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Stock-for-Stock Mergers During the Coronavirus (COVID-19) Crisis – A Potential Strategic Solution

Client Alert | October 5, 2020

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The widespread economic uncertainty caused by COVID-19 poses distinct challenges for buyers and sellers seeking to identify M&A opportunities, as companies evaluate the impact of the pandemic on their businesses to date, and seek to predict its future impact. Continued volatility in the financial markets and the lack of visibility into how the pandemic will affect the global economy in the near or longer term, as well as the pace and scope of economic recovery, introduce elements of conjecture into the valuation process. Securing financing for a transaction is also likely to be difficult, as traditional credit providers may be reluctant to lend, particularly to borrowers in sectors that have been more severely impacted by the crisis.

Buyers and sellers struggling with these challenges may find that stock-for-stock mergers offer an attractive option. Transactions based on stock consideration can enable the parties to sidestep some of the difficulties involved in agreeing on a cash price for a target, by instead focusing on the target's and the buyer's relative valuations. In addition, using stock as consideration allows buyers to conserve cash and increase closing certainty by eliminating the need to obtain financing to complete a transaction.

The extent and duration of COVID-19's impact on M&A activity, and whether companies will trend toward stock-for-stock mergers in lieu of cash acquisitions, remains unclear. However, recent stock-for-stock deal announcements such as Analog Devices's $21 billion acquisition of Maxim Integrated Products, Just Eat Takeaway's $7.3 billion acquisition of Grubhub, Uber's $2.65 billion acquisition of Postmates, Chevron's $5 billion acquisition of Noble Energy, Clarivate plc's $6.8 billion acquisition of CPA Global and Builders FirstSource's $2.46 billion acquisition of BMC Stock Holdings suggest that companies may be more inclined to opt for stock-for-stock mergers against the backdrop of continued valuation and financing risks.

While stock-for-stock mergers may help parties address certain issues posed by the current climate, these transactions also raise concerns that do not arise in cash acquisitions. In particular, a company contemplating a stock-for-stock merger should consider the following:

Valuation issues. Setting the exchange ratio in a stock-for-stock merger requires the parties to determine their relative valuations, which, at first blush may seem easier than agreeing on a direct value for the target in a cash merger. However, stock-for-stock mergers do not eliminate difficult valuation issues, particularly if the parties are in different industries or at different stages of their development. The pandemic is likely to make valuation issues even more challenging if the parties have been impacted in dissimilar ways or levels of severity by the effects of COVID-19, or if the parties have different outlooks regarding the pace and scope of their respective recoveries.

The parties must also determine if a control premium is appropriate, and the size of any premium. A target will generally seek a premium to its current market value for a sale of control, and the demand for a premium may become more forceful if the target believes that its shares are undervalued due to general market or industry conditions. The buyer may resist this demand, arguing that the shares are not undervalued, and that in a stock-for-stock deal, unlike a cash deal, the target's stockholders will have an ongoing equity stake in the combined company enabling them to benefit from any merger gains. In most cases, however, the buyer accepts the target's arguments and agrees to build a premium into the exchange ratio.

Not every stock-for-stock transaction will include a premium, however. In a deal that the parties characterize as a merger of equals, the parties may agree that a premium will not be paid because neither party is acquiring control. They reason that the two companies' respective stockholders should benefit pro rata from gains realized by the combined company, and set the exchange ratio so that it simply reflects the companies' relative valuations.

Decisions regarding whether a premium is appropriate and the size of the premium will be carefully scrutinized by stockholders, activists and plaintiffs' lawyers. As a result, the parties should be prepared to defend their deal based on the companies' relative valuations, the prospects of the post-merger business and applicable factors impacting industry or stock market conditions generally.

Fixed vs floating exchange ratios. Stock-for-stock deals are structured using either a fixed exchange ratio or a floating exchange ratio. Fixed exchange ratios are based on the relative market values of the buyer and the target; floating exchange ratios are designed to ensure that target stockholders receive buyer shares with a specified dollar value. Floating exchange ratio deals do not present the same advantages as fixed exchange ratio deals in today's environment. The parties cannot simply assess relative market values, but instead must determine a fixed value per target share, which is a difficult exercise when markets are volatile and forecasting future performance is difficult. But if the target successfully demands that its stockholders receive a specified price, the buyer may acquiesce, reasoning that a floating exchange ratio deal remains attractive because it can avoid using cash, reduce financing risk and increase closing certainty.

Collars and walk-away rights. Using stock consideration poses certain risks. When the exchange ratio floats, the buyer takes the risk that its stock price falls between signing and closing, forcing it to issue more shares at closing and diluting its existing stockholders; when the exchange ratio is fixed, the buyer takes the risk that its stock price rises between signing and closing and it overpays for the target. The target's risks run in the opposite direction: it takes the risk that the buyer's stock price falls between signing and closing when the exchange ratio is fixed, or that the buyer's stock price rises between signing and closing when the exchange ratio floats, and, in each case, that its stockholders feel they have received insufficient value.

Pandemic-related market volatility and uncertainty about the pace of economic recovery may make parties more sensitive to the risks of using stock consideration. To address these risks, parties to a stock-for-stock merger may consider using mechanisms that were not commonly used before the pandemic: collars and/or walk-away rights based on stock price.

Collars provide a hedge against significant fluctuations in the buyer's stock price between signing and closing by establishing upper and lower limits on the number of buyer shares and/or the value of the consideration that will be required to be delivered to target stockholders. A collar assures each party that the merger consideration and dilutive effect of the transaction will remain within negotiated parameters.

To further mitigate risk, the buyer and target may include a "walk-away" right for one or both of the parties if the value of the buyer's stock drops below a designated threshold (walk-away rights are rarely triggered by increases in the buyer's stock price). This right may be structured as either a closing condition or termination right (with or without associated termination fees). If the walk-away provisions are used together with a collar, the walk-away price may be set at, below or above the level of the collar's "floor." Like collars, the parties have broad flexibility to craft the walk-away provisions to achieve their desired results. For example, if the exchange ratio is fixed, the agreement may provide that if the buyer's stock price falls below the negotiated threshold: the buyer may elect to "top-up" the consideration either through cash or shares, otherwise, the target can walk away, or that the target may choose to either walk away or require the buyer to issue more shares by flipping to a floating exchange ratio.[1]

Walk-away rights have not been used frequently in the past, in part, because a board of directors considering whether or not to exercise a walk-away right is in a difficult position. Issues a board must resolve include: should the board undertake a new analysis of the fairness of the transaction, including obtaining an updated fairness opinion? If the company's stockholders have already approved the merger, how should this affect the answers to these questions? Board decisions regarding walk-away rights are likely to be subject to the same scrutiny, second-guessing and challenges as the board's decision to approve the merger. If the board chooses not to exercise a walk-away right, and the merger ultimately turns out badly for the company's stockholders, will the directors be sued? If the board does exercise a walk-away right and, in hindsight, it appears that the merger would have benefitted the company's stockholders, will the directors be sued?

As noted above, collars and walk-away rights were not common pre-pandemic, and we have not noted a significant increase in their use in recent months. However, parties may consider using these somewhat unusual features in response to these highly unusual times.

Fiduciary duty issues for boards. The COVID-19 pandemic may place additional pressure on a board's decision to approve a business combination (or to exercise a walk-away right). In Delaware, a stock-for-stock merger in which no single person or "group" will control the combined company is generally not subject to the value maximization imperative of a sale of control or to enhanced judicial scrutiny under *Revlon Inc. v. MacAndrews & Forbes Holdings, Inc*. If the target does not have a controlling stockholder, and a majority of its directors are disinterested, the decision to merge should be entitled to the protection of the business judgement rule. As a result, the directors should have broad discretion to approve a stock-for-stock merger that the board believes in good faith is in the best interests of the company and its stockholders.

Even if *Revlon* duties do not apply, the target board is likely to feel significant pressure to make the best deal possible under the circumstances. The board's decision to combine is highly likely to be second-guessed under any circumstances, and even more so if the transaction is undertaken during a period of perceived overall economic risk. The board must assess whether it makes sense to combine at this time despite the current difficulty in projecting the companies' respective future recovery, growth and prospects. Target stockholders may criticize the board for selling too low if the buyer is seen as taking advantage of the target's falling stock price. If the company believes it has a solid plan for recovery, it must consider whether the company will be better off on a standalone basis, or if the combination will bolster its recovery. Before approving the merger, the board should be comfortable that it can defend its decision that the merger is in the company's best interests.

Governance issues. Because target stockholders will have a stake in the combined company post-closing, the parties to a stock-for-stock merger are more likely to be sensitive to governance and social issues than they would be in a cash merger. The relevant issues include, among others, the composition of the combined company board and senior management team and the name of the combined company. Negotiations of these issues can be tricky, particularly in a deal that the parties consider a merger of equals, where there is likely to be even more intense focus on who serves in management roles at the combined company. The current economic crisis may raise the stakes riding on the outcome of the governance negotiations, particularly if the parties' respective management teams have different strategies for dealing with the pandemic and its consequences. Enforcing post-closing agreements on these matters is also difficult. To address post-closing enforcement concerns, the parties may consider expressly including their agreement on governance matters in the combined company's charter, to be effective as of the closing, and requiring supermajority board and/or stockholder approvals to amend the relevant charter provisions.

COVID-related deal terms. Deal negotiators should consider whether and how the merger agreement terms, such as representations, MAE definitions and post-signing covenants, should be revised as a result of the pandemic. Please refer to Gibson Dunn's Client Alert entitled "M&A Amid the Coronavirus (COVID-19) Crisis: A Checklist"[2] for a detailed discussion of these issues. Most stock-for-stock transactions will contain certain reciprocal provisions, including representations and interim operating covenants. In considering whether to make COVID-specific revisions to these provisions, a party should either be prepared to accept the same terms for itself, or justify why reciprocity is not appropriate. Negotiations on these points may also be complicated by situations where the parties' operating results and/or stock prices have not been similarly impacted by the crisis.

Diligence. The target's diligence of the buyer in a cash merger is typically limited to assessing the buyer's ability to perform its obligations under the transaction agreements. However, because the target's stockholders will receive the buyer's stock in a stock-for-stock merger, the target is more likely to comprehensively diligence the buyer. The mutual diligence effort in a stock-for-stock merger may lengthen the timeline, and increase the complexity and expense of the transaction.

Buyer Stockholder Approval. The buyer's stockholders may be required to approve certain stock-for-stock mergers, *e.g.*, if the buyer has to amend its charter to authorize the issuance of additional securities to be issued in the merger, if the buyer is one of the merging parties or if required by securities exchange listing rules because the transaction represents a change of control of the buyer or requires the issuance of securities representing twenty percent or more of the buyer's outstanding common stock or voting power. The requirement to obtain buyer stockholder approval may reduce closing certainty, lengthen the timeline, and increase the complexity and expense of the transaction.

Mixed cash-stock deals. Some parties may consider mergers in which the consideration consists of a mix of cash and stock. While the use of stock may make it easier to finance and close the transaction, the use of stock will also introduce the valuation and other issues discussed in this Client Alert.

Scrutiny. As noted above, the parties to a business combination transaction undertaken in the current environment should expect the deal terms and business rationale to be placed under a microscope. As a result of the uneven M&A activity during the pandemic, every new deal that is announced receives significant attention. The parties should anticipate close scrutiny of the transaction, particularly by stockholder activists and plaintiffs' firms, and develop their deal announcement and communications plans accordingly.

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[1] The March 2020 merger agreement between Provident Financial Services, Inc. and SB One Bancorp provides a current example of a walk-away right. The agreement provides for a fixed exchange ratio. However, SB One may terminate the agreement if the value of Provident Financial's stock drops (i) by over 20% between signing and the date the last regulatory approval for the transactions is obtained and (ii) by more than the drop in the average of the NASDAQ Bank Index closing prices over the same period less 20%. If SB One exercises this termination right, Provident Financial has the option to increase the merger consideration, in cash, by the amount necessary to cause either of these conditions not to be met. As a result, SB One stockholders are assured that the dollar

value of the merger consideration they receive will not fall below a minimum amount.

[2] Originally published March 18, 2020 and available at https://www.gibsondunn.com/ma-amid-the-corona-virus-covid-19-crisis-a-checklist/; updated version available at https://advance.lexis.com/api/permalink/930c7ac9-3d37-4ff9-82dd-39e19a994dce/?context=1000522.

Gibson Dunn’s lawyers are available to assist with any questions you may have regarding developments related to the COVID-19 outbreak. For additional information, please contact any member of the firm’s Coronavirus (COVID-19) Response Team.

Gibson Dunn’s lawyers regularly counsel strategic and private equity buyers and sellers on the legal issues raised by this pandemic in the M&A context. Please also feel free to contact the Gibson Dunn lawyer with whom you usually work, any member of the firm’s Mergers and Acquisitions or Private Equity practice groups, or the authors:

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