be well-served to have sophisticated guidance as they negotiate the LOI; it has been our experience that all too often companies give up value and significant negotiating leverage by signing an LOI without first obtaining input from people sufficiently experienced in acquisitions. The LOI stage is where a buyer can obtain the most value from its advisors that are commercially-oriented in terms of economics, terms, leverage and process. As an example, the structure of the proposed transaction, including the relevant tax implications, will have a significant impact on the overall value to both the buyer as well as the target's owners. Accordingly, it is critical that the structure and material terms be fully considered in advance and accurately reflected in the LOI. Another important, and binding, provision of an LOI is an exclusivity

period, ensuring that the buyer has the undivided attention of the target. Overall, an Irish-based buyer should be fully educated and advised on U.S. customs, terms and practices prior to agreeing to the provisions of the LOI. A buyer that is not sufficiently familiar with prevailing norms may agree to certain requests of the seller at the LOI stage without realizing they conceded real value or agreed to non-market terms, and it can be difficult to make amends for such concessions at later stages in the process.

As a further point on nomenclature and to be U.S.-facing, it is indeed a "Letter of Intent" or "Term Sheet", and not a "Memorandum of Understanding" or "Heads of Agreement."

Price is Just Part of the Overall Negotiation.

While the purchase price is clearly an important term, and one that receives the very close attention of the parties, it is only one of numerous negotiated terms that can have a significant financial impact on the buyer. Other key provisions directly impact the business case of the proposed transaction and can (and, at times, should) serve as "walk away" points. These include the form of currency (cash, notes or shares); the timing of payment and whether price and payment is subject to an earn-out or other contingencies; the level of recourse from representations and warranties and the indemnification obligations; whether the closing will occur some period of time after the signing of the definitive agreement and, if so, the legal and business conditions to the closing; the treatment of employees, including whether incentive payments will need to be made in order to motivate employees to continue to remain with the acquired business; and target-company management commitments. All of these provisions will significantly impact the value of the overall transaction, as much, if not more so, than price. In fact, spending (or saving) a few percentage points on the purchase price most likely will not make or break your company, but it is possible that unsatisfactory resolution of one or more of these issues could.

Be Creative: You Have More Purchasing Power Than You Think.

Oftentimes, Irish companies desire to acquire an attractive target but may not move forward because of the magnitude of the total consideration involved or because they don't believe they can fund a purchase price in line with the seller's expectations. This view often results from too much focus on the cash component of the purchase price and overlooking additional forms of consideration that a buyer can offer. By paying the cash component out over time, and by including additional forms of consideration, a buyer's purchasing power far exceeds the cash on its balance sheet. By being creative in structuring the purchase price, a company can offer more value to a seller than it initially may believe.

Earn-outs (i.e., payments made out over time as milestones are achieved) and performance-based employment contracts to key members of the seller's management team are examples of effective ways to increase the overall purchase price without increasing either the amount to be paid at completion or the overall risk of the transaction. In addition, seller financing is an option, and a seller will often agree to have a portion of the overall consideration structured as a promissory note to be paid over time following the completion date. Moreover, sellers often agree to have all or a portion of the consideration consist of equity of the buyer, and in fact they may insist on this if they strongly believe in the business case of the transaction and the prospects of the buyer or desire to defer the U.S. taxation on their gains.

In addition, buyers should also consider whether obtaining outside acquisition financing for the transaction makes good sense. This could include an equity infusion from a venture capital or private equity firm, or the public markets if listed, as well as a credit facility from a lending source.

Deal Terms in the U.S. – and Deal Structures – Differ Greatly From Those in Ireland.

There are significant differences between U.S. and Irish practice between the various acquisition structures and the common market norms. Because an Irish acquirer does not reside in the U.S. marketplace, it is vulnerable to a U.S. seller that selectively chooses those structures and terms that work to its advantage. Consequently, an Irish buyer approaching the U.S. markets would be well-advised to become educated on prevailing practices in the U.S.

For instance, it is common in the U.S., certainly more so than in Ireland, for a buyer to require a portion of the purchase price to be paid into escrow managed by a third-party financial institution. This escrow provides a source of recovery for damages that result from breaches of representations and warranties. In addition, on a more granular level, differences with regard to provisions such as representations and warranties, closing conditions, covenants -- and even which U.S. state's law governs the transaction – can raise material issues.

Another key distinction in practice in the U.S. is that acquisitions may be structured as a merger. A merger is a transaction in which one corporation is legally absorbed into another in accordance with the procedures established by the states of incorporation of each of the participating corporations. Upon the consummation of the merger, the surviving corporation becomes the owner of the properties and rights of the merged companies and assumes responsibilities for all of their liabilities. One key advantage of a merger over a stock purchase is that all of the target's stockholders are bound if the vote required by statute and the charter are obtained. Put differently, the stockholders who dissent from the transaction are forced to go along as a matter of law, and their sole remedy typically is limited to demanding payment for the fair value of their shares. Thus, the transaction does not depend upon reaching an agreement with each stockholder, or upon each stockholder

actually executing the agreement and delivering their shares. This serves to expedite the timeframe of a transaction and minimize the risk of late-stage negotiations with a recalcitrant stockholder or having to accept a dissident minority stockholder. In addition, because of applicable tax regulations in the U.S., structuring the transaction as a merger offers significant advantages to both the target and the acquirer.

Auctions: Proceed with Caution.

It is not uncommon for a seller to put itself on the market for sale by conducting an auction process. Although good businesses can be acquired at good values in auction scenarios, experienced acquirers understand that they need to act with discipline in these instances. If a prospective buyer falls prey to "deal frenzy," due to the competitive process, they may well subsequently learn that they overpaid for the business, failed to ask for attainable commitments or proceeded too hastily and without conducting sufficient due diligence.

When a buyer does participate in a bid scenario, it greatly increases its chances of success when it keeps in mind the strategic goals of the seller and its various shareholders. While sellers certainly want to obtain the maximum value for its business, they also place a high value on the certainty of the deal ultimately closing; they've put themselves out to market and can incur significant damage to their business if a deal ultimately doesn't get done. A prospective buyer that presents itself as the bidder most likely to be able to consummate the transaction stands a solid chance of being the winning bidder even if its offer, although competitive, is not the highest submitted. In addition, each of the seller's shareholders has certain goals it wishes to achieve from the sales process. For instance, shareholders that are also part of the management team will pay close attention to their role with the combined company moving forward. An astute buyer will ascertain who holds the key votes and assess each such shareholders interests and shape the bid accordingly. Ultimately, a prospective buyer in an auction scenario doesn't always have to be the highest bidder to prevail if its bid contains other attractive features.

Cultivate a Deal Shepherd Within the Target.

Skilled acquirers work to have a "deal shepherd" on the other side of the transaction. This is a person, whether a key employee, key shareholder, or a director, that can serve as a helpful point of contact. Having someone inside the seller that understands the business case for the transaction and serves as a proponent for the deal among the various constituencies of the seller can be invaluable when the transaction hits the inevitable sticking points. An important item is quickly assessing the ongoing role and personal objectives of target management. In addition, although the goal is not to have someone that improperly will provide you with confidential information of the seller, establishing a channel for informal communication can be very helpful. This, of course, can help facilitate bringing the transaction to completion and assist in focusing the diligence review. It can also assist the buyer in planning for post-closing integration matters, such as providing insights as to the status of the intellectual property, employee morale, who actually are the vital employees, etc. In cultivating a deal shepherd, a prospective buyer does need to be sure to tread carefully in order to avoid violating agreed-upon process or inadvertently creating political issues.

Find the Skeletons Before You Own Them: Always Conduct Extensive Due Diligence.

Conducting due diligence (i.e., a review of the background and condition of the seller) is vital to get a full understanding of the contracts, litigation, finances, and other business affairs of the seller. The goal of diligence is to uncover any potential opportunities and problems, and have a understanding of and integration plan for the business, before the transaction is complete. In an acquisitions context, surprises are rarely good.

In general, the key areas of focus consist of (a) general corporate matters, (b) financial, accounting and tax matters, (c) technology and intellectual property, (d) product and service offerings, (e) commercial partnerships, (f) operations, (g) sales and marketing, (h) human resources and employee matters, and (i) legal and regulatory. The review, of course, is also shaped by the unique needs of the industry as well as by the focus of the buyer and the seller. Within each of these rough categories, it is not uncommon for the requests to be of two natures, some requests consisting of document request while other questions to be addressed in management presentations and conversations.

Savvy acquirers will also be sure to examine the social issues and cultural differences between the two companies, and this is of heightened importance when a company is acquiring a seller outsider the acquirer's current geographical base of operations. In addition, a buyer should ensure that it reviews projections and reports actually used by the target rather than relying on reports and other projections specifically prepared for the sales process. Furthermore, a potential acquirer should always visit the target's offices and meet with the top management team and other key employees. Customer diligence is a critical step in the process, and negotiation often centers on the level of progress to be achieved in the transaction before the buyer has access to the seller's customers.

In the U.S., the due diligence process can sometimes be less adversarial and more informal than the manner in which the process is conducted in Ireland. Because due diligence begins very early in the transaction process, the proposed deal is still very much conditional and little-to-no momentum has been established when the due diligence commences. In most cases, it is best for the buyer to approach due diligence as an iterative process, with the initial focus on the business case and utilizing the buyer's team across all functional areas. In addition, if there are sensitivities around the transaction, such as in an auction

context where there are other bidders or in scenarios where the prospective seller still has not committed itself internally to ultimately selling, a buyer may want to have a shortened "priority diligence review" early in the process, followed by a more thorough one as the momentum builds and the transaction becomes more likely.

A buyer can expect, almost without fail, that a seller at some point in the process will complain about the disruptive nature of the diligence process and contend that the buyer has seen all that it needs. Given this, a buyer needs to be able to judge whether the complaint is something that is just to be expected from the process or if there is some legitimacy behind it. Ultimately, anything that can impact pricing or materially impact post-closing integration is fair game for review.

Don't Forget About Employees.

This seems like an obvious point, but parties often overlook specific employee issues until deal terms already have been shaped and agreed upon. Prospective buyers should look at all employment contracts, stock and option vesting and non-competition agreements early in the process. It is important for a buyer to have a strong sense as to what the employees are receiving as a result of the transaction and how the employees perceive the transaction's impact on them. This is particularly important for an Irish company that is using a transaction, in part, to accelerate its expansion into the U.S. by acquiring an employee base. At times, these arrangements have to be renegotiated prior to acquisition, and this requirement should be communicated at the right time so that the opportunity is not lost. In addition, the legal and business analysis should include close focus on essential questions such as the roles of each of the employees going forward in the combined company and which employees are going to head up major operational functions in the combined company. An Irish buyer should be sure to be aware that the use of term employment agreements in the U.S. are much less common than in Ireland and should take appropriate steps to ensure that it does not inadvertently create any such contracts.

A buyer also needs to ensure that the employees of the acquired company will be sufficiently motivated to remain with the combined business and continue in a productive manner. Any additional consideration, whether in cash or equity, that a buyer needs to deliver to retain employees serves to increase the purchase price. Consequently, it is important to get these issues out early in the process to ensure they are included in the discussions as to the amount of the overall purchase price. It is not uncommon for buyers to net retention pools against the purchase price.

Finally, a buyer also should consider the impact on its own employees. Social issues could arise during the post-deal integration if the buyer is obligated to provide more attractive salary and benefits to the employees of the acquired company than it provides to its own historic employees. This issue takes on added importance when a buyer already has some operations and employees in the U.S. but will significantly increase the number of its U.S. employees as a result of the transaction.

Crossing the Border Raises Both Cultural and Technical Issues.

An Irish-based company acquiring a business in the U.S. will confront numerous challenges resulting from the cross-border nature of the transaction. Some of these, such as differences in the diligence and disclosure letter process, the availability of the merger structure, the challenges of identifying an attractive target outside a company's home market, and the need to address appropriately the employee and social issues, have been discussed above. Numerous other issues will confront the Irish acquirer, and how they are addressed will determine the success of the acquisition.

An Irish-based company attempting to acquire a business residing in the United States should be aware that it might face a certain degree of skepticism from its intended target. This skepticism can reside in the directors and key shareholders, who might question the capability of a company with which they had little to no prior interaction and which likely has little operations in the U.S. to consummate successfully a challenging acquisition. U.S. employees, too, might have certain concerns about being employed by an Irish entity. Because of this, an Irish-based company should plan to spend more time "selling" the transaction and the potential opportunities than if they were acquiring a company located in Ireland. Moreover, an Irish company can increase their credibility with the prospective seller and its advisors by assembling a team, including accountants, lawyers, and financial advisors, that have demonstrable experience executing similar transactions.

In addition, the technical complications raised by a cross-border transaction result in the transaction more likely to falter due to reasons other than business issues. Sellers typically expect the transaction to be documented on "U.S. paper," both for tax reasons as well as to minimize the number of unknown variables relating to the most important transaction in their entity's lifecycle. Moreover, an Irish acquirer will need to ensure compliance with U.S. securities laws in connection with both the inclusion of equity in the deal consideration as well as post-completion option grants intended to retain and motivate employees moving forward. Special care, too, will need to be paid to both the U.S. and the Irish tax regimes; an Irish buyer will want to maximize the advantages afforded by Irish tax regulations while also ensuring compliance with U.S. requirements.

Don't Forget to Run Your Business, and Run it Normally.

As noted above, negotiating and executing an acquisition potentially can be time intensive and serve as a significant drain of the resources of the management team. Notwithstanding this, a prospective acquirer still must continue to run its business and perform in accordance with its business plan. This takes on added significance if the company has to satisfy bank covenants in credit documents or meet the expectations of its equity investors, whether they are venture investors or holders

of publicly-traded shares. Moreover, continuing to meet or exceed performance milestones while negotiating a transaction can actually serve to facilitate the transaction, as it preserves the prospective buyer's credibility and negotiating leverage with the seller and could make it an even more compelling suitor, especially if equity constitutes a portion of the deal consideration. Furthermore, continuing to meet operational milestones will strengthen a prospective buyer's position in pursuing acquisition financing from debt or equity sources.

There are certain measures a prospective buyer can employ to help ensure that pursuing a proposed acquisition does not overly hinder the day-to-day running of its business. As noted above, a company should determine well in advance of commencing its acquisition efforts whether the management team needs to be supplemented to implement the plan. In addition, a prospective buyer should carefully limit the number of employees that have knowledge of the acquisition efforts, as widespread knowledge of such plans will serve only to distract the employee base from performing their functions.

SUMMARY

As an Irish-based company considers the "build-or-buy" dilemma, it should give fair consideration to pursuing an acquisition, whether of a stand-alone company or an undervalued business residing in a larger enterprise. Although acquisitions are perceived in some quarters as a higher-risk approach, this need not be the case. The "build" approach – whether by greenfield or by entering into a strategic alliance to leverage existing assets – also contains inherent risks, including being the slower path to growth in a competitive landscape and reliance on a third-party. Moreover, a carefully-executed acquisition strategy, complemented with a well-implemented integration plan, can minimize many of the risks that accompany acquiring a business. Consequently, Irish companies can overcome scaling issues, and successfully expand into the United States, through the implementation of well-considered acquisition activities.

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