Stronger Together:
Private Co. Mergers of Equals
Primer for Companies and Investors

In the face of macroeconomic volatility, many entrepreneurs, executives, and investors are carefully considering Merger of Equals (MOE) transactions for private company enterprises as a way to accelerate growth and scale, and to pool financial and operational resources in light of a challenging funding environment.

The below is a reference list of guidelines and preliminary points for principals and counsel to consider when structuring an MOE or similar transaction between two private companies. While the core focus is on MOEs, the list below also notes certain key matters for **private-private stock transactions generally**.

Overview

- **What's a Merger of Equals (MOE)?**
  - *Elusive Definition*: At its core, an MOE is a transaction (whether or not legally structured as a merger) where two businesses of roughly equal value are combined, and does not refer to any particular legal structure. Many MOE transactions do not reflect a precise 50%/50% valuation split, and a combination of two companies of relatively close valuations (e.g., a 60%/40% split) will typically be viewed as an MOE. Even a more lopsided valuation split in a "private company stock–for–private company stock" deal (e.g., 70%/30% or even 90%/10%) might share some key elements of a "true" MOE.
  - *Stock Deal*: Consideration (whether received by stockholders of one or both of the constituent parties) will either be all stock, or mostly stock.
- **Benefits**

  In addition to the normal benefits of M&A (e.g., product, revenue and cost synergies):
  - *Speed-to-Scale*: MOEs offer one of the quickest paths to dramatically scale a business.
  - *Funding/IPO Opportunities*: Combining two enterprises can also position the business to be more attractive to private capital financing and to the public (IPO) market.
  - *Borrowing Opportunities*: Combining both companies' balance sheets and/or cash flows may make it easier to obtain debt financing on more attractive terms.
- **Risks**

  In addition to normal risks of M&A (e.g., costs, management distraction, dilution, unknown liabilities):
  - *Execution Risk*: Deal execution can be more fraught.
    - In MOEs, it can become difficult to make progress in a timely matter if neither party is in the "driver's seat" (vs in typical mergers where one of either buyer or (in auctions) seller sets the pace and process).
    - If the process drags out, the underlying relative commercial value of the two businesses can easily diverge as results of operations change; even if there is significant divergence, parties may be unwilling to renegotiate economics.
    - In addition to two boards of directors, two sets of stockholders will be required to approve the deal.
  - *Complexity*: Structuring, documentation and negotiations can potentially be more complex.

- *Regulatory Risk*: Regulatory hurdles from more aggressive antitrust/competition authorities can be significant, particularly for "horizontal" tie-ups between companies that offer similar products or services.
- *Integration*: Post-closing integration risks can be higher, with potential clashes of operational culture and strategic vision, as well as potential confusion with customers and commercial counterparties.
- *Employee Impact*: Combining two roughly-equal operations may have a heightened potential for employee redundancies, which, if addressed through reductions in force, may result in operational synergies for the combined entity but at the cost of potential negative impacts on employee morale and the combined company's brand perception.
- *Deferred Exit*: Both sets of equityholders are deferring achieving an "exit" or control premium for their equity until some future point, which might not ultimately be achieved, or might occur at a lower effective valuation for their shares.

Structure

- **Legal Structure**
  - *Legal Structure vs. Business Vision*: Description of MOE from a marketing/branding/governance perspective can be very different from the legal mechanics (e.g., a company representing 40% of the combined value and less than a majority of the post-combination board might nonetheless be the "parent" entity).
  - *Tax-Deferred Shares*: The ultimate structure is often driven by tax considerations and at the direction of tax advisors – ensuring that shareholders are not taxed on the shares they receive in the combined entity is critical in MOE deals.
  - *Flexibility*: MOEs can be effected with almost any normal M&A structure (e.g., reverse triangular merger, share purchase, asset sale), although certain more exotic structures are also frequently used.
  - *Double Dummy*: A "double merger" / "double dummy" structure often is used for an MOE where neither party wants to be viewed as being acquired by the other party. In that case, a "NewCo" is formed, which then separately acquires each of the constituent existing entities in parallel – usually via reverse triangular merger. This approach can avoid triggering change-of-control clauses in commercial contracts of both parties. If, on the other hand, significant cash consideration is used in the deal, the structure can also include a forward triangular merger or a forward merger in order to preserve tax-free treatment.
  - *§351 Exchange*: A share-for-share exchange into a NewCo under Internal Revenue Code sec. 351 is also a possibility for companies with small capitalization tables.
  - *Change-of-Control Analysis*: The choice of structure in an MOE will often be heavily influenced by any change-of-control or anti-assignment provisions applicable to each constituent business – whether arising from debt instruments, commercial contracts, investor agreements or regulatory permits.
  - *Stockholder Approval*: Different legal structures for MOEs will also potentially implicate different stockholder approval thresholds for the constituent stockholder bases.
- **Sources & Uses of Cash**
  - *Partial Cash-Out:* The "consideration" in MOEs will always be principally stock-based, but in some deals one or both sets of stockholders will receive some amount of cash as well.
  - *Cash Election*: While it adds considerable complexity, parties will sometimes allow stockholders to elect their relative mix of stock and cash, whether through an election solicitation or a tender offer (often subject to cutback rules intended to ensure that the level of cash selected does not jeopardize the tax-free treatment of the stock component).

- *Non-Accredited Investors*: Securities law considerations typically will require stockholders of one or both constituent companies who are not "accredited investors" to be cashed out, although in some cases there may be opportunities to structure around this issue or rely on other exemptions from the registration requirements of the Securities Act of 1933.
- *Other Uses of Cash*: In addition to potentially allocating cash consideration to stockholders and needing to cash-out non-accredited investors, the parties need to consider the source of funding for transaction expenses, for management carveout plans and/or payoff of indebtedness, and for go-forward operations and growth.
- *New Funding*: If the cash on the combined balance sheet is insufficient for such purposes, parties will often combine an equity fundraise or debt (convertible or otherwise) incurrence from new or existing investors, to be funded substantially concurrently with the MOE. Depending on the source of the new capital, this may result in three-way (or more) negotiating dynamics.

Valuation

- **Valuation Generally**
  - *Relative vs. Absolute Value*: While cash-out M&A deals focus on absolute dollar value of consideration, MOEs (like other primarily stock consideration-based M&A deals) are often struck on the basis of relative valuations – focusing on the ownership % split.
  - *Per Share Consideration Dollar Value*: Despite the focus on relative value, most deals do require the parties to ultimately assign a dollar value to the "consideration" each set of stockholders is receiving – whether to facilitate cash-outs of non-accredited investors or to enable purchase price adjustments or indemnity mechanics.
  - *Convertible Instruments and Contingent Obligations*: In addition, the deemed per-share valuation will be important for calculating the shares/consideration issuable upon conversion of outstanding convertible notes, SAFEs, options and warrants, and for any management carveout plan (if applicable).
- **Valuation Allocation**
  - *Liquidation Preferences*: Typically in an MOE the liquidation preferences of each of the parties' preferred stock investors will be preserved in some fashion in the combined entity's capitalization. However, how those preferences "stack up" with each other (e.g., all pari passu or ranked seniority) will depend on the specific transaction and the existing rights (including whether some of the preferred stock in the legacy companies is "participating preferred"). In some MOEs, however, the parties elect to eliminate preferences in a bid for "cleaner" capitalization for the go-forward company.
    - *Note*: In a non-MOE private company stock consideration deal, buyers will often propose that selling stockholders receive buyer's common stock, but with the business understanding that such common stock should be evaluated as if valued at the valuation used in the buyer's last private preferred financing round (rather than on the basis of a "409A" valuation of the common stock). How such proposals are evaluated by selling stockholders is highly transaction-specific. Because of the instinct for mutuality in MOEs, by contrast, the negotiations around whether the preferred stock in the constituent companies is converted into preferred stock of the combined company are typically less fraught.
  - *Wiping Out Common*: Depending on the valuation assigned to each constituent company, it is possible that such valuation would not clear the collective liquidation preferences of one or both companies. If that is the case, while often the existence of the common stock is preserved (especially if liquidation preferences are likewise preserved), the parties sometimes consider cancelling the common stock for no consideration. However, as fiduciaries for common stockholder interests, parties should be extremely focused on fulfilling their fiduciary duties in this scenario, and should consult closely with counsel to construct a decision-making process that can withstand review.

- *Equity Awards*: The parties should also consider the impact of equity awards (particularly unvested awards) from both companies, as well as size and structure of go-forward equity retention awards. Typically the parties aim to maintain the basic economic and vesting terms of existing awards (perhaps with some harmonizing on vesting schedules), although if there have been radically different approaches to equity grants historically, that may need to be re-balanced through allocation of go-forward equity awards. In addition, parties often need to consider what the appropriate treatment will be for executives who have equity acceleration provisions (including whether those with "good reason" triggers tied to diminution of duties/responsibilities will waive those, at least with respect to the MOE itself).
- *Other Convertible Instruments and Obligations*: Unlike the roll-over approach most common for equity awards for continuing employees, typically an MOE will trigger the conversion of convertible notes and SAFEs, force the exercise of warrants, and potentially result in a payment under any outstanding management carveout plan. However, this approach can be highly context-specific and requires an assessment of the terms of the relevant convertible instrument.

- **Post-Closing Valuation Adjustments**
  - *What's Good for the Goose*: Parties generally have an incentive to negotiate middle-of-the-road (and simplified) price calculation and risk allocation mechanisms given that such provisions are typically applied equally to both parties.
  - *Earnouts Unusual*: While earnouts (perhaps on both sides' respective business lines) are theoretically possible, they are uncommon in MOEs, perhaps due in part to increased risks of post-closing integration challenges and legal disputes.
  - *Price Adjustments – Can be Simplified*: Customary US M&A-style "closing accounts" purchase price adjustments (e.g., adjustments for cash, debt, transaction expenses and working capital deviations) are sometimes used. At other times, for simplicity MOE parties may dispense with purchase price adjustments and adopt a European M&A-style "locked box" approach. Typically the approach taken will turn on how important the balance sheet of each business is to the go-forward success of the combined entity, as well as each party's comfort in its respective diligence exercise on the other business.

Risk Mitigation and Closing/Post-Closing Risk Allocation

- **Diligence**
  - *Mutual Diligence Process*: The diligence process in an MOE is reciprocal. Both parties will conduct diligence on the other side and respond to diligence requests at the same time, which can be time-intensive for the executive teams on both sides.
    - *Note*: In a non-MOE private company stock consideration deal, sellers will often require some level of diligence on the buyer's capital structure and business, although it is typically not fully reciprocal.
  - *Heightened Diligence Focus*: Because of (i) the transformative nature of MOEs, (ii) the tendency to have more-circumscribed post-closing indemnity regimes, and (iii) the risk that post-closing issues could have an outsized impact on the success of the combined enterprise, parties are advised to pay particular attention to all aspects of diligence (including financial, tax, accounting, product/technical, IP, HR and legal).
  - *Quality of Earnings*: In a typical M&A context, a buyer might engage an external advisor to perform a quality of earnings (QoE) or quality of revenue assessment on the target as part of the diligence process. In the MOE context, parties should consider mutual QoE assessments as a means to assess/confirm relative value.

- **Reps & Warranties / Indemnification**
    - *Mutual Reps & Warranties*: Each company will normally give representations and warranties on its business that are substantially reciprocal.
        - *Note*: In the broader universe of private company stock consideration deals, many sellers will argue that reciprocal or quasi-reciprocal treatment is appropriate for the same reasons that are present in MOEs, and will press buyers for various degrees of representations on the buyer's business and operations, for post-closing survival of some or all of such representations, and/or for post-closing indemnification for breaches thereof. The outcome of these proposals (outside the context of a "true MOE") is highly negotiated and transaction specific (though as a general rule, buyers who are able to issue common stock using the preferred stock valuation often have the negotiating leverage to offer more limited representations regarding their business and more limited indemnification coverage for any breaches thereof).
    - *Indemnity – Potentially Simplified*: Customary private-company (mutual) indemnity structures are often used, with the recourse being issuing additional shares to "wronged" shareholders or having the "at fault" shareholders forfeit escrowed/held-back shares. These indemnities will sometimes have relatively high deductibles and/or narrow scopes to reduce the risk of post-closing disputes and otherwise reduce friction to dealmaking.
    - *Indemnity – Potentially Eliminated/Replaced by RWI*: If the parties are comfortable with their diligence and the attendant risks for doing a deal, they may choose to forgo indemnity protection altogether (i.e., a "public company deal" construct). Alternatively, as is the case for many private M&A deals, representation & warranty insurance (RWI) can be explored. However, depending on the precise structure of the deal and the insurer chosen, RWI costs and coverage can be significantly different for MOEs due to the insurers' collective reluctance to insure a party for "its own" breaches – parties should explore these questions very early in the process with an experienced specialist RWI broker.
- **Closing Certainty**
    - *Generally Low Conditionality*: Because of the high risks to each party from a failed transaction post-announcement, as well as the reciprocal approach to most negotiations, it is common for parties to choose to limit or eliminate closing risk for both parties as much as possible.
    - *Regulatory*: Parties should consider opportunities to make confidential filings with antitrust authorities as soon as possible – in the US the FTC/DOJ allow antitrust clearance filings to be made (and the 30-day initial review period to commence) on the basis of a non-binding term sheet.
    - *Reps & Warranties Bring Down*: Closing conditions regarding accuracy of each party's representations and warranties will often generally be assessed at closing under the "no material adverse effect" standard most typical in public company deals (meaning that such closing conditions would be satisfied in all but extreme circumstances), rather than at the more difficult to satisfy "accurate in all material respects" standard.

Governance

- **Board Composition**
    - *Too Many Cooks*: Simply combining the boards of both constituent companies may result in an impractically large or imbalanced board. Parties need to decide board representation for the combined company to give appropriate voice to key management/founders, as well as principal investors, while also ensuring a healthy and functional board dynamic.
    - *Director > Observer*: As part of an MOE process, parties will sometimes opt for some legacy company directors to convert to observer roles in lieu of remaining as directors or resigning altogether.

- *View to the Future*: Parties are well-advised to shape their boards with an eye to the combined company's medium-term capital plans (e.g., pursuing additional private funding, or IPO prospects).

- **Executive Team Composition**
  - *Too Many Cooks Redux*: Parties need to align early on who will fill the executive slots for the combined company, or risk ending up with a top-heavy organization with mis-aligned go-forward strategies. In addition, failure to agree before closing on allocation of roles and responsibilities can quickly cause morale challenges and disruptive clashes and departures.

- **Investor Rights**
  - *Harmonize Investor Rights*: Parties need to decide what investor rights will be implemented for the combined company, recognizing that there are challenges in asking investors to forego rights that they have enjoyed in one of the constituent companies. This may be impacted by the treatment of the preferred stock in the transaction. Ultimately the combined company will need flexibility to operate under the direction of the board, and MOE parties tend to approach investor rights with an eye to ensuring the company is well positioned for a future fundraising event.

Employees

- **Retention Through Closing**
  - *Employee Retention Closing Condition*: Because the success of MOEs often turn on retaining talent, sometimes the parties will propose that one party can terminate the deal if too many of the other party's employees (or "key" employees) leave before the transaction closes. Because of the incentives to apply terms mutually, however, as noted above, many MOE parties have a bias towards deal certainty and will propose a relatively loose (i.e., easy to satisfy) employee retention condition (if any).
  - *Communication*: Developing an employee communication and engagement plan early can be a critical element of a deal's success. If an MOE is between competitors, there may be cultural "us versus them" and mutual mistrust hurdles to overcome. Parties need also to be prepared to mitigate potential morale issues if leaks occur during confidential negotiations.

- **Right-Sizing**
  - *Pre-deal RIF*: In certain MOEs, the parties may judge it necessary to have a reduction in force substantially concurrently with closing. In such cases, parties need to assess during pre-deal negotiations any severance plans as well as transition plans for certain employees who will be important for short- or medium-term integration but do not have a long-term role at the combined business.
  - *Post-deal RIF or attrition*: In other MOEs, the parties will avoid making a final assessment on reductions or separations from service until after the closing has occurred and integration has begun. In such scenarios, the parties may have the benefit of additional post-closing operational information for assessing the combined company's talent pool. One additional risk, however, is that if employees understand or believe that substantial cuts may be planned post-closing, there may be a lasting impact on morale and/or increased attrition of top talent.

- **Retention Post-Closing**
  - *Equity Pool*: Parties often find it useful to establish a new go-forward equity pool for the combined business, much as in a typical equity financing. One difference, however, is that there may be a heavier allocation towards refresh grants (rather than new hire grants) in connection with the closing of an MOE, given the potential attrition risks, than following a typical equity financing.

This list does not purport to cover all issues that could arise in a transaction, does not constitute legal advice or establish an attorney-client relationship, and reflects only the views of its authors and not their clients or of Gunderson Dettmer. Please contact the M&A team with any questions

Gunderson Dettmer M&A Team

Andrew Luh
Partner

John Olson
Partner

Billy Kwon
Partner

Francesca Crisera Ruiz
Partner

David Moore
Of Counsel

Jennifer Sayles Okorn
Of Counsel

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