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Mergers and Acquisitions in the Transportation Sector

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One effect of the COVID-19 pandemic is the renewed need for transportation providers to consider strengthening operating platforms by expanding into new markets, integrating new offerings or adjacent services, or growing the enterprise footprint by partnering with other companies in the industry. In times like these, when competition is tough and demand is unpredictable, the path forward for all businesses includes achieving competitive advantage and market differentiation to grow enterprise value. Conquering those objectives often takes the form of a *merger* with, or *acquisition* of, a potential business partner. The net effect of any such strategic combination is often a company that is stronger, both operationally and financially, and more valuable than what the two previously separate enterprises could have achieved independently.

Mergers

The terms “mergers” and “acquisitions” are often used interchangeably, but in reality they represent different types of transactions. In a merger, two firms choose to move forward as a single entity, and the corporate form of one or sometimes both of the pre-merger companies is abandoned as one of the entities is merged into the other, or both are merged into one corporate form. In a merger, the equity interests of the non-surviving company (or companies) are cancelled, and equity in the surviving company is issued to the former owners. Moreover, in a merger transaction, the parties’ respective boards and management teams will collaborate to determine how to operate the new company in tandem. Mergers can be the best strategy where the potential business partners’ strengths and weaknesses complement each other such that, when combined, the entities can more effectively compete in the market with greater combined strength.

In certain circumstances, mergers are also beneficial from a tax perspective. If one firm has a strategic advantage in the market yet is suffering substantial losses for the year, another firm may benefit from merging with it to absorb that advantage while gaining the ability to use those losses to offset its own profits. This can provide large financial benefits, but only if the financial forecast indicates future profits despite the current year’s losses. Pitfalls to mergers can occur when the post-merger management teams disagree on strategy, when key due diligence items are overlooked, or when forecasted financial targets are not achieved. Companies considering a merger should consult with both their financial and tax advisors and legal counsel to consider the appropriateness of a given structure and all of the business, financial, and legal implications of the transaction.

Acquisitions

Other times, a company is looking to add a specific set of skills, product line, or product market to its portfolio, and will look to acquire a company with those attributes. Acquisitions are composed of two separate strategies: equity acquisitions and asset acquisitions. In an acquisition, one firm buys all of the equity or all or substantially all of the assets of another firm (the "target"), and the target firm often becomes a subsidiary of the buyer, although, in asset sales, the buyer may simply acquire the assets outright without forming a subsidiary to hold them. In an acquisition, the buyer typically does not alter its own management or legal structure; but, frequently, the buyer will retain some or all of the management of the target firm to assist in both the transition and the ongoing operation of the target.

In an equity sale, the target company's corporate existence continues on, uninterrupted except for change in ownership, which comes with its own advantages and pitfalls. One advantage is that, in certain situations, the buyer may be able to avoid paying transfer taxes on the business assets (such as real estate), because while the ownership of the company changes, the ownership of the real estate does not change and, accordingly, the real estate is never "transferred." Another benefit to equity sales occurs when the target has material agreements, such as customer contracts or intellectual property licenses, that may require the consent of the counterparty to assign, or key business permits or licenses that are difficult to assign or obtain. In an equity sale, the target company frequently maintains such contracts while ownership is transferred, whereas in an asset sale, those contracts would typically require the consent of a third party to be assigned. A careful review to confirm that key business contracts and licenses will remain in place post-closing is a critical due diligence step in any acquisition.

The main pitfall of an equity purchase results from the fact that the buyer is acquiring the *entirety* of the target-meaning all of its assets and liabilities, both the good and the bad. If the target company was involved in litigation or high-risk practices that might otherwise lead to future liabilities, those risks cannot be avoided. When the buyer owns the equity of the target company, it owns all of the assets and all of the liabilities. However, buyers can, and in the ordinary course always do, attempt to mitigate their risks by negotiating indemnification rights against the seller, whereby the seller agrees to be responsible for some or all of certain risks or identified liabilities. Moreover, the seller's indemnification obligations are generally secured, at least in part, by placing a portion of the purchase price into an escrow for a specified period of time. In many transactions, the parties choose to insure some portion of the seller's indemnification obligations through the use of a representations and warranties insurance policy.

The main pitfall of an equity transaction (i.e., taking on all of the target's liabilities) can often be avoided by structuring the transaction as an asset purchase. In an asset purchase transaction, the buyer can choose which specific assets of the target company it wishes to purchase, including, for example, just one segment of the seller's business. One of the principal benefits of an asset sale is that the buyer typically assumes only specified liabilities and, accordingly, is able to leave harmful relationships, uncollectible accounts, and litigation behind with the seller. An asset sale might also be beneficial where a minority shareholder does not want to sell their shares, but otherwise would be outvoted in a sale of assets. While there are still risks associated with an asset sale, such as successor liability, the asset sale structure is generally the best option from the buyer's perspective in terms of isolating those liabilities that the buyer would like to leave with the seller.

Asset purchases can also provide certain tax advantages that may not be present in an equity transaction. One of those advantages is that the buyer achieves a “step-up” in basis for the assets, where the purchased assets are worth more on the books of the buyer than in the hands of the target company. This leads to increased tax deductions for depreciation of those same assets. In addition, the buyer also has the ability to amortize goodwill. “Goodwill” is the value the buyer paid for the assets above and beyond the value of the tangible assets. This value can be amortized over 15 years for tax purposes.

As with any merger, there are tax and other structuring considerations that are important to both the buyer and the seller in any acquisition transaction. Consultation with tax, accounting, and legal advisors early in the process is an important part of any well-planned M&A transaction. Whether it be a merger, asset purchase, or equity purchase, if you have identified a target company that fits into your business portfolio, experienced professional advisors will be able to assist you in properly structuring and executing on the transaction, so that when the deal closes, you can focus on running your business.

Transportation Industry Considerations

Completing a merger or acquisition in the transportation industry involves unique risks and complications that require close attention and experience. The degree of regulation that transportation providers experience, their varied and complex operating models, the need to update regulators before or after certain changes, and the sometimes hidden risks associated with services that impact public safety are all factors contributing to the complexity of deals in the space.

Transportation and logistics providers are heavily regulated both in the interest of public safety and also due to the utility-like nature of their services. A host of government agencies have jurisdiction depending upon the mode, cargoes, nature of commerce, and location of performance. In the United States those agencies include the Transportation Security Administration (TSA) for air service providers, the Federal Maritime Commission (FMC) for ocean service providers, and the Federal Motor Carrier Safety Administration (FMCSA) for motor carriage and logistics providers. Each individual state of operation may also have jurisdiction and applicable requirements depending upon the character of the business. Other federal and state agencies may have additional oversight over commodity-specific operations, such as the carriage of hazardous materials, alcohol, or dairy products.

Regulatory requirements are critical to consider when determining the optimal structure for a prospective deal. For example, the technical requirements imposed by a particular agency may significantly limit the “portability” of any licenses, permits, or operating authorities required to conduct business. Those limitations may merely amount to updating file records, although certain operations can require disclosure of changes in ownership while others have the effect of prohibiting conveyance of licenses to third parties. In practice this means that certain mergers and asset transactions may be cumbersome if not unrealistic to achieve. It can also necessitate extending timelines for closing a transaction to accommodate filings and approvals as well as certain post-close filings with regulators.

Industry operating structures can also shape deals in the transportation space. Many segments of the transportation industry operate through agency and independent contractor relationships that challenge consolidation and portability. A target built on an agency model, or one that relies heavily

upon independent contractors, is often complex in its customer relationships and service delivery due to the integral role of those third parties in the company's business. For example, the third-party relationship can be subject to regulation requiring documentation and oversight in a particular manner. A keen, experienced eye is required to understand legal and commercial risk inherent in those legacy operating models, the documentation in support of those models, and any pragmatic forward-looking risk associated with changing the model. Otherwise, customary changes such as consolidating operations or updating customer relationship can become a challenge regardless of any risk associated with the historic operation.

Accomplishing deals in the transportation and logistics space can be a challenge in and of itself once the target and desired structure are determined. Conducting due diligence of transportation licensure, operating structures, and realized or potential legal exposure is an exercise that goes beyond merely "checking the box" when the right to lawfully conduct business and the lives of the general public are on the line. The heightened stakes for this sector can yield very real impacts on valuations and even the viability of deals. It is not uncommon to identify areas of exposure where regulatory, commercial, or safety risks arise requiring attention immediately prior to or following the closing. Beyond commercial negotiation and operational best practices, the need to engage with one's regulators before or after closing a transaction can necessitate the navigation of bureaucratic structures and notice or approval processes in order to secure the right to complete the deal and conduct business.

Setting The Course for Opportunity

In our experience, the transportation sector has long been a hot market for mergers and acquisitions activity, and the impacts of COVID have not changed that trend. The industry remains both highly fragmented and ripe for innovation. Opportunities for financial and strategic buyers to complete deals that make sense and carry great potential still exist to be found and swiftly accomplished despite the challenges for the industry and businesses generally at this time in world history. For strategic buyers in particular, the possibility of deals with "game-changing" effects for operating models and service portfolios may grow following this adjustment in traffic flows and customer expectations. The choice of an appropriate structure for accomplishing those deals, maximizing potential, and minimizing risk is always essential for laying a strong foundation to build upon post-close. The selection of legal counsel and other professional advisors well versed in the space, its players, and its operations, can go a long way toward achieving the desired goals and objectives by making the right choices along the way.

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