# Building the Paper Trail

## A look at the legal aspects of acquisition transactions

By Thomas M. Edens & John M. McDonald

Management of the legal documentation process required for merger and acquisition (M&A) transactions is one of the most important aspects of selling your business. Long after the transaction has closed and memories have become less than perfect, the legal documents remain to shed light on the earlier intent of the parties. This article is written from the perspective of the selling shareholders versus the acquirer.

There are five important legal phases to concluding an M&A transaction:

- Preparation Phase
- Letter of Intent Phase
- Legal Due Diligence Phase
- Definitive Agreement Preparation and Negotiation Phase
- Closing Phase

### Preparation Phase

Before a business owner introduces his company to potential acquirers and the company is placed on the market, a number of legal planning tasks should be accomplished.

The attorney should verify that the corporate books and records are current. This would ensure that minutes of the board of directors and shareholder meetings are current and up to date. Any potential disputes with previous shareholders should be resolved and properly documented in the corporate records. A UCC lien search should be done to verify that there are not any outstanding security interests that would surprise the acquirers (or you for that matter).

Lawsuits outstanding (or threatened) should be examined to determine which of them should be settled immediately. FDCPA suits are, unfortunately, a common occurrence in the receivables business, and acquirers understand this. What are typically more difficult to address and quantify in an M&A transaction are lawsuits that involve clients, vendors and former employees. Acquirers must deal with any contingent liability and the impact on the future of the company. Acquirers' concerns for contingent liabilities are elevated if the transaction is ultimately structured as a stock transaction and, to a lesser extent, if an asset sale is effected.

### Letter of Intent Phase

Letters of Intent (LOI) are typically prepared by the acquirer's attorney, and the document typically averages several pages. Offers can also be made and agreed upon based on a one page "Term Sheet." The LOI will usually state the amount of purchase price, how it will be structured and when it will be paid. Most LOIs are nonbinding, except for certain paragraphs dealing with confidentiality and exclusivity of negotiations.

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The Letter of Intent will form the blueprint for the definitive purchase agreement also prepared by the acquirer's attorney. Other important issues commonly addressed in the LOI include:

- Who will be expected to sign employment agreements?
- Terms of non-compete agreements.
- Will the transaction be structured as a taxable stock or asset sale or tax-free reorganization?
- Special handling of certain assets and liabilities such as cash (other than trust cash), shareholder loans outstanding, long-term debt and capitalized leases.
- Are there non-operating assets to be retained by the seller and, accordingly, need to be omitted from the sale?
- Will there be escrow or holdback arrangements as part of the transaction?
- Will notes be subordinated, securitized or subject to increases or decreases (claw-back provisions)?

Most Letters of Intent will state that each party will pay their own costs relating to the transaction. Also addressed in most LOIs will be a provision that the selling shareholders will not pursue discussions with other potential suitors for the company for a certain period of time, usually 60 to 90 days.

### Due Diligence Phase

The substantial burden of due diligence—legal, financial and operational—falls primarily on the acquirer. The reason, of course, is that the buyer is trading cash and other consideration for an operating business with many moving parts.

Your attorney may want to review the documents gathered pursuant to the due diligence data request of the buyer. At a minimum, he should suggest that you retain a copy of the due diligence materials because many of the documents supplied to the acquirer's due diligence team will likely be required again as material components of the disclosure schedules attached to definitive documents.

Legal due diligence by the acquirer's legal team will be focusing on activities which typically have the following objectives:

- Ensuring the seller's capacity to convey the desired assets (tangible and intangible) and liabilities.
- Ensuring the transaction is in compliance with the law.
- Reviewing key contracts and various legal documents previously executed by the company.
- Reviewing current, pending and threatened litigation.
- Analyzing the possibility that contingent liabilities exist.
- Ensuring the company and the contemplated transaction are in compliance with regulatory authorities.

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### Definitive Agreement Phase

Assuming that due diligence is proceeding without major negative discoveries, the acquirer's attorney will be preparing the definitive Stock Purchase or Asset Purchase Agreement. This document could easily be over 50 pages in length, plus exhibits such as disclosure schedules, employment agreements, noncompete agreements and promissory notes.

The representation and warranty section of the purchase agreement will be the core of the document. The acquirer is asking the seller to warrant many things about the condition of the business, its assets and the amount and nature of its liabilities—known, contingent or otherwise. These representations will be in the form of affirmative or negative statements about the company. Considerable effort is usually required to negotiate a document that gives the acquirer adequate protection, while the selling shareholders are comfortable that they are not exposing themselves to future liabilities they were not aware of at the time of closing.

Customary representations and warranties requested by acquirers will involve:

**Corporate Existence:** The company is duly organized, and title to shares is exactly as represented to the acquirers.

**Clients:** The company's relations with its clients are in good standing, and the company has no knowledge of any material client's intent of terminating or materially altering the relationship with the company.

**Financial Statements:** The company's financial statements are accurate and prepared on a consistent basis from period to period. The representation will often state that the financial statements are prepared in accordance with Generally Accepted Accounting Principles (GAAP). Unless the financial statements are audited or reviewed, they probably depart from GAAP in some element. Accordingly, a GAAP representation should not be made. You will need to describe exactly what basis your financial statements are prepared—tax basis, cash basis or otherwise. There are a number of subtle GAAP accruals (such as vacation accruals) that could cost you in post-closing adjustments. Your CPA should give you specific advice on this important representation.

**Taxes:** The company has paid taxes when due, all tax returns are current and the acquirer has been informed of audits in progress or notification of future audits. The tax warranties can be very complex, and specific tax counsel is advised to review this section on behalf of the selling shareholders.

**Conflicts of Interest:** The company has no transactions with anyone who would give rise to a conflict of interest. An example would be that your brother-in-law is the landlord and owner of the building.

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**Liabilities:** The acquirer is relying on your financial statements and your disclosure of contingent liabilities. Disclosure and representations about lawsuits and the contingent liability exposure is always an important issue to acquirers.

**Receivables:** The collectability of your receivables has several implications to the acquirer. On the first level is the actual realization of this financial asset. Second, and perhaps more importantly, is the impact on valuation. If receivables (whether transferred to the buyer as part of sale or not) are not collectable, then the corresponding income statement amounts are overstated and the earnings are impaired. Since most acquirers are using a multiple of an earnings stream (usually Ebitda—earnings before interest, taxes, depreciation and amortization), an uncollectable receivable might have a five-times multiple effect on the purchase price or future post-closing adjustments of the purchase price.

**Other Representations:** There are a number of other representations that are common in definitive agreements regarding such issues as employee benefit plans, environmental matters, intangible property and insurance coverage.

**Best of Knowledge:** The seller's attorneys will often negotiate to modify the draft of the initial agreement so the selling shareholders are making some representations to "the best of their knowledge." An example of a representation that an acquirer might request would be that the company has not broken any laws. How does a business owner know "all" the laws, much less if he broke some obscure law that he was not aware of? A "best of knowledge" qualifier can bridge this gap. However, many representations can and will be required to be made without a "knowledge" limitation.

**Offsets:** If there are costs or damages incurred by the acquirers resulting from a breach of representations, there are several methods for the acquirer to seek reimbursement from the seller. Some transactions have an escrow or holdback whereby the acquirer places a certain amount of the purchase price in an escrow account at closing. This account is released to the seller on an agreed release schedule, providing there are no claims. Other transactions are structured whereby any claims by the buyer will be offset against seller notes. Most transactions are for less than 100 percent cash. Therefore, sellers have exposure for offsets to the future payment stream promised by the transaction structure. Still other transactions are silent as to offsets. The sellers should insist on defining what can or cannot be offset against future payments to them.

**Baskets and Caps:** You, as a selling shareholder, will want basket and cap mechanisms in the definitive agreement.

The basket will require the acquirer to absorb the first set amount of dollar value of breaches of representations and warranties. This basket floor could be a fixed amount, perhaps $50,000 or a percentage of purchase price—maybe 1 percent. The cap (the most a seller will be accountable for) will set a maximum exposure that the seller will incur in the most disastrous breach of representations. Caps can range from the amount of the total purchase price to the amount of the escrowed funds. Do not be surprised if the acquirer's attorney does not suggest any cap in the first draft of the definitive agreement.

Oftentimes, the acquirer will require a legal opinion from your attorney. In smaller transactions, it may be cost prohibitive, but in larger transactions it is customary. Your attorney will be affirming that, among other things:

1. The acquisition agreement is duly executed, authorized and binding.
2. The assets or stock is sellable and free from liens.
3. The agreement does not violate the seller's bylaws or applicable state or federal law. This legal affirmation is often softened by your counsel's "knowledge."

The acquirer's representations and warranties are typically few in number and do not present much risk exposure to the buyers. Customary buyer representations involve corporate capacity and authority to complete the transaction as well as the absence of any conflicts or consents that would make the transaction unlawful.

Noncompete agreements are almost always a requirement for shareholders that were active in the business. The noncompete range most often negotiated is from three to five years. Shorter periods are often in the form of extensions to the termination of the employment agreements.

Obviously, all of the above issues are negotiated at the time of preparation of the agreement. A transaction structured as a stock sale can expect the acquirer's attorneys to require more stringent representations and warranties than an equivalent asset sale structure.

### Closing Phase

There are a number of duties, however, that must be accomplished at closing. The seller's attorney will typically make sure the following tasks are completed:

- Certificates of good standing have been obtained from the secretary of state.
- Consents have been obtained from landlords, clients and other vendors or users of services of the company.
- Disclosure schedules have been made current as of the closing date.
- All required closing documents have been executed by the selling shareholders or key employees, if applicable.
- Closing amounts, payees and wire instructions are accurate and supplied to the acquirers.

**Now, it it not uncommon for the sellers to reside in California, the seller's attorney to office in New York, the acquirer to be domiciled in Illinois, the acquirer's attorney's office in Washington, D.C., and the M&A advisor residing in Texas.**

Closings, however, are not what they used to be. In the not-too-distant past, most closings were gatherings of the attorneys, M&A advisors and principals of the target company with acquirers. Now, it is not uncommon for the sellers to reside in California, the seller's attorney to office in New York, the acquirer to be domiciled in Illinois, the acquirer's attorney's office in Washington, D.C., and the M&A advisor residing in Texas. The closing can occur without any party traveling anywhere. The speed of doing business by Internet, e-mail, overnight delivery, fax and wire transfers of funds have become widely accepted and preferred. Smaller transactions during which most of the parties reside in the same locale will usually close at one of the attorney's offices. Oftentimes, the closing of the sale of one's largest asset, which has been stressful, emotional and tense, has now ended in an anticlimactic fashion. But it is done!

### Summary

The merger and acquisition transaction experience of your lawyer will be very important for the protection of your interests in the selling process. You are wise to hire an attorney who has substantial, recent experience in the transactional areas discussed herein. The attorney who handled your neighbor's second divorce is probably not the counselor you want driving the legal efforts of your transaction. If your transaction attorney has been recently recommended to you, a way to learn more about his specialty and legal background is to refer to the Web site *www.martindale.com*. Legal costs will be a small fraction of the transaction size, yet can save the selling shareholders substantial problems that could arise later if something goes wrong with the transaction. You will, of course, want to be sure your attorney has a block of time to devote to the process. CM


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