Dallas Bar Association Securities Section

Managing Securities Risks in M&A Transactions: From Due Diligence to Post-Closing Integration

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Agenda

- Framing the Issues
- The Role of Due Diligence
- Effects of Transaction Structure
- Drafting Documents and Disclosures
- Risk Allocation
- Post-Closing Integration and Compliance
- Deal Playbook

Framing the Issues

- Patent and Latent Risk:
  - Securities issues in M&A transactions of all kinds harbor both patent and latent offering, compliance and disclosure lists and risks
- Separate Issues:
  - Although occasionally intertwined, securities compliance issues in M&A transactions are independent of other issues specific to the corporate law and governance aspects of M&A transactions
- Legacy and Future Risks:
  - Issues relate primarily to legacy risk associated with companies being acquired, and latent disclosure or other issues that manifest only post-closing
- Risk Mitigation:
  - Due Diligence
  - Transaction Structuring
  - Documentation
  - Disclosure Obligations
  - Post-Closing Compliance

Why the Securities Risks do Matter

- The SEC has heightened scrutiny of private offering exemptions, pursuing issuers for deficient Reg D practices and unregistered broker-dealer activity tied to finders' fees
- Whistleblower complaints, often arising post-announcement, can trigger Rule 10b-5 investigations impacting both buyer and seller
- Insider trading enforcement remains robust, with DOJ and SEC coordinating on cases involving deal integration leaks
- These trends demand enhanced diligence, disclosure discipline, and integration compliance.

Issue Spotting in Due Diligence

- Verification of capitalization tables, stock ledgers and company documents and amendments
  - Evaluate all prior financing rounds (e.g., Reg D, Reg S, Reg A, Reg CF, EB-5)
- Confirm a full disclosure and knowledgeable examination of instruments such as:
  - Convertible Notes
  - Warrants
  - Options
  - Incentive Plans (e.g., equity incentive awards, pension plans, ESOPs)

Issue Spotting in Due Diligence

- Trust but verify: corporate, real estate, tax and other counsel involved in a typical M&A engagement must confirm their own understanding of the applicable securities issues involved, regardless of other stakeholders who may be participating in the transaction
- Develop a complete understanding of broker-dealers, investment advisers/wealth managers and/or finder or other professionals and/or fees involved in identifying and closing the transaction
- For example:
  - A cap table cannot be fairly or properly evaluated without a complete disclosure of all offering documents, marketing collateral, subscription agreements, board approvals, or Form D filings
  - A broker involved in a transaction may or may not be working within the rules to which they are subject
  - Use common sense to underwrite the work being done, by whom, and those who have relied or will rely on that work

Issue Spotting in Due Diligence

- Disclosure & Cap Table Risks
  - Incomplete investor records can equate to the presence of undisclosed holders, phantom dilution, and trigger rescission claims
  - Rule 10b 5 antifraud liability exists if material misstatements or omissions are made in disclosure documents or purchase agreements
- Disclosure schedules (not just for associates)
  - Schedules are a tool both for basic and complex disclosures, and also to ensure proper risk allocation
  - Schedules and due diligence must align as to cap table, subscription agreements, stock/option ledgers, and securities filings
- A buyer must tie reps to disclosure schedules — and build indemnities if records are incomplete

Diligence Issue Exercise

Convertible Notes

- Monolith Manufacturing Company, LLC, is selling to Kwantüm Technologies, Inc.
  - MMC raised capital in both a “Seed Round” and “Round A”
  - The investors in each case consisted of a mix of “friends & family”, as well as certain sophisticated investors in Round A who had a more informed perspective on the investment along with expectations as to outcome
  - Monolith failed to obtain subscription agreements in the Seed Round, and filed no Form D
- Other notable facts
  - It is unclear to what extent or how the Monolith Seed Round notes were approved as no minutes exist
  - Subscription agreements were prepared and executed for the Round A notes; however, the Round A notes had conversion rights nearly identical to those in the Seed Round
- What issues are presented?
  - Control buyer and/or successor liability for securities compliance failures?
  - Is the offering exemption for Seed Round or Round A clear?
  - Can reps & warranties save a buyer from potential exposure? Rep & warranty insurance?
  - Can prior violations be undone?
  - What opinion letters are needed vs. those that may be issued by opposing counsel?

M&A Structuring and Securities Issues

- In M&A, deal structure drives how securities liabilities transfer
  - In stock purchases or mergers, the buyer typically assumes the target's securities law risks, including past noncompliant offerings
  - In asset deals, buyers may limit exposure, though successor liability can still attach depending on a facts and circumstances analysis that most would want to avoid when facing a material securities compliance issue
- Minority shareholder rights are not trivial or less relevant because of the composition of those shareholders
  - Concepts such as pre-emptive rights, tag-along and drag-along rights, appraisal rights and others all raise disclosure issues, amongst others
  - Equity rollovers and earn-outs must rely on valid exemptions, often under Reg D or Reg S when in the context of an arms'-length M&A transaction
- Cross-border transactions compound risks with dual regulatory regimes
  - U.S. law vs. local (in-country) laws

Structuring Issue Exercise

Cross-Border Rollover

- Facts
  - Monolith Manufacturing Australia, Pty Ltd, is selling to Kwantüm Technologies, Inc.
  - MMA is selling 70% of its share capital to KTI, with the remaining 30% being rolled over by MMA's owners into a newly-issued Series A Preferred Stock of KTI
  - MMA's owners are wealthy, but also Australian citizens who are located in Australia
  - The owners are unfamiliar with the particulars of various stock classes, minority shareholder or other rights
  - KTI is a late-stage growth company with very sophisticated founders with experience in the capital markets
- Which securities compliance regimes applies?
  - Regulation S?
  - Regulation D?
  - Local laws?
- Potential issues:
  - Unregistered offering liability
  - Rescission claims resulting from disclosure issues
  - Cross-border enforcement exposure

Drafting Documents and Disclosures

- Acquisition Documents
  - Valid Issuance & Authorization: All securities properly authorized, issued, and fully paid/non-assessable
  - Compliance with Securities Laws: Past and current offerings complied with federal/state/foreign securities requirements
  - No Undisclosed Equity Rights: No outstanding options, warrants, convertible securities, phantom rights, or side agreements
  - Accuracy of Capitalization: Cap table complete and correct, no undisclosed ownership interests
  - Survival & Indemnification: Securities reps not boilerplate; negotiate survival periods, escrows, and allocations
  - Boilerplate = Latent Liability
    - We know that many reps and warranties are often born of boilerplate. But they are critical
    - Draft to cover past issuances comprehensively
    - Push for longer survival of securities reps because violations may not appear until much later

Framing the Issues

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Drafting Documents and Disclosures

- Risk Allocation:
  - Multiple avenues exist relative to risk allocation in transaction documents
- Indemnification:
  - Buyers must ensure indemnification terms (baskets, caps, and survival periods) address the unique tail of securities liabilities
  - Securities claims may surface years later, so do not let general survival periods end too quickly
  - For securities reps, push for extended survival — sometimes through standalone securities indemnities
- Escrows & Holdbacks:
  - When diligence shows cap table inconsistencies or missing documentation, escrows and holdbacks are essential
  - These create a ready source of recovery for rescission claims or investor disputes without needing to chase former shareholders
  - Indemnification

Drafting Documents and Disclosures

- R&W Insurance:
  - Representations and warranties insurance is increasingly common, but it often excludes known issues such as identified cap table defects, unregistered offerings, and broker/finder rule violations
  - Insurers may impose securities risk carve outs
  - Counsel must negotiate scope carefully and cannot rely on insurance as a cure all.
- Specific Indemnities:
  - Where diligence points to high risk areas buyers must insist on specific indemnities tied to these categories of risk
  - This creates clarity and separate recovery beyond the general cap
- Negotiation Leverage:
  - Ultimately, the allocation of securities liability is a reflection of diligence strength
  - If the buyer uncovers deficiencies, then it gains bargaining power to demand larger escrows or broader indemnity.
  - Sellers may resist, but enforcement trends give buyers strong justification

Public Company Deal Considerations

- Mandatory SEC Filings:
  - Form 8-K, proxy statements, tender offer materials, registration statements (as applicable)
- Disclosure Risk:
  - Misstatements or omissions expose buyer/seller to Rule 10b-5 liability; corrective filings may be required
- Shareholder Litigation:
  - M&A transactions with public entities often attract stockholder suits over adequacy of disclosures
- Timing Impact:
  - SEC review and comment process can delay closing and integration plans
- Integration of Reporting:
  - Acquired company disclosures must align with acquirer's ongoing reporting obligations under the Exchange Act

Public Company Compliance Exercise

SEC Whistleblower

- Fact Pattern:
  - KTI is a public company that announces its acquisition of MMC via Form 8-K
  - Whistleblower alleges MMC misled investors in prior private fundraising
  - SEC scrutiny now extends to KTI as buyer
- Risks Triggered by Announcement:
  - SEC Investigations (possible Rule 10b-5 violations)
  - Buyer liability despite not participating in prior offerings
- Market Impact:
  - Stock price volatility and reputational harm are only the beginning
- Key Questions:
  - Does buyer need corrective filings?
  - Can the deal still proceed as planned?
  - How can indemnities or insurance respond?
  - How can the buyer later verify or evaluate whistleblower claims that MMC misled prior MMC investors?

Post-Closing Integration and Compliance

- Legacy Rescission Exposure
  - Buyers may inherit liability for past unregistered or defective offerings
- Carrying Forward Deficiencies
  - Missing Form D/Blue Sky filings can result in state or SEC actions post-closing
  - Failure to obtain consents or waivers from legacy holders can prove very costly
- Governance Alignment
  - Improper diligence of seller governance requirements related to securities offerings can potentially be far more than a speed bump
  - Often less evaluated is the need for a buyer to Integrate a seller's governance & investor rights, or to adjust them as needed in the rollover
    - For example, what if a seller granted information rights, preemptive rights, or veto powers to prior investors?
    - If overlooked in diligence, then these rights can survive the transaction and constrain how the buyer operates the post-deal business.
- Future Financing Impact
  - Securities history influences IPO/SPAC readiness and valuation
- Burden of Scrutiny
  - Integration often under-resourced
  - Legal teams focus on closing but fail to scrub past issuances, leaving ghosts such as cap table issues to persist

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Post-Closing Integration and Compliance

- Integration of compliance programs is critical
- Insider Trading Controls
  - Implement acquirer's insider trading policy across target; restrict trading by legacy employees
- Reg FD & Disclosure Controls
  - Synchronize external communications, press releases, and investor updates to prevent selective disclosure
- Whistleblower Protocols
  - Harmonize reporting channels; ensure compliance with SEC whistleblower protections
- Investor Relations & Information Rights
  - Review legacy investor agreements for inspection or information rights → align with acquirer disclosure standards
- Training & Culture
  - Conduct onboarding sessions on securities law policies for legacy employees and management

Post-Closing Integration and Compliance

Integration Exercise

- Fact Pattern:
  - Legacy MMC employees trade in KTI stock during integration on the basis of confidential information regarding business strategies and the presence/absence of synergies
- Risks Created:
  - SEC and DOJ insider trading enforcement exposure
  - KTI as buyer will have exposure and potential liability for failing to implement adequate policies
  - Potential derivative shareholder litigation if stock price is affected, whether up or down
- Questions for Counsel:
  - How quickly must compliance be harmonized?
  - Can acquirer be penalized for inherited behavior?
  - What remedial steps are effective if violations already occurred?
- Best Practices:
  - Conduct quick internal investigations
  - Voluntarily disclose significant violations to minimize penalties
  - Implement enhanced controls and training as part of remediation package

SEC Enforcement Priorities

- Scrutiny of private offerings, Reg D compliance, misuse of exemptions
  - Increased focus on corporate disclosure accuracy in M&A deals
- Insider Trading Enforcement (SEC + DOJ)
  - Coordination between agencies on merger leaks and material nonpublic information (MNPI)
- FINRA Oversight
  - Investigations into unregistered finders, broker-dealer compensation issues
- Cross-Border Transactions
  - For cross-border deals, it is no longer just the SEC acting in isolation
  - Foreign regulators in Europe, Asia, and Latin America frequently coordinate enforcement, especially as global information-sharing agreements expand
- Emerging Asset Classes
  - Digital assets and secondary trading increasingly scrutinized as securities in acquisitions

Deal Playbook

Case Study

- Case Study (Ripped from the Headlines):
  - Target raised $12M through a purported Reg D private placement over 4 years
  - No investor questionnaires or accreditation verification performed
  - Several investors were likely non-accredited and, as such, the offering exemption defective
- Net Effect:
  - Buyer inherits potential rescission liability + investor litigation risk
  - SEC inquiry post-close forces remediation costs in millions
- The Reality:
  - The buyer, a private equity firm, closed the deal after pushing for general reps but not insisting on documentary proof of investor qualification
  - Six months later, one of those investors filed a rescission lawsuit arguing that the securities were sold unlawfully
  - When the SEC became involved after a parallel whistleblower complaint, the buyer found itself facing the prospect of rescinding the offering—returning $12M plus interest
  - Buyer had to set aside new working capital and negotiate multi-party settlements

Deal Playbook

For all deals, a robust checklist and best practices guide can help eliminate risks

- Confirm exemptions and filings in diligence
- Negotiate strong securities/equity reps and warranties
- Obtain subject matter knowledge and expert guidance where needed
- Do not rely on bankers or brokers as a source of underwriting or truth in the diligence process
- Include escrows/holdbacks for potential securities/equity exposure
- Ensure the early integration process includes compliance training and updated protocols
- Not just SOP
  - Build a repeatable checklist and variants to ensure you and your clients are protected

- **Program Opportunities**
  - CLEs and Speakers
  - Targeted Industry Events
  - Marketing and Development Opportunities
- **Section Engagement**
  - All Members Encouraged to Participate
  - Request a Panel Slot or Speaking Opportunity
- **Industry Outreach**
  - Later this Year SEC/FINRA Regulators Will Participate
    - What do you Want to Hear from Them?
  - Later this Year Principals of RIAs and BDs Will Participate
    - What do you want to Hear from Them?

THANK YOU

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