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Learning the Art of Acquisition

Understanding the Fundamentals Leads to a Successful Transaction

Throughout the current and past economic expansion, there has been a significant level of merger and acquisition activity. Part of that has been fueled by the run up in stock prices, as public companies utilize their stock as consideration for acquisitions. With the recent downturn in the market, the pace of M&A activity may increase as public companies with deflated stock prices become more susceptible to takeovers and those seeking capital for expansion are not as able to access the public markets. In addition, companies to accomplish various strategic objectives will always utilize acquisitions, and sales will always be the most common means for business owners to monetize their investment.

Accordingly, many business owners may find themselves involved in an M&A transaction. For those unfamiliar with the process, an acquisition can be intimidating. The process is, however, fairly standard and the following primer of the steps involved may alleviate unneeded anxiety.

Confidentiality Agreement

When two parties desire to explore a potential transaction, the first document they should sign is a confidentiality agreement. Generally, before negotiations begin in earnest, the buyer will want to conduct an extensive due diligence examination of the seller. During that examination, the buyer will have access to sensitive information regarding the seller. The confidentiality agreement requires that the buyer keep that information, and the fact that negotiations are in process, confidential.

Letter of Intent

Before negotiating the definitive agreement, often the parties will negotiate a letter of intent (LOI) on major economic terms. Generally, the LOI is non-binding, except for certain specified sections such as confidentiality provisions and no-shop clauses (discussed below). The LOI outlines the deal structure (such as asset purchase, stock purchase or merger), the purchase price and form (such as stock, cash or notes), payment terms and closing contingencies.

LOIs often contain no-shop clauses prohibiting the seller from negotiating with other potential buyers during an agreed upon period of time. These clauses protect the buyer from expending the resources to negotiate a transaction only to have the seller turn around and sell to a third party. Before entering into a no-shop clause, the seller should consider whether it should first approach other potential buyers.

Although a LOI is usually non-binding, it forms the basis for the definitive agreement. Material deviations

from the LOI are met with resistance by the disfavored party. It is critical to expend the effort to negotiate as favorable a letter of intent as possible and highly advisable to consult with counsel before signing it.

Due Diligence

As indicated above, the buyer will normally conduct a thorough due diligence examination of the seller. This examination identifies legal issues to be addressed and helps the buyer evaluate the merits of the potential transaction. Often times, information discovered during this process drive the structure of the transaction and/or it's pricing. For example, if the seller has a significant number of contracts that cannot be assigned without third party consents, the buyer may elect to pursue a stock purchase or merger transaction to avoid the need to obtain those consents. When real estate is involved, the buyer will also want to conduct an environmental review. Since the environmental laws require property owners to inform the regulatory authorities of any contamination discovered on the property, the parties need to carefully negotiate how that review will be conducted.

The due diligence examination is time consuming and cumbersome but it should not be taken lightly by either party. For the buyer, a less than thorough review may result in costly surprises arising after the acquisition. For the seller, a misstep could risk losing the deal or result in a material price or other adjustment.

Definitive Agreement

To bring about the transaction, the parties will negotiate a definitive acquisition agreement and, depending on the parties' intentions, various ancillary agreements such as those dealing with noncompetes, employment, consulting, leases and so forth. Generally, the buyer prepares the first drafts of the agreements. In an auction situation, however, the seller usually prepares the acquisition agreement and requires each bidder to submit both its price and required revisions to the agreement – both of which impact its chances of being selected as the buyer.

The acquisition agreement has essentially four main sections: purchase price, representations, indemnification and covenants. The purchase price section specifies what will be purchased, (for example stock or assets), the amount to be paid and the form of payment. If part of the consideration is buyer stock, the agreement should address how and when that stock could be resold. Some transactions include an earnout where the seller will be paid more if certain conditions occur post-closing. In those situations, the parties should carefully negotiate the terms of the earnout. For example, if based on post-transaction profit, how will profit be defined? Will it be before or after acquisition related expenses?

The representations section contains extensive representations by the seller concerning its business. These representations generally include, for example, that the seller's financial statements are accurate and there are no undisclosed liabilities. The representations are typically heavily negotiated with the buyer seeking as expansive language as possible and the seller seeking limitations such as knowledge or materiality qualifiers. If the purchase price is paid in cash, the buyer will make very few representations to the seller. If, however, part of the consideration is paid with buyer stock, the seller is justified in seeking expansive representations from the buyer so it can evaluate and protect the worth of that stock.

If any of the representations are breached, the indemnification section sets forth the breaching parties' potential liability. Many view this as the most critical section of the document. The buyer desires broad indemnification provisions aimed at making the seller responsible for any preclosing liabilities and the buyer responsible for post-closing liabilities. The seller, on the other hand, desires certainty that the purchase price will remain in the seller's pocket. Depending on the parties' relative bargaining power, typical provisions within the indemnification section include a survival period for the representations (that

is, how much time the buyer has to discover a breach and bring an indemnification claim against the seller), a basket, a cap and the procedural mechanics for indemnification.

The basket represents an agreed upon amount of damages the buyer must suffer due to the seller's breach of its representations before the buyer is entitled to any amount from the seller. The concept behind the basket is that the seller should not be bothered with minor matters. The basket can be either a deductible or a threshold. If structured as a deductible, the buyer can recover only the amount of its damages in excess of the basket. If structured as a threshold, once the basket is exceeded, the buyer can recover all of its damages from dollar one.

The cap sets the seller's maximum liability for breaches of its representations. The buyer will want the cap set at the purchase price whereas the seller will want it set at some small percentage of the purchase price.

The covenant section sets forth the actions the parties are required to take and are prohibited from taking prior to the closing. This section generally requires the seller to continue operating in the ordinary course and requires that the parties use their best efforts to satisfy all conditions to closing.