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KEY SERVICE INSIGHTS

MERGERS AND ACQUISITIONS NEWSLETTER

FOLLOW THE CASH FLOWS OF THE ACQUISITION TO UNDERSTAND THE TRUE RETURN TO THE SELLERS

Cross-border acquisitions usually have additional complexities as the laws of more than one country must be planned for and coordinated. Typical acquisition planning in one country may be different than in another country. A structure that is common in one country may significantly change the deal for an acquiror or target in another country.

In a deal where we represented the target that was a U.S. domestic partnership being acquired by a fund located outside the U.S., the letter of intent required the primary owner ("*Owner*") of the target to loan $5 million to the acquisition company ("*Newco*") to fund part of the purchase price and Newco would then repay the Owner in seven years. The Owner agreed to the loan as the acquiror agreed to pay ten percent interest on the loan.

Once the cash flows to repay the loan were detailed, the economics of the repayment of the loan did not result in the benefits the Owner thought they were receiving. This was certainly intentional on the acquiror's part and the issue with the cash flows was not caught by the target's corporate counsel during the drafting of the letter of intent, which the acquiror used in later negotiations.

The Owner sold a portion of their equity interest in the target to Newco (*new entity formed to acquire the target*) and exchanged a certain portion of their equity interest in target for equity interest in Newco (*typical equity rollover transaction*). Newco would initially enter into the $5 million loan agreement with the Owner after which Newco would assign the loan to Topco (*new entity formed as blocker corporation*) who owned the remaining equity interest in Newco. Topco was wholly owned by the fund that was the true acquiror of target.

For purposes of this illustration, it is assumed that Owner received forty-five percent of the equity interest in Newco with the balance of the equity in Newco being owned by Topco. Topco would receive an annual fee from Newco to fund the annual interest payment and Topco would have a receivable from Newco to repay the $5 million principal on the loan.

An issue with the proposed loan structure is that the Owner would be repaying themselves indirectly forty-five percent of the $5 million loan and the interest payments as the loan is being funded by Newco. Instead of receiving ten percent interest, the Owner was receiving five and a half half percent interest. Further, as the loan was initially structured, instead of receiving repayment of $5 million from the acquiror, the Owner would be receiving $3.75 million from the acquiror and paying themselves $2.25 million through the Owner's pro rata ownership in Newco.

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The issue with the principal repayment was pointed out to the acquiror and the acquiror agreed the loan principal would only be repaid against the acquirer's interest in Newco. If this was not pointed out to acquiror, the acquiror was more than happy to essentially swindle the Owner out of $2.25 million.

The acquiror was not agreeable to changing how the interest payments were paid however and referred to the letter of intent in its refusal to cover the full interest payments. To move the deal forward, the Owner eventually agreed to receive the lower interest rate of five and a half percent. By not understanding the flow of funds at the letter of intent stage, the Owner lost a substantial part of the benefit they thought they were receiving through the interest payments on the loan.

It is important that the target has appropriate professionals that understand both tax and the cash flow of the transaction at all stages of an acquisition including the drafting of the letter of intent. While all parties may be eager to get a deal done, the acquiror's interest is to get the best deal for their stakeholders and this does not typically coincide with the interest of the sellers. In order to try to avoid conflict, the acquiror will sometimes employ tactics that seem like the seller is getting the benefit they bargained for, but once the tax and cash flow implications are revealed, the acquiror has in fact clawed back part of the purchase price from the seller.

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