WHAT TO DO WHEN SOMEONE WANTS TO BUY THE BUSINESS

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Imagine that your long-time client calls you and gives you a piece of exciting news – he has decided to sell his business, and has an interested buyer. You have watched the business grow, through the years assisting with capital raising, contract drafting, and litigation. Although the business's cash flow has provided much over the years – it has put food on your client's table, sent his children through college, and provided employment for a number of people – most of the earnings of the business have been plowed right back into it, fueling growth in the good times and keeping heads above water in the tough times. Now the time has come for your client to monetize the value of his life's work. He, and perhaps you, have visions of drawing up a simple agreement, receiving a handsome check, and riding off into the sunset. The reality is that a long and potentially hazardous journey is just beginning. What do you do now?

Keep running the business. Selling a business is a full-time job; and while it is temporary, it is not as short-term as many people may assume. For entrepreneurs, running the business can already be the equivalent of two full-time jobs; adding a third is one too many. However, one of the biggest – and most common – mistakes that a business owner can make is to lose focus on the day-to-day operations of the business while selling it. The sale process is a long one, and the end is uncertain. Many owners, upon the "death" of a deal, have surveyed the landscape to find not only the transaction evaporated but the business dilapidated from neglect. Even if the deal closes, any intervening deterioration of the business may result in a downward adjustment to the purchase price or the worsening of other deal terms. In the end the deal may be one that your client would not have accepted in the first place but cannot now walk away from. Where possible, primary responsibility for running the day-to-day affairs of the business and primary responsibility for running the transaction should not reside in the same person. However, we know entrepreneurial businesses well enough to know that this is not always possible. Where your client is wearing both hats, you can give him good counsel by reminding him throughout the process that the business must continue to be fed and watered.

What has happened so far? The first order of business is finding out just what has transpired between your client and the prospective buyer. Have they had an informal chat? Several chats? Have they talked price? Scratched out some numbers on the back of a napkin? Drawn up a letter of intent? Signed it? This paper will assume that one or more discussions have occurred, which include a basic understanding that the entire business will be purchased and the purchase price, but no other terms have been discussed and nothing has been reduced to writing.

Who is the buyer? Buyers fall into one of two general categories: "strategic" and "financial". Strategic buyers are other participants in your client's industry or related industries. A strategic buyer will be interested in expanding market share by absorbing the client's business into its own, or views the client's business as an entrée into an industry in which it perceives synergies. Financial buyers are typically private equity funds or similar investment entities. A financial buyer will be interested if it views the client's business as an undervalued asset on a stand-alone basis and sees an opportunity to enhance the balance sheet and sell it in the short or medium term for a profit. It is important to understand which type of buyer you are dealing with, as they have different approaches to various terms and aspects of the transaction. For example, strategic buyers may be willing to pay more than financial buyers, because they expect the acquisition to bring not only the existing value of the business but additional value in the form of synergies. However, financial buyers may be better able to fund the full purchase price in cash at closing.

Keeping it Confidential. Before your deal goes much further, and certainly before any financial or other proprietary information is shared, it is critical that a good confidentiality agreement be put in place. If you learn that the parties have already signed a confidentiality agreement, it should be reviewed and, if necessary, amended or replaced. This is especially true if the buyer is a strategic buyer, in which case the buyer may be a competitor whose interest in the business is at least partially motivated by the opportunity to examine your client's financial information and other trade secrets, and to find out who your client's key employees are and how they are currently compensated. In a typical transaction in which the purchase price is paid in cash, the flow of confidential information is virtually entirely from seller to buyer, so a "one-way" confidentiality agreement which binds the buyer from using or disclosing seller's information is a reasonable approach. Aggressive buyers may want a confidentiality agreement that is "mutual" (i.e. binding on the seller as well), if for no other reason than to prevent the seller from publicly disclosing the fact of the buyer's offer or any details about the transaction. If the buyer is paying any of the purchase price in the form of stock in the buyer, then your client will need to conduct due diligence on the buyer and a mutual confidentiality agreement would be expected. A good confidentiality agreement will address the following terms.

- *Scope of "Confidential Information"*. Buyers prefer that "Confidential Information" be defined in a way that is specific to the contemplated transaction and, if possible, limited to written material that is labeled "Confidential." Sellers prefer a broad definition that includes any information about the seller's business that may be conveyed to the buyer, whether or not it is labeled. The labeling requirement is difficult for the seller because as the due diligence process ramps up the information exchange can become free-flowing and rapid. Buyers will usually not insist upon this requirement.

- *Scope of confidentiality obligation*. In virtually all circumstances, the buyer will be prevented from utilizing the seller's confidential information for any purpose other than analyzing the contemplated transaction. If the buyer is active in the seller's business, the buyer may try to include an acknowledgment from the seller to that effect to forestall a later presumption that the buyer must be violating the confidentiality agreement simply by bidding against the seller for business.

- *Flexibility to share information with representatives*. In the course of the transaction, the buyer will need to share information with accountants, lawyers, bankers, and other transaction advisors. It is usually impractical for the seller to try to prohibit this information-sharing or to obtain a confidentiality agreement with each of the individual representatives. Instead, the seller should make it clear that the buyer must share information with its representatives on a "need to know" basis, make its representatives aware of the confidential nature of the information, and remain liable to the seller for its representatives' unauthorized disclosures.

- *Procedures for court-ordered disclosure*. If a court or other government agency subpoenas or makes another legal request or demand of the buyer to disclose your client's confidential information, even the most airtight confidentiality agreement will not shield it. However, you can seek to require the buyer to notify your client in the event of any such request, permit your client to participate in the process in order to oppose or seek to limit the request, and require the buyer to disclose no more than is legally required.

- *Copying of materials*. Buyers prefer to be able to freely copy materials and to keep copies. The confidentiality agreement should require the return or destruction of all materials at the seller's request, although it is not unreasonable for the buyer to retain one copy for archive purposes.

- *Non-solicitation covenant*. Particularly if the buyer is a strategic buyer, it is advisable for the seller to obtain a non-solicitation covenant. The concern is that the buyer will use the confidential information to identify and poach key employees. Buyers will usually resist this (even if they have no such nefarious intentions), because they prefer not to be bound by a covenant that they might inadvertently breach, resulting in potential exposure. Opportunities for compromise are to provide an exclusion for general solicitation (i.e. solicitations that go to the general public and do not target your client's employees specifically) and limiting the application of the covenant to employees identified during the diligence process.

- *Liability for accuracy of information*. The function of the confidentiality agreement is to protect the seller from disclosure, not to protect the buyer from inaccuracies in the information provided (the purchase agreement will be the place for that concept). Therefore, the seller should not agree to make any representations about the accuracy of the confidential information, and in fact should try to include express disclaimers as to the accuracy or completeness of the information provided.

Building the Team. Having locked down the confidentiality agreement, you and your client are ready to move wholeheartedly into discussions with the potential buyer. This process will be a team effort. The team has its quarterback – that's you. Now is the time to determine who the other members of the team will be, which ones are already in place, and which ones will need to be added and when.

- *Client transaction lead*. Someone in the seller's organization will be tasked with primary responsibility for negotiating and concluding the transaction. This will be the person who will be communicating with you, on a near daily basis, for the next several weeks, if not months. This could be the company's owner, a high-ranking subordinate, or an in-house lawyer.

- *Transaction advisor*. In most significant M&A transactions, the seller (and in many cases the buyer) will engage an advisor to assist with the business aspects of the sale. This advisor may help identify the pool of likely buyers, determine the level of interest among identified prospects, calculate the value of the business, manage the sale process, and generally provide transactional and financial advice to the client. This advisor most often goes by the name investment banker, but may also be called a transaction consultant or a transaction advisor. If your client has not engaged an investment banker, now is the time to consider whether to do so. If the client is not experienced in the M&A process, he may not see the value in bringing a transaction advisor onto the team. The value of a transaction advisor depends on the nature of the sale and the transactional experience of the client. Where the sale process takes the form of an auction process, the need for an investment banker is at its maximum. However even where, as in our example, the seller and buyer have already found one another, the right investment banker can add value. For example, they can assist in determining and substantiating (and thereby maximizing) the purchase price, performing financial modeling, and normalizing financial statements. Although an investment banker's fee is a significant transaction cost – ranging from 1.5% to 2.5% of the transaction value up to 5% or more – those fees are usually contingent on the closing of the transaction (unlike your fee, in all likelihood), and so the seller can be assured at least that when the fee comes due there will be source of funds from which to pay it. If your client is a seasoned M&A warrior, has strong financial and valuation skills (or another member of the team has such skills), and an auction process is not envisioned, then the argument in favor of an investment banker diminishes. However, for many sellers, a sale of the business is a once-in-a-lifetime event, and they would do well to consider taking advantage of these services.

- *Tax advisor*. Every M&A transaction needs a good tax advisor. This can either be a tax lawyer or a tax accountant, but in either case should be someone familiar with the particular tax issues that arise in connection with acquisitions and dispositions. The tax advisor will be called on to provide input in connection with the structure of the transaction, the tax representations and warranties in the purchase agreement, the disclosure schedules, and tax planning (including estate tax planning).

- *Accounting advisor*. Ideally, this will be the person who has the best day-to-day familiarity with the seller's books and records. In many cases, but not all, this will be the same person who is the tax advisor. The accounting advisor will provide input as to the financial statements, the financial statement representations and warranties, and other accounting matters.

- *Other specialists*. Depending on the nature of the seller and its business, it may be advisable or necessary to include other specialists on the team, such as environmental consultants, or industry-specific regulatory experts.

- *Legal team*. Depending on the nature of the transaction and the breadth of your competencies, you will likely need some level of assistance of lawyers in other practice areas, including securities, banking, environmental, labor & employment, insurance, litigation, real estate and intellectual property law.

Of course, it is financially impractical to assemble a "dream team" for every transaction. The reality is that you will need to use your judgment to build a right-sized team that can give the client the advice it needs within the constraints of a budget that is commensurate with the nature and size of the transaction. This analysis is best done as early as possible in the transaction.

Maximizing Value. At this stage, a purchase price may have been determined, or at least mentioned. Assuming that the price is acceptable to your client, one of the goals will be to keep the price from eroding throughout the due diligence and the transaction process. Your client's business may have significant curb appeal, but how will it stand up to having the buyer poke through the cabinets and examine the plumbing? There are a number of aspects of the business that you and your client should evaluate and, where necessary, address to prepare the business for sale. Note that there is no need to wait until a buyer is at the door to address these matters. If a business is potentially for sale (and we would suggest that *every* business is *always* potentially for sale), it is a good idea to consider these matters before a deal is on the table.

- *Financial statements.* If the client has audited financials and good internal controls, they are a step ahead of the game. However, it is not unusual for a private company not to have audited financials, and it is not necessary to have them to successfully conclude a transaction. However, the financial statements must be of sufficient quality that they hold up to the buyer's (and the buyer's accountants') careful scrutiny. The purchase price is often determined (or at least verified) by reference to a financial metric such as EBITDA. If the financial statements start springing leaks, it will be purchase price that comes dribbling out. If the seller has any uncertainty about the state of the business's financial statements, i.e. whether they fully comport with GAAP (or legitimate reasons for deviating from GAAP can be articulated) and fairly reflect the financial condition of the business in all material respects, hiring a good M&A accountant to review and, if necessary, restate the financial statements can be time and money well spent. And it is never too early to implement good financial controls, whether or not a sale is on the horizon.

- *Tax planning.* The client's tax advisor should evaluate the structure of the business to determine what effect it will have on the tax impact of the sale. For example, if the business is organized as a C-corporation and the transaction is structured as an asset sale, a significant "double tax" may be imposed. It may be possible to make organizational changes to the seller's corporate structure in advance of sale that would result in better tax treatment. Note however that there are limitations under applicable tax laws to what can be done on the eve of sale to achieve tax benefits.

- *Employment agreements.* Buyers typically expect that the business they will acquire has customary arrangements in place with its employees, including agreements that restrict the employees from competing against the business and soliciting the employees and the customers of the business during the term of employment and for a period of time (typically one year) afterward, and using or disclosing the business's confidential information. If the buyer discovers that these protections are not in place, the buyer may take the opportunity to negotiate the purchase price downward. Alternatively, the buyer may require your client to put such agreements in place as a condition to closing, which may give the client's employees leverage to extract financial or other concessions, particularly if they sense that the consummation of the transaction depends on their cooperation.

- *Intellectual property.* Is the client's intellectual property well-documented? Consider whether important registrable trademarks and other intellectual property are registered with the USPTO or other applicable agency. If the client has developed proprietary intellectual property, it will be important to the buyer that the employees and consultants who have participated in the development of the intellectual property have executed written assignments of their rights and inventions to the business. If the client uses third-party intellectual property, there should be licenses in place with respect to such use.

- *Title to assets.* Often, a private company will use assets in the course of its business – even on a regular basis – that it does not actually own or have a valid lease or license to use. It may be a forklift that really belongs to an affiliated company, or a storage facility that belongs to an accommodating neighbor, or a patent that is registered in the name of the employee inventor. After the sale, the buyer will expect to be able to utilize all of the assets that the seller used before the sale, and to get a representation to that effect from the seller in the purchase agreement. Now is the time to inventory all of the assets that are used in the business, to identify any that are not owned of record by the seller, and to either legally transfer them to the seller or implement arm's-length leases or licenses giving the seller the right to use them (don't forget to reflect the cost of doing so in the seller's financial statements). This will prevent erosion of the purchase price, not to mention the fact that these are good practices for tax and accounting purposes.

- *Assignability of contracts & leases.* A key issue is the assignability of the seller's contracts (including leases) to the buyer. The importance of assignability of a contract depends on the impact that the contract has on the value of the company, which in turn is a function of the duration, the counterparty's termination rights, and the seller's economic benefits under the contracts compared to the benefits available in the market. Contracts have the maximum impact on purchase price when they are long-term, difficult for the other party to get out of, and provide above-market revenues or below-market costs to the seller. All contracts, and particularly the more valuable ones, should be analyzed to determine whether and to what extent the counterparty's consent will be needed to consummate the proposed transaction. For any given contract, the answer to the question of consent may depend on the manner in which the transaction is structured (e.g. stock purchase vs. asset purchase); therefore the relevant provisions of the contract should be read carefully with the transaction structure in mind. If the transaction structure has not been finally determined, the contracts may need to be analyzed under multiple scenarios; the assignability analysis may inform or even dictate the structure that the transaction ultimately follows.

- *Ownership records.* The question of who owns your client's business may seem ridiculous on its face – your client does! But, can he prove it? The buyer will want to review documentation evidencing – and receive representations from the seller regarding – the identity of the owners of the company. This is particularly important in a stock purchase. A well-maintained corporate minute book will include stock records, including a stock transfer ledger and all original stock certificates issued since the formation of the company (or lost certificate affidavits in lieu thereof), original charter documents stamped by the Secretary of State, and minutes of all meetings of the board of directors and shareholders (or written consents in lieu of such meetings). Once upon a time, these books were leather-bound portfolios embossed with the name of the company and the corporate seal. Today a corporate minute book is more likely to be an unceremonious 3-ring binder if you are lucky, a disorganized manila file-folder if you are not. It may not exist in physical form at all; it may be a collection of electronic documents scattered among various emails and folders on the company's computer servers. To compound the problem, today a private company is likely to take the form of a non-corporate entity such as a limited liability company or a limited partnership, which more often than not have uncertificated ownership interests. The ownership of such entities is usually evidenced merely as a roster of members attached as an exhibit to the limited liability company or partnership agreement. This exhibit (if you are fortunate enough to find the agreement in the first place) may be out of date, blank or missing entirely. It is important at this stage to gather all of the corporate records that you can, assemble them in an orderly manner, and create or replace any key documents or certificates that cannot be found. Generally, a buyer would rather find that you have recently done curative work on corporate records than to have to ask you to do it following the buyer's due diligence.

- *Current litigation profile.* Although litigation and regulatory proceedings are a fact of life for many businesses, now is not the best time to be dealing with a handful of pending or threatened matters, particularly those that may impact the buyer going forward. If there are matters that can be settled or otherwise resolved, that may smooth the way toward a successful acquisition. Of course, strategic cost/benefit decisions will need to be made and settlement concessions should not be made too lightly.

Memorializing the Parties' Intent. Once a confidentiality agreement is in place, and transaction discussions have become reasonably detailed, the usual next step is to draft, negotiate, and (sometimes) sign a document that sets the stage for the transaction. This document will outline the basic terms (which are usually non-binding), and contain some basic covenants to facilitate process (which are usually binding). It is most often called a letter of intent, but may be called a memorandum of understanding, letter of understanding, agreement in principle, gentlemen's agreement, handshake agreement, term sheet, or transaction outline, to name several alternatives. Some lawyers may ascribe different shades of meaning to these terms (for example a "term sheet" may suggest a document with less detail and a greater likelihood of being unsigned), but they are essentially interchangeable.

Why enter into a letter of intent, particularly if the transaction terms are non-binding? One reason is to make certain that your preliminary negotiations are just that – non-binding. In the absence of a written agreement expressly stating that neither party is bound by preliminary discussions, courts may find a binding oral agreement where none was intended. Another reason is that the parties will often abide by the terms in the letter of intent, and a party who seeks to depart from a term in the letter of intent generally does so at the expense of negotiating capital, unless there is a clear and legitimate basis for making the change (such as discovering something expected in due diligence). With regard to the level of detail in the letter of intent, there are various schools of thought. Some M&A professionals believe that the seller's leverage is at its maximum immediately before the letter of intent is signed, whereupon the seller's leverage begins to seep inexorably away (at least until the end of the exclusivity period), and it is therefore to the seller's advantage to "lock in" the deal terms in as much detail as possible in the letter of intent. Others believe that the buyer is usually more prepared and better represented at this stage, and benefits from putting as much as possible into the letter of intent before the seller is really paying attention. In this case, of course, because your client has you on board (and you have read this article), your client will not be caught flat-footed in this manner by an opportunistic buyer. We believe that the best reason for devoting a reasonable amount of time and resources on a well-developed letter of intent is to paint as clear a picture as possible of the path that the parties are intending to walk down. The process of putting the parties' deal terms on paper will typically bring at least a few misunderstandings to the surface, which are better dealt with (or at least identified) at this stage than after several weeks of diligence and negotiations.

Although letters of intent are often referred to as non-binding, and they generally are insofar as they describe the proposed transaction terms, there are often a number of binding provisions. These provisions will generally apply from the time the letter of intent is signed until the letter of intent is terminated or a definitive agreement is signed, which will then take precedence. Following are key binding provisions to be addressed in a letter of intent.

- *Buyer's access for due diligence.* Buyers prefer to have binding commitments from the seller to cooperate with the buyer's investigation of assets, properties and records. The seller should secure reasonable limitations, such as on the buyer's ability to communicate with third parties (such as the seller's customers) and to perform environmental investigations.

- *Seller's conduct of its business.* Buyers sometimes seek a covenant from the seller to conduct the business only in the ordinary course as historically conducted. Sellers will generally resist making these covenants until a definitive agreement is signed. Even without a covenant, however, a seller should be modest about taking unusual actions involving the business while in the middle of a sale process without communicating with the buyer. Note also that there may be antitrust implications that arise from pre-closing covenants that are overly restrictive, particularly if the buyer is a strategic buyer.

- *Exclusivity*. From the buyer's perspective, this is among the most important elements of the letter of intent, and may be the key reason that the buyer wants a letter of intent at all. It is reasonable for a seller to grant the buyer a limited exclusivity period in view of the time and expense that the buyer is about to incur in due diligence. However, in granting exclusivity, the seller cedes significant leverage. Therefore the seller should avoid granting exclusivity until the purchase price is satisfactory and the letter of intent contains all of the important deal points on terms that are satisfactory to the seller. In addition, the exclusivity period should be no longer than is reasonable necessary to get to a definitive purchase agreement.

- *Confidentiality*. If a separate confidentiality agreement has not been executed, one can be incorporated into the letter of intent.

- *Costs.* The usual arrangement in an M&A transaction is that each party pays its own costs, including legal fees. It is advisable to have that in writing up front, particularly if the buyer is a financial buyer, because financial buyers may be accustomed to lending transactions in which it is common for the borrower to pay the lender's expenses, including legal fees.

- *Governing law and dispute resolution.* These terms should be included. Note that this provision determines the governing law and the manner for resolving disputes related to the *letter of intent*, not the purchase agreement. The definitive purchase agreement will contain its own governing law and dispute resolutions terms, and these may be specified at this stage in the non-binding section with the other transaction terms.

The key non-binding provisions to be addressed in a letter of intent are:

- *Purchase price.* Determination of the appropriate purchase price for a privately-owned business is part science and part art. Methods of business valuation include taking a multiple of some expression of earnings (often EBITDA), reference to recent comparable transactions, valuation of the underlying assets, and net present valuation of expected future earnings, among others. Transaction participants will often emphasize a method that supports their preferred result. As indicated above, obtaining an investment banker's or business appraiser's input on the market valuation of the business can be a valuable exercise. One word of warning: if the client has issued stock at a nominal or otherwise below-market price within the last year or two, that price could be used against him now.

- *Purchase price adjustments.* The purchase price may be subject to certain adjustments, which can be identified in the letter of intent. See *Adjustments to Purchase Price*, below.

- *Transaction structure.* The structure of the transaction will be based on primarily on tax, operational and third-party considerations. See *Structuring the Transaction*, below.

- *Important representations & warranties.* Even successful and sophisticated business owners are sometimes surprised to find that, after an extensive and intrusive due diligence investigation by the buyer, they will be asked in the purchase agreement to stand behind a lengthy list of representations about the business and its operations, assets and liabilities. Often the letter of intent simply says that the seller will make "customary" representations and warranties. However, an aggressive seller may seek to limit the scope of the reps and warranties in the letter of intent. On the other side, a buyer may want to identify certain reps and warranties that are desired by the buyer which may be out of the ordinary.

- *Escrow arrangements.* A portion of the purchase price (varying, but often around 10%) is typically set aside and deposited with an independent bank for a period of time (usually a year or two) to serve as a ready source of funds in the event that the buyer is entitled to indemnification from the seller under the terms of the purchase agreement. The necessity for an escrow arrangement increases as the creditworthiness of the seller decreases, and is at its maximum where the seller is an entity that upon consummation of the transaction will liquidate and distribute the purchase price to its owners, leaving behind nothing but an empty shell.

- *Important closing conditions.* In most simple transactions, an agreement is signed, money is paid, and property is conveyed, all at one ceremony. In more complicated transactions, including most large M&A transactions, a binding purchase agreement is signed which contains a series of conditions that must be satisfied before the parties are obligated to close, and a separate closing ceremony occurs after the satisfaction of the conditions. Examples of common conditions are third-party approvals (e.g. the consent of contract counterparties or landlords), regulatory requirements (e.g. Hart-Scott-Rodino or CFIUS filings), and the effectiveness of ancillary agreements (e.g. the execution of employment agreements between the buyer and the key employees of the business). It is advisable to include important conditions in the letter of intent, particularly if they are atypical or if there is a likelihood that the other party will object. For example, a condition that the buyer must have obtained financing for the purchase price is strongly disfavored by sellers, and if not raised up front will likely create a confrontation later.

- *Indemnity limitations*. The "caps," "baskets," survival periods and other limitations to the indemnification provisions (see *Post-Closing Indemnification*, below) are often among the most intensely negotiated provisions in the transaction. And often they are among the last provisions to be finally agreed upon. Therefore, it is an ambitious gambit to try to pin these terms down at the letter of intent stage, and when done it usually takes more time to reach agreement on the letter of intent. However, if you are able to get favorable terms (even non-binding ones) at this stage, it can give you leverage in difficult negotiations down the road.

Below is additional detail on three areas in particular that have a direct impact on the economics of the transaction: Structuring the Transaction, Adjustments to Purchase Price and Post-Closing Indemnification.

Structuring the transaction. The most significant structuring decision is whether the transaction will proceed as a sale of assets or a sale of stock.

- Asset purchase. This is usually a buyer's preferred structure because it provides an opportunity to "cherry pick" the pieces of the seller – assets, liabilities, and employees – that it wants, and leave the rest behind. Some unwanted liabilities may attach anyway, such as environmental, product defects, ERISA, and tax liabilities. As a result reps & warranties and indemnities on these subjects are usually longer and more developed than reps & warranties on other subjects. The seller's taxable gain on the transaction will be the extent to which the purchase price for the assets exceeds the seller's basis in the assets.[1] In addition, the buyer will be able to "step-up" the tax basis in purchased assets; for this reason the purchase price will need to be allocated among the assets being sold. The buyer and seller's interests may not be aligned with respect to the allocation and there may be a negotiation within the range of justifiable values. This should be considered early on.

- *Stock purchase*. Buyers generally do not prefer this approach for tax and liability reasons. Most transactions that take this form do so because there are practical difficulties with consummating an asset purchase. For example, the seller may have a large number of vehicles or other titled assets, the transfer of which would require individual registration with a government agency, a number of contracts that require third-party consent to assignment, or a large number of employees which would have to be terminated by the seller and rehired by the buyer. By purchasing the stock of the company that owns the assets, is the party to the contracts, and employs the employees, these issues can be avoided. The buyer will take a basis in the purchased shares equal to the purchase price, while the acquired company will maintain its basis in its underlying assets. The seller's taxable gain will be the extent to which the purchase price exceeds the seller's basis in the stock being sold.

- *Merger*. This mechanism is a variation of a stock purchase which is useful when the target company has a large number of stockholders. In that case, the merger structure provides a mechanism for acquiring the shares without obtaining the approval of 100% of the shareholders of the target company.

- *338(h)(10) Transaction.* In simple terms, this is a stock purchase that is taxed as an asset purchase for federal income tax purposes. In most transactions, this election would result in a tax benefit to one party (usually the buyer) and increased tax cost to the other. However, in certain limited circumstances (most

[1] We are not tax lawyers. Although this section addresses certain basic tax concepts, a tax professional should be consulted with respect to these issues in any transaction.

commonly involving a target company that is a subchapter S corporation), a 338(h)(10) election can benefit one party without adding cost to the other party.

Adjustments to Purchase Price. An acquisition agreement will often provide for the purchase price paid at closing to be adjusted for various items after closing. The most common adjustment, used particularly but not exclusively in stock purchase transactions, is the working capital adjustment. This adjustment provides for the purchase price to be increased to the extent that the target's working capital exceeds an agreed-upon threshold, and to be decreased to the extent that working capital is less than the threshold. There can be a similar adjustment in an asset purchase transaction if the buyer is acquiring receivables and other current assets, and assuming certain payables. More customarily, an asset purchase transaction will provide for the purchase price to be adjusted for pro-ratable items. The parties can agree to make other appropriate adjustments depending on the specifics of the transaction.

- *Working capital adjustment*. The working capital adjustment provides for the purchase price to be increased or decreased, depending on whether the amount of the current assets at closing exceed (or fail to exceed) the amount of the current liabilities at closing above an agreed-upon threshold amount. In a transaction in which closing does not occur simultaneously with signing, the seller will usually provide an estimate at closing of the working capital adjustment (which will impact the purchase price paid at closing), and then the parties will "true-up" the working capital adjustment following the closing. The true-up may result in a payment from the buyer to the seller or vice-versa, depending on whether the working capital amount estimated at closing was greater than or less than the working capital amount as finally determined in the true-up. Often the parties will agree upon a "normalized" working capital amount as the threshold and provide that the working capital adjustment will be based upon the normalized amount. However, depending on the pricing of the transaction, and whether the buyer anticipated the target having any working capital, the threshold amount may be set at zero.

- *Current assets and current liabilities*. The determination of what assets and liabilities are included in the working capital calculation is of primary importance. The seller will benefit from including all current assets to the extent provided for under generally accepted accounting principles (GAAP) and as reflected in its regularly prepared financial statements. However, the buyer may wish not to pay for certain current assets from which it does not expect to benefit, such as certain prepaid expenses, deferred taxes, and affiliate or past-due receivables. On the liability side, the buyer may wish to include accruals for various expenses not reflected on the financial statements and/or liabilities it discovers during due diligence. Long-term debt and selling expenses which are to be discharged in connection with the closing of the transaction are also generally excluded from the calculation of current liabilities. The regularly prepared financial statement of the seller will generally be the starting point for the working capital adjustment, but either party may require certain exceptions to reflect what they believe to be a more accurate picture of the company. For this reason, one approach that is useful in minimizing later disputes is to attach a *pro forma* closing statement to the acquisition agreement, and require both the statement delivered by the seller at closing and the post-closing true-up statement delivered by the buyer to conform to this *pro forma* statement.

- *Cash*. Cash is a current asset that deserves specific mention. Sometimes parties include cash as part of the current assets, and at other times, cash is treated outside the working capital adjustment. Under the latter approach, the purchase price is adjusted upward by the amount of cash at closing (or the target corporation is entitled to distribute such cash to its shareholders immediately prior to closing). The determination of the appropriate working capital threshold cannot be made until one first determines which current assets – especially cash – are to be included.

- *True-up process*. The buyer is generally given 90 to 120 days following closing to complete its post-closing true-up statement. The buyer then sends this statement along with supporting documentation to the seller for its review. The seller is then given an agreed upon time (around 30 days) to review the buyer's proposed adjustment. During this period, the buyer will be obligated to make the appropriate books, records and personnel available to the seller. If the seller does not send an objection notice, then the estimate submitted by the buyer will be binding on the parties. If the seller does object, it is required to communicate its objections in writing to the buyer. If an objection notice is timely provided, the acquisition agreement will typically require the parties first to seek to resolve the matter through direct discussions, and failing that, to designate an agreed upon accounting arbitrator to make the final determination. The determination by the accounting arbitrator is binding upon the parties. Sometimes the fees and expenses of the accounting arbitrator are split 50-50 between the parties, and sometimes the fees are allocated such that the party whose estimate was further apart than the arbitrator's final determination, pays the fees.

- *Payment of adjustment*. Once there is a final determination of the post-closing adjustment, the buyer or seller, as applicable, is required to make a payment in a prompt manner. An acquisition agreement may provide for interest compensation. If there is an escrow arrangement in the transaction, the buyer may agree that a downward adjustment can be paid out of the escrow account (as opposed to the seller having to fund it out-of-pocket).

- *Prorated items*. Most asset purchase agreements will provide for a proration of taxes, utilities, and other recurring items of expenses and revenues. To the extent possible, the amount of these items will be determined or estimated at closing and then trued-up after the closing. If no estimate can be made, then the agreement will provide for there to be a calculation of the actual amount of these items at a specified time following closing. Thereafter, as applicable, either buyer or seller will have to pay the amount owed as an adjustment to the purchase price. Disputes for these items are not as common as working capital adjustment disputes because the amount of these items is readily available from third party sources. If there is a dispute, the acquisition agreement will usually allow for an accountant arbitrator process to resolve such disputes. The key is for the parties to agree in advance as to what items will be included in the pro rata calculation.

- *Debt*. In most stock sale transactions, there will be a reduction in the purchase price at closing for the amount of debt of the target company (since generally a buyer wants to buy the company debt-free). If after closing it is determined that the debt was actually greater than or less than the amount estimated at closing, then there will be true-up for the actual debt amount. Usually a buyer will require a payoff letter from all creditors at closing and this minimizes the chance of material adjustments for debt post-closing.

- *Capex*. Another area that lends itself to a purchase price adjustment is capital expenditures. If in the due diligence process a buyer determines that a previously unanticipated level of capital expenditures will be required following the closing, it may seek a downward adjustment in the purchase price for such expenditures. Conversely, if prior to closing the seller incurs significant capital expenditures, the seller may seek an increase in the purchase price on the theory that the buyer rather than the seller will receive the benefit of such expenditures.

Post-Closing Indemnification. Indemnification provisions are among the most important and extensively negotiated provisions in an M&A transaction. So it is a bit odd that they are typically found toward the very end of an acquisition agreement, often right before the legalese of the "miscellaneous" provisions. These provisions provide the buyer with its remedies for any losses or expenses suffered from a breach of the representations, warranties or covenants of the seller. It is through the indemnification provisions that a buyer will seek redress if following the closing it encounters a liability or expense that it did not anticipate from the due diligence process. From the seller's perspective, it is by the application of indemnification provisions that the purchase price for which the seller has bargained could be lost without careful drafting (a buyer will also provide indemnification for certain matters, but such provisions seldom come into play). Indemnification may come in the form of a direct claim by the buyer against the seller for damages or from a demand by the buyer to be indemnified from a third-party claim regarding a matter for which the seller has agreed to provide protection. As part of its indemnity protection, a buyer will generally have the right to recover fees and expenses incurred by it in enforcing its indemnification claim and for fees and expenses incurred in connection with the underlying third-party claims. In a transaction involving a public company, a seller will not have post-closing indemnification obligations.

- <u>*Who is liable*</u>? The question of whether the shareholders of the target corporation should be liable for the indemnification obligations is always an issue in an asset sale. Since typically the selling corporation will not have meaningful assets following the sale (other than the purchase price received, which will presumably be distributed to the owners), the buyer will require the shareholders to stand behind the indemnification obligations. When the buyer is buying stock, there is really no question that the shareholders[2] will be liable, because following the acquisition of the target company, unless the selling

[2] It should also be noted that if a shareholder itself is an entity, then the buyer will also seek to have the owners of that entity join in the indemnification obligations.

shareholders are liable, no one will be left to support the indemnification obligations. The only question in a stock sale (and a question also present in an asset sale) is whether the selling shareholders should be jointly and severally liable for the indemnification obligations, as opposed to being liable for a portion of the liability that corresponds to their respective ownership percentages. In most cases, the buyer will take the position that it should not have to take the insolvency or other non-performance risk of a selling shareholder and will require joint and several responsibility. In some cases where there are one or more principal shareholders, and one or more minority shareholders who have not had much day-to-day involvement in the company, the buyer will agree to look just to the principal shareholders. An escrow or holdback arrangement is another way for a buyer to avoid having to chase the sellers for their indemnification obligations.

- *Who may be indemnified*? Indemnification provisions generally will cover the buyer and its various directors, officers and affiliates, including, in the case of an acquisition of stock, the acquired company.

- *Scope of the indemnity*. The indemnification provisions will cover the various representations and warranties made by the seller (i.e., absence of undisclosed liabilities, compliance with laws, contracts with third parties, and the like), as well as the covenants or undertakings made by the seller in the agreement. If during due diligence a specific item of risk has been identified, the parties may agree that the seller will provide an indemnity for such item (for instance, a seller may agree to remain liable for a specified ongoing litigation matter). In addition, buyers will often seek specific indemnification protection for certain areas of risk, including pre-closing taxes, pre-closing employee benefit issues and pre-closing environmental liabilities. Most sellers will readily agree to provide such indemnity for taxes (except to the extent covered in the working capital adjustment) but will resist such absolute indemnity application for these other items.

  In an asset sale, the seller will also be obligated to provide indemnification for pre-closing liabilities to the extent such liabilities are not specifically assumed by the buyer under the terms of the purchase agreement. This directly increases the potential indemnity risk to the seller and is another reason why a stock sale can be more beneficial to a seller. However, it should be noted that depending on the negotiating leverage of a buyer or a seller, a buyer may be able to impose "asset type" indemnification obligations on a seller in a stock sale or a seller may be able to reduce its indemnification exposure in an asset transaction to indemnification obligations similar to those in a stock sale.

- <u>*Limitations on indemnification*</u>. Subject to certain exceptions noted below, typically the buyer's sole remedy for a breach after closing by the seller of any of its representations, warranties or covenants will be the indemnification provisions contained in the purchase agreement. A seller will seek to limit its indirect indemnification liability through the use of a deductible/basket, a cap, the exclusion of certain types of damages, and the application of a limited survival period for the representations and warranties.

  - <u>Deductibles and Baskets</u>. A deductible or basket will prevent the seller from being subject to an indemnification claim until the buyer's losses reach a certain threshold. Once the buyer's losses have reached this threshold, the seller may be required to indemnify the buyer (i) only to the extent the buyer's losses exceed the threshold (a deductible), or (ii) to the extent of the losses incurred by the buyer back to dollar one (a basket). Sometimes a seller will also seek to include a *de minimis* limit such that the seller will simply not have any liability for a claim or series of related claims unless the total amount involved is in excess of that limit.

There are two primary justifications advanced for the use of a deductible or basket. Under one theory, the basket is intended to simply be high enough to avoid the seller having to deal with frivolous claims or more "ordinary course" type minor problems that arise following closing. Under this theory (which is the one usually advanced by a buyer) the purchase agreement would provide for a deductible rather than a basket and the amount set would be relatively low. The other theory is that the "basket" should be set high enough so that the buyer only has a claim for truly material losses. The basis for this theory is that no buyer should expect to buy a "perfect" company and indemnification should be available only after problems have proven to be material.

Generally, the basket or deductible will be negotiated on the basis of a percentage of the purchase price and will be larger if a deductible is utilized rather than a basket. In negotiating a deductible and basket, a buyer will want to avoid the "double-dipping" effect that can occur if the representations and warranties include materiality exceptions. The way for a buyer to avoid giving a seller this over protection is to scrape-out the materiality concept for purposes of determining whether a breach has occurred and the amount of any damages.

- <u>Cap</u>. Sellers will always try to cap their liability by including a maximum amount over which the buyer will not be entitled to indemnification. A buyer will typically advance the position that the cap should be tied to the amount of consideration received. The seller will want the cap to be some smaller percentage of the purchase price received. The seller's argument for a lower cap is that the seller deserves to have a "peace of mind" and know that following the sale of its business, it will be able to retain a meaningful portion of the amount received from the business they just sold. A buyer's willingness to accept a lower cap will often depend on the types of items that are carved out from the caps and/or if there is some particular catastrophic types of loss that it believes it needs protection against. Typical carve-outs from an indemnity cap (and often the deductible/basket and survival periods) are for matters relating to taxes and employee benefits. Buyers will often seek to receive a carve-out for environmental matters, but here the seller can counter that because a buyer may protect itself in pre-closing by conducting an appropriate environmental assessment, such a cap exception is not appropriate. In more recent years, buyers have also sought to exclude employment related matters from the deductible and the cap. The risk of class action and government group litigation for wage and hour, job classification, and similar matters, has greatly increased buyers' sensitivity in this area.

- Waiver of Certain Damages. A seller will try to limit its damage exposure to "direct damages" and to exclude consequential, punitive, and other special damages, including loss of profits. The seller's position will be, for instance, that if there is undisclosed liability, its indemnification obligation should be limited to the amount of such liability. A buyer, on the other hand, will argue that since it has bought the company on the basis of some multiple of earnings and an expectation that a certain amount of profits will flow from the contracts and business acquired, limiting the buyer to direct damages is not appropriate. One compromise position sometimes used is for the parties to agree to waive consequential damages but then also agree on what does or does not constitute a consequential damages (e.g., agree that the loss of profits do not constitute consequential damages).

- Survival. Most negotiated agreements will include an outside date after which the buyer is no longer entitled to bring an indemnification claim for a breach of a representation or a warranty. This survival period can range from a few months to a few years, with the general survival period being between one to three years. A buyer will typically insist upon a longer survival period for potentially significant liabilities, including environmental, tax and benefit matters. In these areas, it is not uncommon for the survival period to be described as the expiration of the applicable statute of limitations, plus some period of time. However, a seller should be cautious in agreeing to this survival period for environmental matters since unlike taxes and benefits, there really is no set period of time for which an environmental liability could arise. It is also common to provide that certain representations survive indefinitely, without limitation, including those relating to ownership and capitalization (particularly in a stock transaction), the authorization of the seller to enter into the transaction, and there being no broker involved on the seller side.

- *Exclusive Remedy*. A buyer will almost always insist that the indemnification provisions should not be its exclusive remedy in the case of fraud and will similarly argue that the applicable caps, deductibles/baskets and survival periods (discussed below) should be excepted for fraud. More often than not, the buyer will attempt to take the same position with respect to an intentional breach or willful misconduct, or criminal conduct. From a seller's perspective, given the breadth of various fraud statutes, it should seek to limit the fraud exception to "intentional fraud" or at the very least, exclude negligent misrepresentations or omissions.

- *Anti-"sandbagging"*. A seller may seek to include a provision prohibiting the buyer from recovering for a breach of a representation and warranty if the buyer had actual knowledge of such breach prior to closing. If a buyer agrees to such a provision, then along with the burden of establishing its claim for a breach of misrepresentation will come the additional burden of the buyer of first establishing it was not aware of such a breach. In fact, a seller's inclusion of that provision is likely to prompt the buyer to include a specific provision in the agreement stating that it has the right to rely on the representations and warranties made by the seller, regardless of any investigation or knowledge obtained by the buyer prior to closing.

- *Procedures for third party claims*. Since seller indemnitors will be paying for third-party claims, they typically negotiate for the right to control the litigation against such third-party. Buyers will generally agree to such provision with certain limitations. The strongest position for the buyer to take is that the seller only has the right to control the litigation if the seller first acknowledges it is liable for the claim. In general, the right of a seller to control the litigation should also only be applicable for a claim for the payment of money, rather than an injunction that could be binding upon the acquired business on an ongoing basis. In any event, a seller's right to settle a case will typically require the buyer's consent unless such settlement results in no liability being imposed upon the buyer or the target company. Finally, the buyer will most always retain the right to engage its own counsel to monitor the activities of the counsel engaged by seller to handle the claim.