Negotiating the Deal

After a potential buyer and seller in each other have expressed an interest, the process moves into a mating dance phase, in which negotiation permeates every stage. From establishing confidentiality ground rules, reaching agreement on the price and setting the structure, to preparing the acquisition agreement and related documents, closing the deal and resolving post-closing tiffs, representatives of the buyer and seller (quite often the lawyers) and the clients themselves are involved in negotiations at some level. This chapter deals with setting the basic terms, including price and structure, and the documentation of the deal in its preliminary stages.

Know yourself*
(the needs of your client)

Know your enemy
(the needs of your adversary’s client)

Fight a thousand battles
(negotiations)

Win a thousand victories
(agreements acceptable to both parties)

* with apologies to Sun Tzu

Acquiring Background Information

Before becoming involved in direct negotiations, counsel should at the outset either have or gather background information that might be helpful in effectively representing the client, including information regarding the business and industry of the buyer and the target, the level of experience and sophistication of the parties, their competitive positions, the comparative leverage of each party vis-à-vis the other, and the business goals and objectives of each. This fact gathering may be particularly important in representing a new client.

Here are some examples of information that counsel might well try to obtain.

- What is the business case for the buyer’s acquisition, and how does it fit within the buyer’s current and long-term strategies?
- What is the industry in which the buyer and target operate? Is it growing? Is it contracting? Are the industry dynamics changing? Are there strong concentration trends in the industry or among the customers? Is the industry regulated? Are those regulations changing?
• How is the business of each of the parties performing compared with past performance, with the other party, and with its peers?
• What aspects of the target’s business are of highest interest to the buyer? Is it the ongoing business, its trade name, its market position, a new product line, its intellectual property, its financial performance, its management, or something else?
• What does the buyer want to do with the target post-closing? Continue to operate the target as is? Use it as a platform for expansion or further acquisitions? Move and consolidate its operations with another facility of the buyer? Simply close it down and eliminate a competitor?
• How important to the buyer is financial performance of the target both before and after the closing? A publicly owned buyer will be more concerned about the accretive or dilutive effect of the acquisition on its earnings.
• Are the parties direct competitors? Will the due diligence process yield information that the other party could use to its advantage if the transaction fails to close? Should the client establish an information wall between its operating team and its due diligence team to lessen its exposure to charges of unfair use of proprietary information? Will the transaction attract the attention of antitrust regulators or other governmental agencies?
• What are the seller’s objectives? Maximize current cash payout? Receive an equity stake in the buyer, an attractive investment that it believes has strong growth possibilities? Eliminate any worry over post-closing indemnification claims or an earnout, even if it means accepting a lower purchase price? Ensure that the employees continue to have jobs? Ensure that the operations remain in the current community? Obtain capital sufficient to achieve the potential of the business?
• Is the client experienced in M&A transactions? Does it understand the process? Is it sophisticated? Is the client well organized? Does the client have the expertise to evaluate what the target business is worth?
• Does the client need the assistance of other advisors, such as accountants, investment bankers, appraisers, risk managers, or technology evaluators? Can the client be expected to read with care and understand due diligence reports and the acquisition documentation? Will the client go off on its own and make commitments to the other party without consulting or advising counsel?
• How much experience and comfort does counsel have working with this particular client?

These are but a few examples of the types of information that counsel may ideally gather. These questions will not only frame the legal issues to address in the context of negotiating and closing the transaction but will also shape the role that counsel will play and affect the manner in which he interacts with the client.

**Negotiating the Price**

In the acquisition process, no deal can be done without an agreed-upon price. In many respects, the subject of price negotiation is sprinkled throughout the text of this Guide, as virtually every aspect of the acquisition process can influence price. From the initial decision to sell a business to the exclusion of an unwanted asset, price is influenced. In all business transactions, price receives continuing scrutiny by the parties. Accordingly, price negotiation (usually downwards) is a fluid concept that runs through the whole process.
Usually transactions begin with a stated purchase price. It may appear in a letter of intent or term sheet, or it may merely be raised in conversation between the parties. Rarely is that stated purchase price the same number that appears on the closing statement. Buyers will sometimes suggest a purchase price higher than they ultimately are willing to pay in order to attract the attention of an otherwise complacent seller, assuming that once hooked, the seller will negotiate further on the price. In such instances, the buyer often uses the due diligence process to justify price reductions. Just as often, the buyer tests the waters with a low price, after which the seller, if interested, counters with a higher price. Sometimes an investment bank will be able to push the price higher.

Issues such as consulting agreements, covenants not to compete and the sale of ancillary assets that are owned by affiliates of the target may affect the price negotiations. Sometimes tax advisors will drive the economics of these agreements causing tradeoffs that are truly a price adjustment.

Usually discussions regarding pricing occur before the earliest agreements are negotiated or the structure set, with the parties trying to get a sense from each other as to the general purchase price or range required to make the transaction a reality. Depending upon the parties involved and whether or not brokers, investment banks, or other representatives are participating in the marketing of the acquisition, issues relating to pricing may be in play at very early stages.

The price negotiation process can be highly emotional and clients are well served to understand that “it ain’t over ‘til it’s over.”

**The Parties and Their Representatives**

Once the parties have decided to pursue a transaction, both the buyer and seller should consider the appropriate persons to negotiate price on their behalf. The principals themselves may decide that they are best suited to conduct the price negotiations. Negotiation between principals allows for direct communication and often an expedited pricing process. Direct communications between principals may also help to minimize the spin that may be placed upon offers presented by third parties. On the other hand, direct communications between principals may also inflame the negotiation process. Where the target is a private company, and especially in instances in which the seller has built the business and feels the entrepreneurial pride of having nurtured the enterprise, suggestions of a price below the seller’s expectations are likely to result in emotional reactions.

Because direct negotiations between principals often lead to grandstanding and the introduction of emotions in ways that become nonproductive, often third party negotiators are involved. Among these third parties may be attorneys, consultants, brokers, and investment bankers. Attorneys are often placed in the role of negotiating price and serving as the spokesman for the client. The attorney can sterilize the discussions and can often present the position of the buyer or seller in a fashion that is purely business. The attorney may also be able to provide color and insight into the price being offered or demanded when presenting offers and counteroffers. As a non-principal, you may be able to move the process along more rapidly and smoothly.

The prospective seller should have done, or have had done, the analyses and models that support its position on price long before negotiations begin. While attorneys may be helpful, often they do not have the financial or business background necessary to fully appreciate the pricing of a transaction. While much information is available regarding pricing methodologies,
valuation techniques, and industry information (such as appropriate industry multiples at any
given time), most attorneys would admit that they are not financial analysts. When the attorney
is acting as the price negotiator or facilitator, it is imperative that he not get in over his head
and always recognize when the price negotiations have passed beyond his comfort zone. For
this reason, consultants, business brokers, and investment banks can play a very valuable role
in the price negotiation process. Even so, the attorney in the middle of price negotiations
should have at least a rudimentary understanding of how value is assessed from a financial
standpoint, which is discussed in Chapter 7.

Where specific issues relevant to the transaction are presented, engaging a consultant who is
expert in those areas may well enable the parties to quantify a particular risk or value. For
instance, in the event of an environmental concern, engaging an environmental consultant who
can quantify the extent of the environment remediation risk may enable a party to place a price
tag on that aspect of a transaction, allowing the parties to move ahead to an agreement on price.

Business brokers and transaction consultants can often provide information relating to the
relevant markets, similar transactions and valuation models that can be applied to the business
opportunity in assisting a buyer, a seller, or both parties in recognizing and establishing an
appropriate value range for the transaction.

In larger, more sophisticated transactions, investment banks are often engaged, either to
market the transaction or to seek business opportunities for clients. Investment bankers are able
to provide not only expertise relating to the marketplace and relevant valuation techniques, but
are also often able to assist in developing possible purchase price structures. The knowledgeable
investment bank is privy to the capital markets and has substantial experience relating to the
cost of capital that may need to be developed in an acquisition transaction. Further, when the
investment bank possesses significant industry-specific knowledge and knows the likely inter-
ested financial and strategic buyer candidates, it can add even more value for a seller.

The particular facts and circumstances, as well as the various personalities involved, will
often dictate who and how many persons will make up the negotiating team. As relationships
between the parties are developed, the roles of individuals may change, with certain parties
taking the lead at certain times, while finding themselves in only ancillary and supporting
roles at other stages of the transaction. In any circumstance, however, it is extremely important
that all persons participating in the price negotiation process, whether for the buyer or for the
seller, are working in a coordinated fashion to achieve the client’s goals.

When a buyer or seller has multiple persons involved in the price negotiation on its behalf,
it is imperative that the flow of information be unobstructed. The whole team must understand
who the point person for price negotiation will be. Multiple lines of communication will
invariably lead to inconsistent information being conveyed, issues being conceded without the
full understanding of the parties, and in some instances, a need to retract or clarify information.
This type of confusion over mixed messages can slow down, if not frustrate or kill, the price
negotiation process, and also lead to mistrust.

**Personalities**

In selecting a price negotiator, do not underestimate the dynamics of personalities. A strong,
entrepreneurial, dynamic principal may often serve as a great price negotiator. Such a person
may be able to instill great confidence and may be able to tell the story of the business
opportunity better than anyone. On the other hand, having a client with a very strong per-
sonality lead the price negotiation may cause concern if that person cannot accept the buyer’s
criticism of the business (which will invariably be raised to decrease or otherwise test the purchase price being sought by the seller). Consideration of who is negotiating on behalf of the other side and the chemistry of the two negotiators is likewise important.

The use of third parties or multiple parties may also serve to allow the parties to obtain two bites at the apple. Where an advisor is used to convey a message relating to pricing and price negotiation, if that message is not well received or otherwise rejected, it still allows the principal to step in and continue to discuss the issue at hand. The use of an advisor also allows the other party to quiz the advisor on how the principal is likely to react to a suggested deal term without necessarily making a formal offer. Similarly, the person receiving the information in a discussion among advisors can reserve making any decisions regarding the pricing issue, on the grounds that the advisor is without authority to make a decision. This indirect negotiation will necessarily prolong the negotiation process, but will often result in more reasoned, less emotional counter-offers and enable the sort of horse-trading often essential to reaching a deal.

**Client Priorities**

Another issue to be considered by the attorney when participating as a price negotiator is to fully appreciate and understand the priorities of the client. Obtaining the optimum price is not necessarily the highest priority of every seller. Many times, the comfort of limiting representations or avoiding significant indemnification obligations may be more important than additional dollars in the pricing of the transaction. Similarly, a seller’s ability to wash its hands of certain business conditions or to know that the duration of representations will be significantly curtailed may cause it to be willing to accept less consideration. Similarly, the ability to continue to have an opportunity to consult and or to earn additional payments after the closing may cause a seller to accept a lower price.

From a buyer’s perspective, the converse may be true. A buyer may be willing to pay more for a business opportunity if it is assured of a creditworthy and collectible guarantor of the indemnity obligations, or perhaps if an exclusive supply agreement for the buyer is included. Each of these issues should be fully discussed with the client before the price negotiation process begins. These very same issues must also remain at the forefront of an attorney’s thoughts when multiple clients are represented to make certain that these various tradeoffs do not disparately impact the client group.

**That Last Dollar Is Often Expensive**

A savvy, experienced investment banker friend, when faced with near fatal deal drift in a fully priced deal, observed that over his career whenever a seller (or an auction) pushed a buyer to a price beyond that with which the buyer was comfortable, the deal was inevitably far more difficult to bring together and close.

**Internal Factors Affecting Price**

Because every business acquisition is unique, it is difficult to discuss meaningfully how a particular pricing model should apply in the abstract. However, regardless of what pricing
technique is to be employed, there are various issues to consider in all transactions. Many of these are internal to particular sellers or the business enterprise itself, while many forces will be external and applicable to the marketplace.

Internal forces may motivate the seller to dispose of the business enterprise. In a closely held business, this may include a variety of personal issues. The following are typical of drivers in many deals:

**Age of seller.** Whether a single or multiple seller is involved, the age of the seller may well impact the motivation to sell the business. Where the seller is approaching or past retirement age, especially when there is no second generation involved in the business, the prospect of selling the business will become more dominant.

**Health of seller.** The significance of the health of the seller cannot be underestimated. In most closely held businesses, there is a sense of ownership of not only the business itself, but of all its activities and the employees and other people affected by any sale. Where a seller’s health is deteriorating or in question, the perception of the ability to continue to keep the business enterprise will serve to motivate the seller and often cause the seller to accept a lower purchase price.

**Number of sellers.** Where there are multiple sellers, disputes can cause the group to become dysfunctional or otherwise fractious. This tension may lead to some being more motivated to dispose of the business enterprise. This observation is especially true in instances in which minority shareholders are threatening the majority shareholders with claims of oppression or other inappropriate conduct, which can frequently arise when ownership of a family business moves to the second and third generations.

**Restrictive agreements.** Where the sellers are parties to restrictive agreements or other contractual obligations, the ability to adequately market the business enterprise may be affected. For instance, where shareholders have a right of first refusal, this may chill the marketplace and depress the purchase price offered by a third party, recognizing that it may simply be serving as a stalking horse.

**Uncertain management.** Where the seller’s management team is uncertain, either because of age, health, mobility, non-ownership, or lack of commitment to the enterprise, the ability to deliver a functioning, turn-key operation will be in question. If a buyer perceives that an attractive management team is not likely to remain in place, the risks associated with obtaining the business enterprise will increase, thereby causing the price to decrease.

**Expiration issues.** Where some of the significant assets of the seller are likely to expire or otherwise cease to have the market advantage that the business presently enjoys, the buyer will be less likely to pay top dollar. For example, where a seller has developed certain intellectual property that has not been protected and is likely to be replicated in time, the window of opportunity will be seen as closing. Similarly, where patents or other protected intellectual property are among the assets of the business enterprise, the duration remaining on the protection will directly influence the purchase price. Other examples where the timing of the business cycle or opportunity will significantly depress the purchase price include disappearing contracts with major customers and market opportunities that will be of a specific duration.

**Financial condition.** Many businesses enjoy favorable financial relations through leases or other business settings, including the use of fully depreciated equipment. As these favorable financial circumstances expire and additional capital is required by the business enterprise, the owners often determine that it is an appropriate time to sell the business. These potential expenditures may have a significant impact on the value to outsiders, and may strongly motivate the seller.
External Factors Affecting Price

In addition to various internal forces, the marketplace itself will dictate many pricing issues, including the following:

**Number of interested buyers.** The number of prospective buyers in the marketplace will greatly affect the purchase price. Where the business attracts a number of suitors, the seller is in an enviable position and can often play them off against one another to obtain the most favorable price. On the other hand, especially in specialized industries, there may be very few prospective buyers. In those instances, especially where it understands the marketplace, it is the prospective buyer who may have the upper hand. The purchase price will also be influenced by whether the prospective buyers are financial or strategic buyers, and whether one or more of them are competitors.

**Cost of money.** The purchase price will necessarily be influenced by the cost of money that the buyer will have to pay to consummate the transaction. Where third-party funds are being sought, the interest rates and terms of borrowings will become a part of the economics of the transaction. In instances in which the buyer intends to use its own funds, the lost opportunity cost of the inability to deploy these funds in other investment opportunities will influence the price. Even in instances in which the seller is willing to finance some or all of the purchase price, the prevailing interest rates will necessarily influence the price negotiation and ultimate purchase price.

**Form of payment.** The form of payment the buyer desires and the seller is willing to accept will influence the price negotiation. Where the seller is willing to consider alternatives to an all cash purchase price, there will be greater flexibility in the price negotiations. Whether a seller is prepared to accept stock or other equity in the buyer (or in an affiliate of buyer), to accept notes or other subordinated debt instruments, to include an earn-out or other post-closing payments, or to lend a portion of the purchase price (through seller financing), will all influence the price negotiation as these elements will be taken into account in developing the “true price” in the eyes of the parties.

**Similar opportunities.** If other similar opportunities exist in the marketplace, the opportunity offered by the sale of the target will necessarily be affected. As with virtually any good, as the supply of businesses in the marketplace increases, the price is generally depressed. A sophisticated buyer should be aware of alternative business opportunities and will pursue the most favorable one. Conversely, where the supply of businesses is limited (especially in settings in which the number of prospective buyers is greater), economic forces will increase the ultimate purchase price.

**Synergies.** Many prospective buyers will see synergies that can be developed between the target business and other businesses already operated by the prospective buyer. Where the business can be a supplier or a customer of other related business enterprises, the value to the particular buyer will be enhanced. While the prospective buyer may not acknowledge this increased benefit, the seller needs to consider this issue so that it can better understand a buyer’s motivation, perspective and likely willingness to meet its pricing demands.

**Complementary companies.** A buyer and seller must be cognizant of not only competitive businesses, but also the effect the transaction will have on the complementary businesses relied upon by the target, such as suppliers, vendors, and customers. A sophisticated buyer will factor all of these issues into its assessment of value.

**Sale of a subsidiary or division.** Where the target is a subsidiary or division of a much larger company, often the seller will have many priorities unrelated to price, such as the certainty of closing within a targeted year or quarter, the placement of key management people, or the
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The desire for a continuing market for product lines retained by the seller. Any or all of these objectives may cause a seller to consider a much lower price from a buyer that can address these issues than from a competing buyer who cannot.

Closing Price Adjustments or True-Ups

While most acquisitions are priced off a multiple of the earnings stream or cash flow, implicit in the price is a certain level of assets (particularly current assets) to support the business. Therefore, most buyers want assurance as to the value of the balance sheet of the acquired business at the time of closing. The acquisition agreement will usually contain a representation about the status of a current balance sheet (typically unaudited). Parties frequently negotiate a purchase price adjustment (often referred to as a true-up) by which a cash payment is made to the buyer if there is a deficiency from an agreed-to amount of net current assets, net worth or other measure (often determined by reference to the latest balance sheet upon which a representation has been made).

Method of measurement. While two frequent methods of measurement are net worth or net current assets (working capital), the precise formulation could be anything agreed to by the parties. Often it is argued that net worth is not the appropriate standard because in setting the purchase price the parties have already agreed that the target is to be valued by some other means. Net current assets are relevant to most buyers because a certain level of working capital is required to operate the business in the ordinary course.

Setting the target. The target figure is determined by what is shown as net assets or net current assets, usually expressed as a dollar amount. While the latest balance sheet usually provides an appropriate reference point, in some instances the parties may negotiate a normalized figure. For example, for a cyclical business such as a retail, where inventories vary substantially, a snapshot taken at the end of October may not be appropriate when the closing is expected at the end of January. When the most current balance sheet does not represent the business being purchased (e.g., a subsidiary that will be stripped of cash or the purchase of less than all assets), the measurement method and target amount will need to be adjusted.

Settling up. If on the closing date, determined by a closing date balance sheet, the net worth, working capital, or other measurement is less than the target amount, the seller would be required to make up the difference. Most sellers argue that, as a matter of comity, the converse ought to work as well—if there is an excess, the sellers should get the benefit. Arguably the true-up should be coordinated with indemnification. For example, many acquisition agreements contain representations with respect to the accounts receivable and inventories. If the values of those are adjusted in the closing date balance sheet and the purchase price is adjusted, does the buyer get a second bite at the apple (presumably for the same damages) through indemnification?

Whose perspective? From whose perspective is the calculation made? Buyers may have a new basis in the assets of the business through a purchase of assets, a deemed purchase of assets, or push down accounting. While it would be possible to measure the value of assets from the buyer’s perspective (that is, a new basis), it would be unusual to do so. Both the seller and buyer know the seller’s basis in the assets. How the buyer will account for the assets in the purchase is not known to the seller and may not be known to the buyer for a substantial period of time after the closing. Therefore, the seller’s accounting is what is normally used for the true-up calculation.

Who prepares? Who prepares the closing balance sheet, the seller or the buyer? The preparer of the closing date balance sheet has a distinct advantage. The buyer will argue that it needs
to have the information for purposes of setting up its own accounts, and in fact it may need to involve its auditors in preparing its own opening balance sheet. The seller will argue that it understands how the historical financial statements have been prepared and the methodology that needs to be applied. It is usually the same accounting personnel (now employees of the buyer) doing the accounting, so that may not be persuasive. When the target being sold is a business unit and the seller keeps the books centrally, the case may be more persuasive.

Security. Sometimes the payment of the true-up is secured in some way. As between a corporate buyer and a corporate seller in a divestiture situation, the obligation may be unsecured. Normally, however, the buyer will withhold a portion of the purchase price or will put a portion of the purchase price in escrow solely for purposes of securing the true-up. Other arrangements are possible, such as the ability to reduce the principal amount of a note given by the buyer in the event of any deficiency.

How is the measurement made? The methodology applied pursuant to the acquisition agreement in preparing the closing balance sheet is variable. Often the agreement will specify that it is to be prepared in accordance with generally accepted accounting principles consistently applied or as applied by the target. The problem with the standard is that the results produced by GAAP are generally imprecise. That may be particularly true in the sale of a business unit where non-GAAP measures may have been historically used and either adjusted at an intermediate subsidiary level or otherwise regarded as immaterial. If there is concentration on a few assets, such as inventory, the methodology in determining the value becomes much more critical and historic practices may or may not represent GAAP. There is also tension between GAAP and consistent application. Assume that the buyer understands the principles by which the latest balance sheet was prepared, but it is not GAAP. Assume that the seller failed to include an accrual for vacations on the latest balance sheet. Consistency would require that accrued vacations also be ignored on the closing date balance sheet; GAAP requires that they be accrued. Most practitioners believe that GAAP trumps consistency.

Certain classes of assets pose problems. For example, in the sale of assets certain prepaids may disappear (insurance normally is not assignable) and the unamortized amount of premiums paid would be shown as a prepaid. The value of inventories is fluid—how are manufacturing variances handled? Are reserves properly established? For example, in a business involving many items of inventory, how can one know what is slow moving or obsolete? The auditors may not have historically questioned accounting methodology used by the target, but in the acquisition of a business it becomes very important.

Sometimes instead of using imprecise measures such as GAAP, the parties actually agree to a methodology for valuation of particular assets. A listing could go on for several pages describing how particular classes of assets are to be valued for purposes of the computation. This often is a description of the target’s historical practices, but it could also involve a negotiated formulation of how a particular class of assets is to be valued, such as inventories.

Estimate. Often the net worth, working capital or other target amount is estimated at closing and the payment made at closing is adjusted based on that amount. The purpose of doing so is to reduce swing in the amount of the purchase price adjustment. The seller normally bases the estimate upon a good faith estimate, although it may be required to present supporting documentation.

Reviewing the closing date balance sheet. While the preparer of the closing date balance sheet has a leg up, most agreements do not provide that the closing balance sheet as prepared is final. Buyers preparing it may attempt to achieve such a position by providing that the seller cannot object except for arithmetical or manifest error. Usually the agreement provides, however, that the preparer provides the balance sheet and associated workpapers and the recipient
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is given a specified amount of time to object. The recipient is normally provided access to the books and records. It is usually required to object with some specificity.

"Disappearing assets." One consistent problem is assets that disappear with the deal. For example, in the sale of a subsidiary, cash will usually not go with the sale because most consolidated enterprises manage cash out of a central location. Therefore, in determining net current assets, the balance sheet needs to be normalized to reflect what will be eliminated in the transaction (typically cash and intercompany payables). One particular asset that would be eliminated in many acquisitions is a deferred tax asset held on the books of a subsidiary where the buyer is taking a new basis in the assets. Immediately prior to the sale those assets exist; immediately after the sale they do not. Therefore, what appears on the closing balance sheet? This illustrates the need for specificity in determining how a closing balance sheet will be prepared.

"Is You Is or Is You Ain’t My Asset?"*

Seller agreed to sell several of its subsidiaries pursuant to an acquisition agreement. One of the subsidiaries carried on its books a "deferred tax asset" in the amount of $9 million. The acquisition agreement provided for an audit, as of the closing date, and a post-closing adjustment based on the difference between the net book value of the subsidiary entities determined in accordance with GAAP (with certain specified adjustments) as of the closing date, and the preliminary net book value taken from the preliminary financial statements which seller furnished to buyer shortly before the closing. Seller’s auditors certified that the $9 million deferred tax asset was appropriately accounted for on the books of the subsidiary as of the closing date. However, the buyer invoked the dispute resolution provisions relating to post-closing adjustments when it realized, some months after the closing, that the deferred tax asset had "disappeared" once the target’s subsidiary was no longer a part of the seller’s consolidated group. An arbitrator ruled that the closing financial statements fairly presented the financial condition of the subsidiaries as of the closing date and refused to allow an adjustment. The buyer’s internal financial due-diligence team, its lawyers and its outside auditing firm may have wished their diligence was more diligent and that the specific exceptions to GAAP described in the stock purchase agreement had included a carve-out relating to the deferred tax asset.

*A with apologies to Billy Austin-Louis Jordan ("Is You Is or Is You Ain’t My Baby")

A discussion of the actual operation of true-up provisions post-closing is contained in Chapter 15.

"Resolving differences." If there is an objection, the agreement normally requires that the parties negotiate their differences in good faith for some period of time or it may have an internal mediation procedure, such as kicking it up to the CEOs of the two entities. While the agreement could be silent, leaving the ultimate remedy to litigation, the parties typically select a form of arbitration (although rarely labeled as such)—usually formulated in different ways, the agreement normally provides that the parties will have a recognized accountant determine the accuracy of the closing balance sheet. Sometimes the accountant is actually designated in the agreement while at other times it requires mutual agreement after the fact. Courts have held that the proceeding is in the nature of arbitration and that judgment can be entered on the award.107
Earnouts

Although it can take as many forms as there are varieties of transactions, an earnout is essentially a form of deferred purchase price payment tied to post-closing performance indicators. The amount (and sometimes the obligation to pay at all) is related to the success of the business sold measured against milestones that can range from one big financial factor to a laundry list of items.

Earnouts lend themselves to creative thinking and can be tailored to a particular transactional hurdle or type of business. In many M&A transactions, the buyer and seller are simply unable to agree upon what both believe to be an appropriate purchase price, often as a result of differing views on valuation of the target business or its significant assets. Earnouts can be an effective tool to bridge that gap. For example, in many service business acquisitions, the assets that are being purchased are comprised of client or customer lists or goodwill; items that do not necessarily command a high value due to the speculative nature of continued revenue or even any revenue. Sellers can simply be unrealistic in their expectations, and earnouts can be a “middle ground” approach to get a deal done.

For the financial buyer, earnouts are often also used as a means of providing incentive to individual owners to increase the profitability of the acquired business. For the strategic buyer (as well as the financial buyer), the earnout is also an effective tool to ensuring a successful transition of ownership. Tying up a part of the consideration for the business typically proves to be an effective motivator. In addition to the acquisition of service businesses, earnout structures are also sometimes used in transactions involving the acquisition of new products or product lines—assets whose value is wholly dependent upon the future sales or performance of the new product. Acquisitions of troubled companies may also include earnout provisions, as both buyers and sellers would like to base a portion of their valuations on the future performance of the once-troubled company, since historical financial performance is necessarily not a good indicator of value. In a sense, the earnout is a variation of the post-closing purchase price adjustment that lets the seller “put its money where its mouth is” in that continued positive results will result in a higher purchase price.

The drafting of an earnout is fraught with issues. To highlight just a few—what measurement standard ought to be used—gross revenues, net income, EBITDA? What business unit should be evaluated for purposes of calculating the earnout payment—the entire business or just a specific product or division? Over what period of time should the earnout measurement apply? What calculation would be the best method to use—a percentage of gross revenue, a multiple of net income, or some combination? Finally, how should the parties deal with differences in accounting approaches used by the buyer and the target?

Standards of measurement. Gross revenues or sales, although easily measured, are not really a measure of profitability or value. For example, significantly increased gross revenues post-closing may have been generated as a result of management significantly increasing expenses to generate that kind of revenue. That having been said, it is probably the most objective measurement standard available. EBITDA (or some variation) is a seller-favorable standard of measurement, as it will permit the seller to realize an earnout payment based upon an earnings measure that does not reflect any post-closing changes to the capital structure of the acquired unit or any increased interest expense associated with post-closing working capital that varies from what was assumed by the buyer in its valuation modeling. It is an often used standard of measurement, as it is generally thought of as a good indicator of true post-closing financial success of an acquired unit.
A standard of measurement that is anything other than EBITDA will require that the agreement specifically address how the parties will treat items such as the capitalization of transaction-related charges by the buyer, amortization of goodwill and increased depreciation charges or changes in depreciation by the buyer as a result of any step-up in basis. Fees and expenses associated with acquisition indebtedness should also be addressed in the acquisition agreement and, from the seller’s perspective, excluded from any calculation.

Generally speaking, the seller should also be very cautious about expense treatment by the buyer post-closing. Overhead, compensation (including employee benefits), insurance premiums and any other costs that might be charged by the buyer against earnings should be specifically identified and appropriately treated in the earnout provisions so that it is clear which expenses affect the earnout calculation and which do not. A seller will want extraordinary one-time transaction expenses to be excluded as income deductions for purposes of calculating the earnout.

While this discussion highlights the most common financial measurement approaches, a variety of other measuring sticks (including non-financial, such as a product in development actually coming to market) will be used, from time to time, as circumstances dictate and as the parties negotiate. If an earnout is being used to bridge a gap in purchase price expectations between the parties, it is important to customize the earnout to address the root cause of those divergent perspectives. Therefore, while certain traditional standards can be pointed out, no exclusive, dispositive list of approaches exists, nor should it.

**What business unit?** Having agreed as to the standard of measurement, the next critical issue is to what that standard of measurement will be tied. For example, where the strategic buyer has purchased a target in order to acquire a specific product or product line, a standard tied specifically to that product or segment is the appropriate business unit to measure. Sometimes the measurement standard of the entire target that has been acquired is the most appropriate unit; particularly where the earnout has been suggested to reconcile significant valuation disparity between the buyer and the seller. In addition, where the seller’s management team will remain employed by the buyer post-closing, utilizing the entire target as the business unit is a way of further motivating the management team to perform.

In many acquisitions, the operations of the acquired business will be integrated with the buyer’s existing business. Because of this significant overlap in products or business segments, it is important to carefully establish what the buyer can and cannot do to ensure that sales, for example, are not moved away from the acquired business to an affiliated entity and therefore reduce the standard of measurement for purposes of calculating the earnout payment.

**Determining the measurement period.** Another critical issue involves establishing when or for what period the standard of measurement generated by the business unit is to be determined. Is the earnout to be calculated and paid on a periodic basis over a period of time, or will it be calculated and paid on a one-time basis? Often a buyer and seller agree upon a specific period of time over which to measure performance. This period of time is often subject to acceleration or termination upon the occurrence of certain specific events, or even sometimes at the option of the buyer (subject, usually, to some sort of buyout provision). For example, the termination by the buyer of the employment of an owner employed post-closing can trigger an earnout calculation, payment and termination. The sale by the buyer of the business or product line that it acquired from the seller could also serve as an earnout payment event. Many times, where the buyer contemplates a future disposition of the assets or business acquired from the seller, it will negotiate an election to terminate the earnout provision in order to facilitate the disposition of that asset; typically the seller will then ask for a make-whole provision that represents an early buyout of the now-shortened earnout period. Some-
times these negotiations result in affording the parties various puts and calls that can be exercised under specified circumstances. The seller might even receive some sort of consideration based upon the value realized by the seller in its disposition of the acquired assets or business.

Calculating the payment. The acquisition agreement should address the method of calculation and payment of the earnout. With respect to the method of calculation, there are a few options. Many buyers and sellers will agree upon either a percentage of value or a multiple of value, depending upon what standard of measurement they have already agreed to use. In other words, where the parties have agreed upon the use of an EBITDA standard of measurement, the earnout amount is likely to be some multiple of EBITDA for a specified period. Often, logic dictates that this multiple correspond to that used by a buyer in valuing the target company.

Conversely, percentages of gross revenue might be used in the product acquisition situation where a gross revenue standard has been chosen as the standard of measurement. Another issue to consider is whether the earnout provisions will include payments triggered by the acquired entity or the product meeting certain performance or financial benchmarks—and whether an earnout payment will nevertheless be made where performance falls just short of the benchmark.

Specific issues for the seller. It goes without saying that the seller’s interest is to structure the earnout to maximize the amount it will be paid for the business. Of course, underlying that goal should be the concern that the seller not realize less than what it ought to because of the structure of the earnout. Since the buyer will usually be in full control of the business it has purchased, as well as the accounting for revenue associated with the business, proper planning against intended or unintended effects of the buyer’s post-closing actions is necessary to protect the seller’s interests.

The most important issue from the seller’s perspective is avoiding or obviating the buyer’s ability to reduce the amount of the earnout through its control of the acquired unit or product. The tension here is that while sellers, particularly those that remain as members of the management team post-closing, would like to be able to directly impact the amount of their future compensation, the buyer is likely not willing to cede control of its newly acquired asset. Although a buyer and seller might try to address this tension with a contractual covenant requiring the buyer to operate the acquired unit in a manner consistent with the seller’s conduct of the unit prior to closing and to adequately promote the products of the acquired business through appropriate (perhaps objective) marketing efforts and expenditures, these kinds of provisions are fraught with ambiguity. Closely tied to this issue is that of the buyer sufficiently capitalizing the acquired unit on a post-closing basis, as this is another area of potential intended or unintended effects on an earnout calculation resulting from actions of the buyer. Other items that the seller should concern itself with are situations where the buyer makes a subsequent disposition of some or all of the acquired assets or business, extraordinary items such as a casualty loss or substantial increases in capital expenditures.

As a final note, if the buyer’s venture post-closing is highly leveraged, a seller may discover that the earnout payment that was bargained for is deeply subordinated to the lender.

Consistent accounting methodology. An important step in negotiating an earnout is to require consistent accounting methodology, both pre- and post-closing. If the buyer applies an accounting methodology that is not consistent with what the seller employed, the parties’ earnout calculations will differ. Simply requiring application of GAAP accomplishes nothing. A specific covenant is often included in the acquisition agreement regarding accounting methodologies to be used by the buyer post-closing. Some particular areas of concern are LIFO versus FIFO inventory methodology, depreciation schedules, and bad debt allowances. In addition, post-
closing changes in GAAP probably ought not affect the accounting treatment and methodology for purposes of calculating earnout payments and the parties may wish to so agree.

As a means to determine compliance, sellers should consider including a contractual right to examine the appropriate books and records of the buyer, particularly if the seller will not have any direct involvement with the business post-closing. Where an examination right is granted, it is not unusual to complement this provision with an obligation of the buyer to bear the costs (along with interest or some other penalty) if the examination should reveal that the results on which the earnout is to be based have been misstated.

Avoid hamstringing the acquired unit. As already discussed above, the buyer should consider the need to negotiate a contractual right to terminate the earnout mechanism, whether through a buyout or otherwise, if the continued existence of the structure would prove to be an impediment to the buyer’s subsequent ability to deal with the purchased business. A buyer should also be concerned with, and guard against, hamstringing the acquired unit by agreeing to so many limitations or conditions upon operation of the unit post-closing that it stunts the growth or success of the business.

Exercise of Control over an Acquired Unit

The case of *Horizon Holdings, L.L.C. v. Genmar Holdings, Inc.* illustrates the risk in not addressing in the acquisition agreement the manner in which an acquired unit will be operated after the closing. This case involved the acquisition by Genmar Manufacturing of the aluminum boat manufacturing business of Horizon Marine, in which Horizon and its founder had an opportunity to realize up to $5.2 million additional consideration in an earnout. It appears that a number of issues relating to the earnout had been discussed by the parties, but were not covered in the acquisition agreement.

The operations did not produce the earnings to support an earnout payment, and Horizon and its founder sued, claiming that the defendants breached both the express provisions of the acquisition agreement and the implied duty of good faith and fair dealing. A jury returned a verdict awarding the plaintiffs $2.5 million in damages on the breach of contract claim. The jury was instructed that under Delaware law they should consider “whether it is clear from what was expressly agreed upon by the parties that the parties would have agreed to prohibit the conduct complained of as a breach of the agreement had they thought to negotiate with respect to that matter.” The court heard several post-trial motions, and denied a motion for new trial. The court stated that because the acquisition agreement was silent as to most of the issues discussed by the parties prior to its execution, evidence as to those discussions was appropriate to provide context for the good faith and fair dealing claim. It concluded the jury could have determined that the defendants engaged in conduct inconsistent with the spirit of the agreement, namely undermining the founder’s authority to run the operation after the closing, abandoning the Horizon brand, mandating the production of other boats at the facility and reimbursing only for standard cost for the production of the other boats.

While most buyers will assume that, at least as to significant business decisions, they will be entitled to operate the business that has been acquired, those decisions (such as, in this case, using the acquired facility to produce several lines of boats and thus achieve some synergistic benefits) may be directly counter to a seller’s interest in achieving payment under the earnout.
Unanticipated benefits to the seller. While it might be going too far to say that the buyer’s goal is to minimize the amount to be paid through the earnout, there are ways to effectively control the amount of the earnout—not to minimize what should rightfully be paid to a seller, but rather to prevent overpayment to a seller based upon the buyer’s efforts post-closing or sheer good fortune.

A buyer will want to avoid paying for an increase in the performance of the acquired unit post-closing that has nothing to do with the acquired business itself. For instance, these increases are sometimes directly the result of the buyer’s more effective skills or even perhaps simply a result of increased efficiencies resulting from the combination of product lines. The buyer does not want these events to inure to the benefit of the seller through the earnout. If the purpose of the earnout is to more realistically reflect the true value of the transaction, the buyer would want to exclude these kinds of growth items. The practical problem is that it is very difficult to draft around these kinds of unanticipated events. The buyer should consider and identify any items that it can address in advance and exclude them from the earnout, such as expense reductions achieved by the buyer’s management.

Disputes. As should be evident, disputes can (and often do) arise when actual numbers and results are determined and the earnout calculations are made. Parties to an earnout may therefore want to carefully consider whether these disputes should be dealt with in the same way as any other contract interpretation dispute (whether by litigation, arbitration, or some other dispute resolution mechanism) or whether they want to include a specific dispute resolution mechanism to deal with the earnout. For instance, the parties may choose not to deal with earnout disputes using the same alternative dispute resolution mechanism that is used for other disputes in the acquisition agreement. They could, for example, provide a mechanism where the earnout dispute is resolved by discussions between the accountants for both the buyer and seller, with a third accounting firm designated to finally resolve the matter in the event that the buyer’s and seller’s accountants are unable to do so. That having been said, parties who provide that disputes will be resolved by accountants should understand that they will, in all likelihood, approach any dispute as a number crunching exercise and will not consider the equities among the parties. Therefore, an arbitration panel consisting of those with legal, business, or other backgrounds may be preferable.

Negotiating the Structure

Structuring the transaction is one of the most challenging aspects of M&A practice. The goal is to find the optimal structure given different, often conflicting, considerations and desires of the parties.

Negotiation of the structure is largely a function of first considering all of the issues that may influence the structure. Once all of the relevant issues are assessed, the parties should be able to determine which structure or structures will be acceptable and should be in a position to assess and weigh the economic, tax and other consequences of alternate structures. The costs and benefits to each party should be considered.

After determining which alternative structures are possible and the likely economic consequences of each, negotiation of the structure, hand in hand with negotiation of the price, can proceed rationally. While negotiation of the structure is distinct from price negotiation, it
often involves many of the same issues and there is frequently an interplay as structural changes impact the economics of the deal. Counsel usually takes the lead in these negotiations because the structure will more often revolve around legal considerations and the transaction documents.

It is critical to have a clear understanding at the earliest point possible regarding the form of the transaction, as this decision influences the purchase price. In general, where the acquisition is for stock, all of the liabilities and assets of the business enterprise will be acquired as a result of the acquisition. The owner of the assets will not change, but rather only the ultimate owner of the enterprise. Conversely, in an asset transaction, only those assets that are expressly included in the transaction will be transferred, and in general only those liabilities that are agreed to be assumed by the buyer will pass.

A buyer will want to pay less for an acquisition of stock (in which it assumes all known and unknown liabilities of the business enterprise) than it will be willing to pay to acquire the assets and assume only specified liabilities of the target company. The form of the transaction will substantially influence the ultimate value as perceived by the buyer and seller. The tax considerations of the transaction, including the tax effects on the seller and the buyer, as well as the ongoing tax consequences resulting from the form of the transaction and allocation of the purchase price, must be considered and given due attention to avoid unintended consequences. In an asset sale, whether the selling entity is a C corporation or an S corporation will have a material effect on the ultimate amount to be received by the shareholders of the target. Similarly, where portions of the purchase price are attributable to capital assets and other portions are attributable to items that must be treated by the seller as ordinary income (such as consulting agreements and covenants not to compete), the amount of the purchase price is likely to be affected. These same issues must be considered by the buyer from a standpoint of the basis, deductibility, depreciation, and other tax consequences that it will experience.

Many of the structuring issues will be transaction specific, while others will reflect general market conditions. Some of the more important issues are discussed below.

**Substance of the Transaction**

The structure often follows logically once certain agreed upon aspects of the transaction are known. For example, once it is determined whether the transaction is a true acquisition or business combination, decisions as to whether to pursue a statutory merger or stock acquisition as opposed to an asset transaction will become more apparent. Similarly, when a division of a company is being acquired, the fact that only a portion of the company is involved will result in the transaction being structured as an asset sale. These examples point out the importance of considering the economic and strategic substance of the transaction before proposing a structure.

**Stock vs. Assets**

Most acquisitions can be consummated either as an asset or a stock transaction. Where an asset transaction is favored, a variety of issues must be considered as the transaction is truly one of the sale of each of the individual assets and an assumption of agreed upon liabilities.
Conversely, where the transaction is structured as a stock acquisition, by its very nature the acquisition results in a transfer of the ownership of the business entity itself, but the entity continues to own the same assets and have the same liabilities.

### Whether to Structure as a Stock or Asset Purchase

Tax issues are not always the most important factor in determining whether to structure a transaction as a stock or asset purchase. When taxes are a consideration, the parties generally consider the amount of the shareholders’ net after-tax proceeds; the buyer’s desire to assign a high basis to the assets for depreciation purposes; and any gain recognition by the corporation.

An important non-tax reason why parties choose an asset purchase is the buyer’s desire to avoid responsibility for the seller’s liabilities.

The seller sold the assets of its business to a newly incorporated buyer. The trade name of the seller was well-known and protected by a registered trademark. As part of the transaction, the seller sold its trademark to the buyer, which chose to use the trademark as its name.

The parties included a provision in the acquisition agreement that the buyer “shall not, either directly or indirectly, assume any of seller’s liabilities or obligations of any kind whatsoever, absolute or contingent, whether or not accrued, determined or determinable.” The seller also agreed to indemnify and hold the buyer harmless from any of these excluded liabilities.

A year after the closing, the buyer was served in an action for breach of contract. The claim arose in the year prior to the sale of the business and was based on an alleged breach of contract between the seller and one of its customers. The buyer was not in existence at the time the claim arose and claimed it was improperly named as a party. The plaintiff responded that it had named the buyer appropriately as a defendant, since it bore the name of the company that breached the contract with the plaintiff.

The general rule is that a corporation purchasing the assets of another corporation is not liable for the debts and liabilities of the selling corporation. This general rule is based on the premise that a sale of corporate assets transfers an interest separable from the corporate entity, but is subject to certain exceptions discussed in this chapter.

Even before discovery could begin, the buyer was dismissed as a party to the lawsuit. If the transaction were structured as a stock purchase, rather than an asset purchase, the buyer would not have been dismissed.

Where the transaction is structured as an asset purchase, a variety of other factors must be considered in defining and refining the structure. First and foremost is a clear definition of the scope of the assets to be sold. As a general premise, most asset transactions contemplate a sale of all of the operating assets of the seller. However, this basic definition is hardly unambiguous.

It is imperative that the parties understand precisely which assets are to be sold. In instances in which the operating assets will not include accounts receivable, cash, or cash equivalents, the buyer will need to make certain that it has access to capital sufficient to operate the business until it is able to generate its own receivables and turn those receivables into operating capital.

It is also important to fully determine which assets of the operating business the target owns and to address fully any liens that may encumber the assets. In many businesses, certain of the operating assets are not owned by the enterprise, but rather are licensed, leased, or being
purchased on time. In such instances, it is necessary to fully appreciate and understand the relationships that the target has with third parties that supply those operating assets.

In almost all asset transactions, there are certain excluded assets. These too must be well defined. It is not uncommon for a transaction to exclude cash and cash equivalents. Similarly, in instances in which the buyer is attempting to minimize the purchase price, the accounts receivable can be excluded from the assets to be sold.

The parties may also agree to exclude a significant asset from the transaction, where that asset presents difficulties for the buyer. This observation is particularly applicable to instances where real estate is involved. Issues involving environmental contamination or past use of the property may create concern, or the parties may be unable to agree upon the fair value for the particular asset. In such instances, the structure of the transaction may be modified by the use of a lease or license to address these concerns and allow the deal to proceed.

When determining which assets are to be included or excluded from the transaction, it is critical to the buyer that the assets that allow the target to enjoy success be included. Where assets such as intellectual property are necessary to the target’s operations, a buyer will only be interested in the transaction if it can continue to make use of the intellectual property. In most instances, the buyer and seller will understand this to be the case; however, where a seller does not wish to part with ownership of the intellectual property, or otherwise is only a licensee of the intellectual property, the structure of the transaction must address these issues.

In an asset transaction, each of the assets must be transferred from the seller to the buyer. Title to the assets must be the subject of an appropriate deed (for real property) or bill of sale or assignment (for personal property and contracts). Further, assets that are the subject of public filings or registration (such as patents) will require assignments and filings with appropriate governmental entities to ensure that the buyer can enjoy the assets. This aspect of an asset transaction causes it to be significantly more cumbersome. Where the assets to be conveyed are incapable of being assigned or transferred because of restrictions, required third party or governmental consents, security interests or other reasons, the transaction may have to be structured to avoid a transfer of assets. In such instances, the use of long-term paid-up licenses may be a tool to avoid the prohibition on transfer while still allowing the buyer to enjoy the benefits of the assets.

One of the most difficult features of an asset sale is the need to obtain consents to assign material contracts of the seller as well as the transfer or reissuance of various governmental permits and other rights to do business held by the seller. This issue is addressed in more detail later in this chapter. From this standpoint, a stock sale or merger (and especially a reverse merger) presents fewer impediments.

An asset transaction also raises challenges (and opportunities) in the treatment of employees of the target. They are generally under no obligation to join the buyer nor do they automatically have the same right to a position with the buyer that may be provided in an existing employment arrangement with the target. Stock sales and mergers pose fewer issues in this regard, but also afford the buyer less flexibility to pick and choose whom it wants to employ.

**Nature of the Buyer**

The structure of the transaction will often be affected by the nature of the buyer. A strategic buyer (an entity that plans to actively run the company), will likely have certain goals and plans for the target. These plans may include dismantling the target, selling off certain assets or folding certain of the business functions into an existing business owned or operated by the buyer. On
the other hand, a financial buyer (an entity that does not intend to actively run the target with its own management), may leave the business enterprise intact with essentially the same management, with the buyer causing the target to improve its financial performance and enhance its return on investment.

**Legal Form of the Target**

The form of the business being acquired must be considered in assessing the appropriate structure for the proposed transaction. Whether the target is a subsidiary, a division, a corporation (S corporation or C corporation), a limited liability company, or other business enterprise, must be addressed to make certain the structure will achieve the intended results for the parties, from a business, tax, economic, and contractual viewpoint.

**Form of Consideration**

The form of consideration the buyer intends to use will affect the structure. Where seller financing is involved, the seller will demand that certain aspects of the business remain in place and will often place other restrictions on the buyer’s ability to change business operations, dispose of assets, or otherwise impair the security that supports the seller financing. In this instance, additional issues regarding the buyer’s principal commercial lenders and competing security interests must be addressed.

*How will the price for the target be paid?* The subject of how the price for the target will be paid should be explored and considered early in the transaction. Even if cash is going to be the medium of payment, a seller should determine if the buyer has the cash resources available or if the buyer will be required to finance the purchase price.

If the buyer plans to finance the purchase of the target, will arranging for the financing be a condition of the buyer’s obligation to close? Should the seller insist that condition be satisfied or waived a significant amount of time before the closing date? Should the seller negotiate for a break-up fee if the buyer does not close because of a financing condition? A seller might also consider having the right to walk if the buyer has not waived or confirmed satisfaction of its financing condition by a certain date. The seller may insist on the right to continue marketing the target until the condition is satisfied. A good deal depends on how long the seller will be comfortable keeping the business off the market and how confident it is in the ability of the buyer to obtain its financing. This suggests that these issues should be considered for inclusion in some fashion in the letter of intent or term sheet.

*Seller financing.* Sometimes a buyer will propose that the seller finance some portion of the purchase price. This is not a financing approach adopted in most M&A deals, but is sometimes encountered in connection with the purchase of small or family-owned businesses.

Accepting the buyer’s promissory note has some appeal: It has the effect of deferring the payment of part of the purchase price and, therefore, deferral of a part of the taxable gain that may have to be recognized in connection with the sale. The deferred balance bears interest, typically at a rate higher than what a seller can obtain from its bank or on its other investments, which may seem attractive. Because part of the price is to be deferred, a seller or target may be able to negotiate a higher price for the target if it is deferred rather than paid all in cash at closing.
There are usually a number of considerations that militate against a seller’s willingness to accept the promissory note or deferred payment. The seller becomes a lender to the buyer in this situation. Most of us remember what our bank or other lender requires of us in buying a car or home. Is the buyer creditworthy? Who on the seller’s team is qualified to evaluate this? Is there to be security? If so, what is the collateral? Is there to be a guaranty of the obligation? If so, from whom? Is the guarantor creditworthy? Will the security interest and/or guaranty be subordinated to the obligations owed by the buyer to others? Will the security interest be capable of a speedy foreclosure if there is a default? What if the business files for bankruptcy? Or the guarantor or buyer? The questions go on and on and pose a real challenge in advising the client. Needless to say, if a significant part of the purchase price is to be deferred and there is a default, the seller is likely to lose and never see most of the price for which it bargained, and the business recovered via foreclosure of security interests will likely barely resemble the business that changed hands at the closing.

Given the number of considerations and issues, this again, is an area worth considering for detailed coverage in the letter of intent or term sheet.

What about the buyer’s stock? Because a seller is interested in liquidity, stock used to pay the purchase price in a transaction is usually only acceptable if it is publicly traded and marketable.

Stock transactions can be very appealing because they may permit the sale to be treated as a tax-free reorganization. That means the taxable gain the shareholders of the target would recognize will be deferred until they sell shares of the buyer’s stock received in the reorganization.

An initial question if stock is to be the medium of payment is whether the seller would invest an amount equal to the purchase price in the buyer’s stock in the first place. Thus, this becomes a very significant investment decision for the seller in which the help of an experienced professional financial advisor or investment bank may be appropriate. Counsel should consider making that recommendation in those circumstances.

Keep in mind that there are numerous varieties of stock: common, preferred and different series and classes of each. Common voting shares are usually required as the consideration to be exchanged in a tax-free reorganization.

If the buyer’s common stock has performed well in the market, accepting its stock may be worth considering. What are the issues: What kind of stock? Will there be voting restrictions on the stock? Will it be marketable and when? When can the client sell or borrow against it? Stock may not be freely marketable unless procedural steps (such as registration under the Securities Act) have been taken to make it marketable. Post-closing registration is often problematic in that a buyer may lose its ability to register. Post-closing disputes between the parties may cause the buyer to use registration as leverage in the dispute. Events affecting the buyer may require that it defer or delay registration efforts temporarily. If the market price of the shares to be registered is falling, the target or its owners bear the decline in value and will be pretty unhappy.

Again, these issues are worth discussing early and dealing with in reasonable detail in the letter of intent or term sheet.

Another stock-related issue is: how many shares will be issued at the closing? Public company stock prices obviously fluctuate. The number of shares to be issued may be determined by dividing the price for the target by the price of a share of the stock to be received at closing as of some date. But what date?

The buyer may want to price the deal by fixing the value of its traded stock and the exchange ratio with the target’s stock at the time of signing the acquisition agreement or the announce-
ment of the deal. The seller will be concerned that the buyer’s stock will decline and may want a formula that sets the value of buyer’s stock and adjusts the exchange ratio at a date close to the closing (or through an average price over a defined period prior to closing.) The buyer may be worried about a precipitous drop under such a formula that results in too much dilution for buyer’s shareholders, although if there is a steep increase, this formula would protect against a windfall for the target’s shareholders. There are a variety of mechanisms (such as price collars and walk rights) to address some of these concerns over extreme price moves. These issues are often negotiated in some detail early in the deal process.

### Pricing Risk in Taking Publicly Traded Stock

The manner in which stock of a buyer is valued for purposes of an acquisition can have a significant impact on the seller and the buyer.

Let’s say that the parties agree to a price of $10 million for the target, payable in shares of the buyer’s publicly traded stock. At signing of the acquisition agreement, the market price of the stock is $100 per share and the agreement provides that the seller is entitled to receive 100,000 shares ($10 million divided by $100). At closing, the market price of the buyer’s stock is $150 per share so the 100,000 shares are now valued at $15 million. The share price can drop up to $50 after closing, and the seller will still have $10 million in the buyer’s stock.

What if the parties agree to a price of $10 million for the target, but the market price of the buyer’s stock is to be determined at closing. Since the market price of the stock is $150 at closing, the seller will receive 66,667 shares, which still have a market value of $10 million. If the stock declines to $100 shortly after closing, the stock received by the seller would be valued at $6,666,700.

The effect of significant fluctuations can be ameliorated by collars on the upside, downside, or both. Of course the market value in these examples is only on paper, and the real value will not be realized until the stock is ultimately sold.

Because the market price of stock may fluctuate widely over time, parties often seek to ameliorate the effect of the fluctuations in several ways: (i) using averages of market prices of the stock over a period of consecutive trading days, for example, 10 days or 30 days; and (ii) using ranges or collars such that if pricing occurs close to closing and the value of the stock has drastically fallen or has significantly increased with a commensurate reduced number of shares, then the adjustment may be modified or the seller may walk. Conversely, if the pricing occurs early on when the letter of intent is signed and then the market price of the shares rises dramatically over the price used to determine the number of shares, the buyer has the right to limit the number of shares or walk owing to a now significantly over-valued purchase, excessive dilution, or both.

### The Speed of the Transaction

Depending upon the sensitivity of the parties to the timing of the transaction, and if the size does not require governmental clearances, some structures may proceed more swiftly than others. For example, acquiring the assets of a corporation, without assuming the liabilities, may be perceived as a more expeditious way to acquire the business than to acquire the stock,
as the buyer will likely perceive a need to conduct a more detailed and extended due diligence where it is becoming liable for all of the obligations of the enterprise. On the other hand, obtaining clear title to each of the assets and rights to be acquired in an asset transaction may cause substantial delay. Where a swift conclusion of the transaction is important, achieving this goal may be assisted by negotiating alternative structures.

**Psychology of the Transaction**

In many instances, a transaction takes on a life of its own. The personalities involved will develop a psychology that may influence the structure. Where there is a sense that the transaction is becoming too complex or convoluted, attempts to streamline the structure may allow the transaction to move forward. Conversely, where a party expresses very specific concerns, the anxiety expressed may be alleviated by the addition of certain terms tailored to the transaction. The psychology of the transaction may also dictate a need to give and take in the negotiation process, including negotiation of the structure. It is human nature to expect something in return when being asked for a concession. While this reaction may seem obvious, it should not be overlooked. When seeking a concession from the other party, you should expect to be asked to provide a *quid pro quo* for that concession. By the same token, where the requested concession makes sense and will allow the transaction to proceed, it may be counterproductive to demand a concession simply for the sake of saving face or winning the last point.

In many instances, the structure and the concessions requested are intended to benefit the transaction, and address one or more series of concerns, rather than to renegotiate the deal. The handling of how these requests are presented and, just as importantly, how they are responded to, can be as significant as the substance of the request itself. Once the deal terms or the structure have been determined, attempts to change these points will often be perceived negatively and adversely affect the relationship of the parties and the psychology of the transaction. Whether expressed or not, most parties will keep a mental scorecard regarding issues addressed, and how each is resolved. One should not lose sight of the importance of how issues are presented in addition to what issues are presented.

**Existing Impressions**

If there is a letter of intent, or if there have been discussions among the principals or their advisors before any definitive agreement has been prepared, these early documents and discussions will likely influence the expectations of the parties. Information included in the letter of intent and discussion points between the parties may establish a preliminary expectation regarding the structure. For example, where a letter of intent expresses plans to enter into an asset acquisition, this preliminary statement will likely serve as an impediment to any change in the absence of compelling justification.

**Liabilities of the Target**

Whether the transaction is asset-based or stock-based, the intended and unintended assumption of liabilities will influence the structure and the negotiation. While an asset acquisition
allows the parties to specifically address liabilities intended to be assumed by the buyer, various liabilities may, by statute or common law, still become the buyer’s obligation. Environmental, employee benefit, employment, tax, and products liability matters, can all become obligations of a buyer depending upon the structure of the transaction and the provisions of the documents. Where liabilities are intended to be assumed, one expects the price of the transaction and the structure to overtly address this condition. Balance sheet adjustments are often used to address liabilities for which the buyer will be responsible. In most transactions, some liabilities will be unknown, contingent, or otherwise uncertain. In these instances, indemnification provisions will often allow the parties to proceed while acknowledging the uncertainty of these issues. The use of certain thresholds and limitations (baskets and caps) can effectively quantify a range of acceptable risk.

Ownership of Assets

When a party acquires the stock of a corporation, all of the target’s assets remain owned by the corporation, together with the leases, licenses, and other contracts to which the target is a party, thereby delivering to the buyer all of the benefits of the property and contract rights. Generally, the acquisition of all of the stock of the target will also allow the buyer to make use of all of its operating assets, whether or not they are owned by the target or are the subject of leases or licenses, but even here, limitations on assignment may create impediments to a buyer.

In the asset sale, the bill of sale conveying ownership of the target’s assets, and assignments of the contractual rights of the target under contracts to which it is a party, are intended to deliver to the buyer the ability to operate and make use of all of its operating assets. However, where non-assignment or “change in control” provisions are included in contracts, they must be carefully reviewed to determine whether the form of the transaction can avoid triggering such provisions or, if they are triggered, to properly address the need to obtain consents of third parties. Regardless of the structure, the parties must negotiate and address the issues that affect the ability to continue to use those assets of the target and of third parties that are necessary to the continued operation and success of the business.

Financing

The buyer of a business enterprise will in many instances seek financing for the transaction from a new lending source. In such instances, it is generally required that the assets of the target be sold free and clear of encumbrances. Where a buyer (or its lender) is willing to acquire assets that are and remain encumbered, the purchase price will be significantly affected and the structure of the transaction may be modified to appropriately address these consequences.

Guaranties

In closely held businesses, one or more of the principals often guarantees the obligations of the target. Similarly, in many acquisitions, the obligations of the parties are guaranteed. Structuring issues in a transaction can be significantly simplified where a principal is willing to guarantee the obligations of the entity. Where a creditworthy guarantor is present, many con-
cerns of the parties may be alleviated, allowing the structure of the transaction to be less cumbersome. On the other hand, the refusal to grant a guaranty may result in the need for the structure of the transaction to include a variety of characteristics to ensure that further or continuing claims can be addressed and remedies obtained. From a seller’s standpoint, the challenge may be to remove shareholders from guaranties to which they are subject.

**Existing Agreements**

It is important that all of the agreements to which the company is a party be carefully reviewed to make certain the proposed transaction will not violate existing duties or obligations. For example, where “change in control” provisions exist in agreements to which the seller is a party, these agreements should be closely scrutinized. The structure of the transaction may avoid triggering certain “change in control” provisions. Similarly, where rights of first refusal are triggered only by a sale of stock, rather than by a sale of assets, the parties may structure the transaction to avoid having to address this issue.

Every business is party to a host of contracts that affect its operations. From machinery and equipment leases to supply agreements, companies obligate themselves to continuing relationships with third parties. In the context of an acquisition, these contractual relationships must be addressed to ensure the benefits of these contracts are not lost, or that the target is not otherwise in breach as a result of the transaction. In most instances, the third party will be willing to consider an assignment to the prospective buyer. This is especially true when the prospective buyer will continue the business and may enhance the business opportunity for the third party. However, as with most other business situations, where a third party perceives it has greater leverage, it may make demands as a trade-off for permitting or consenting to an assignment. All of these issues can influence the structure of the transaction.

**Issues Specific to Stock Transactions**

A stock acquisition has several issues that are unique, each of which may influence the structure. Some of these are internal to the corporation while others are statutory or market driven. In contemplating a stock transaction, each of the following issues should be considered.

*Securities law issues.* In a stock transaction, the conveyance of the capital stock is the sale of a security. As such, federal securities laws as well as applicable state laws must be reviewed to make certain that the transaction comports with these laws. In many instances, certain notices and other disclosures will be required.

*Shareholder matters.* Participation by all of the shareholders is required to deliver all of the shares of the target to the buyer. In some instances, shareholder agreements will exist which include drag-along rights that require a minority shareholder to agree to sell its shares when holders of a majority (or supermajority) of the stock are selling their shares. In the absence of drag-along rights or unanimous consent, it may be necessary to engage in a statutory merger or other transaction to permit all of the shares to be acquired. Short of unanimity, the buyer may face having to deal with minority shareholders and this possibility will likely affect the structure of the transaction.

Many shareholders in closely held corporations enter into shareholder restrictive agreements that grant various rights and place various restrictions on each shareholder’s ability to
transfer stock. These documents must be considered in structuring the transaction. Only after a thorough review of all applicable shareholder agreements can counsel intelligently discuss and negotiate the structure. Tag-along rights, drag-along rights, supermajority requirements, rights of first refusal, dissenters’ rights, and other provisions may all significantly influence how a transaction must be structured.

**Substantive Law Issues**

There are many substantive law issues, the resolution of which may impact the structure of the transaction. Some are:

*Environmental.* Of significant concern to buyers in today’s business world is the avoidance of environmental exposure and liability. Federal and state statutes address responsibilities for environmental contamination. The quantification and assessment of these risks and the likelihood of exposure will often influence the structure of the transaction, the exclusion of certain assets, or the indemnification obligations of the parties.

*Employees and employee benefits.* Where the company provides pensions and other employee benefits, the effect of the transaction upon these obligations must be considered. ERISA includes various requirements and may cause the buyer to become liable for certain obligations. Assessing and quantifying these obligations is a necessary part of developing the structure. In addition to pension and employee benefit matters, issues relating to union contracts, unemployment compensation, workers’ compensation, and other employee matters must also be addressed. If the buyer intends to employ the entire workforce, and continue the same working conditions (and union contracts, if applicable), the structure may not need to substantively address displacement of the workforce. On the other hand, where the buyer is interested only in the assets of the target and is not interested in acquiring the human capital associated with the business, a variety of issues may become not only relevant but paramount.

In most businesses today, absent a union or other contractual arrangement, the workforce is employed on an at-will basis. In the at-will setting, the acquirer is generally free to offer employment to those employees it desires, but is not under an obligation to do so. However, certain federal statutes, such as the WARN Act, and some state statutes, place requirements upon a business where there will be a substantial displacement of workers as a result of the transaction.

Where union labor is present, the union contract (collective bargaining agreement) must be addressed. Certain collective bargaining agreements will prohibit transactions without consent being obtained or concessions being made. Often, the form of the transaction will be negotiated to permit the buyer to address the employment issues in the most favorable manner. Even where the employees are not unionized, issues relating to successor liability as an employer are relevant and must be considered. Where employment agreements with certain key employees are desired, the parties may choose to structure the transaction in a manner that does not trigger the right of an employee to terminate the agreement and obtain severance or other benefits.

*Taxation.* Various tax issues must be considered in determining how to structure an acquisition. Issues relating to the tax consequences of the transaction itself, as well as the allocation of assets, depreciation and basis issues, must be considered. Shifting various portions of the purchase price from a recognition of capital to ordinary income can produce adverse tax results and cause the effective value of the transaction to vary significantly. Attention to
these issues will avoid unintended consequences and disappointment. The importance of addressing the tax consequences of an acquisition cannot be overstated. What may appear as an equivalent transaction can produce extremely disparate tax results to the parties depending upon the characteristics of the entities and the structure of the transaction. The characteristics of the selling entity, whether a pass through entity for tax purposes or a tax paying entity, will influence decisions regarding structure. The characteristics of the assets being sold will influence the structure. The ability to cause the transaction to be “tax deferred” and the allocation of the purchase price among various assets or contractual obligations will influence the structure.

**Intellectual property.** The ability to acquire the benefits of patents, copyrights, trademarks, and licenses may be critical to the success of the enterprise. The transaction must be structured to avoid the termination of rights or otherwise adversely affect licenses and claims to intellectual property. Where the intellectual property is owned by parties other than the target (and is licensed to the company), the structure of the transaction will have to address these tangential relationships to make certain the buyer obtains the right to continue to utilize the intellectual property.

**Other Regulatory Issues**

Depending upon the business of the target, and upon its capital structure and size, a variety of regulatory issues may influence the structure. Any acquisition in a regulated industry (such as in the banking, insurance, television and radio or healthcare industries) may require governmental filings or approvals.

Moreover, the HSR Act, if applicable, will require a statutory notice and clearance of the transaction by the Federal Trade Commission or the Department of Justice. The size of the transaction and the parties participating in the transaction will influence whether or not this statutory requirement is relevant. When applicable, the necessary HSR filing will influence the timing of the transaction and may influence negotiation regarding certain aspects of the structure.

**Successor Liability**

Every buyer’s nightmare is that, after closing, an unknown and costly liability presents itself and attaches to the target business. Successor liability is not an inevitable consequence of buying a business—it can be planned against and addressed in a pro-active fashion.

Although there are nuances from jurisdiction to jurisdiction, there are some fundamental successor liability principles. If an entity acquires the capital stock of another, the transaction results only in a change of ownership of the acquired entity and all obligations in existence prior to the transaction remain those of the acquired entity. The buyer only becomes obligated for those liabilities to the extent of its ownership of the target company. A merger transaction is no different. Acquisitions by merger result in the surviving entity succeeding to all of the rights and obligations of the acquired entity. Consequently, these transactions start with a baseline assumption of obligations by the buyer and, while efforts can be made to push back
this baseline by contractually excluding certain obligations, bolstering representations and indemnification provisions, or providing for an escrow, the fundamental risks remain—absent a favorable contract provision after applicable indemnification periods have run or when no sell-side party remains to recover against, the buyer remains holding the bag. As a result, stock purchases and mergers can often leave attorneys little room to maneuver.

Asset purchases, on the other hand, may avoid these problems, subject to legal limitations. Asset purchases do not, as a general proposition, result in the buyer assuming any of the obligations of the target outside of those expressly assumed by contract in the acquisition agreement. As with most rules, certain exceptions apply by virtue of federal and state statutes and judicial decisions. The principal recognized exceptions developed by the courts to the standard proposition that buyers in asset deals are not subject to successor liability (significant distinctions exist within this general framework from jurisdiction to jurisdiction) are as follows:

- **Express or implied assumption.** The buyer expressly or impliedly agrees to assume the liability.
- **Liability imposed by law.** Failure to comply with bulk sales laws, fraudulent transfer, and tax laws may be subject a successor to liability.
- **De facto merger.** The transaction amounts to *de facto* consolidation or merger, whereby the seller is effectively absorbed into the buyer. The elements required for a *de facto* merger generally are that there be a continuation of the seller’s enterprise, a continuity of shareholders (e.g., the selling shareholders are given a stake in the continuing business), a cessation of business and liquidation, and an assumption of those liabilities necessary for the uninterrupted continuation of normal business operations.
- **Mere continuation.** There is a continuity of the corporate identity, as distinguished from the continuation of the business or operations. This continuity can be evidenced by the common identity of the officers, directors and shareholders, and the existence of only one corporation on completion of the transfer.
- **Continuity of enterprise.** There is a continuity of the business operations, as distinguished from the corporate structure. This can be evidenced by the same employees, supervisors, production facilities, products and name, together with a continuity of assets and general business operations.
- **Product line.** The transaction involves the acquisition of a manufacturing company and continuation of manufacture of the products. The other elements are the virtual destruction of the plaintiff’s remedies against the original manufacturer, the buyer’s ability to spread the risk and the fairness of requiring the buyer to assume the burden of being responsible for defective products which attach to the predecessor’s goodwill.
- **Fraud.** The transaction is entered into fraudulently for the purpose of escaping the liability.

In order to isolate any known or unknown liabilities, buyers often form an acquisition entity to acquire assets and avoid merging the target into buyer when the buyer is acquiring stock—at least until unforeseen liabilities have had a chance to surface. Conspicuous concerns known prior to closing can be dealt with in any number of specifically tailored ways, including reference in the representations, the escrow of funds, set-off rights, etc. Those concerns that spring up after closing are often understood too late to be addressed adequately. Consequently, the key to reducing successor liability risks is getting out in front of the issues as soon as possible. There is no substitute for thorough and thoughtful due diligence.
What to Avoid

Given the nature of the successor liability inquiry, the laundry list of do’s and don’ts for asset transactions is constantly changing as new fact patterns and policy concerns present themselves to the courts. None of the factors included in the following list is dispositive; although as indicated, some are viewed as more determinative than others.

• **Inadequate consideration:** The failure to provide a fair price for the assets purchased is a common problem. The policy concern rests in providing adequate consideration for the seller to meet the claims of its creditors.

• **Stock as consideration:** If stock of the buyer is a significant portion of the purchase price paid to the seller (and then distributed to its shareholders), it can result in a continuity of ownership between the buyer and seller that is problematic.

• **Dissolution of seller:** A highly damaging fact is any contractual obligation for the seller to cease business and to liquidate soon after closing. Also, rendering the seller incapable of meeting its obligations by the immediate distribution of the purchase price or the payment of part or all of the purchase price directly to the shareholders will leave the seller incapable of meeting its obligations.

• **Continuity of management:** Retaining the officers, directors, and senior employees of the seller to operate the post-closing business creates operational continuity and continuity from the perspective of the public.

• **Continuity of employees:** Contractual provisions requiring the buyer to hire the seller’s employees should be avoided.

• **Same facility:** Operating at the same facility and using the same telephone number as the seller can be pointed to as an indicator of continuity in the operations.

• **Same products/services:** Performing the same services or producing/selling the same product as the acquired company can be a factor.

• **Using the seller’s trademarks/trade names:** This factor reflects a concern that the public would not appreciate a difference between the buyer and seller given that the public face of the operations remains unchanged. Adopting a similar corporate name is a corollary to this indicator.

• **Holding buyer out as a continuation:** A buyer holding itself out as being the same or a continuation of the seller, including by claiming that the business has been in existence since the date the seller commenced business, can be a problem.

• **Assuming critical obligations:** Assuming obligations that are necessary for the uninterrupted operation of the purchased business, such as real property leases, purchase orders and employee benefits, are indicative of a desire to preserve the business in its pre-transaction state.

Certainly, some of these factors simply cannot be avoided if a buyer intends to gain the full benefits of its acquisition. In most acquisitions the entire purpose is to produce or sell the same product or service; therefore, trying to avoid this indicator is nearly impossible. Moreover, a number of these factors being present in any given transaction is not necessarily problematic. The troubling part is that, without any bright-line rule or a set number of factors that trigger successor liability, a buyer can never be absolutely certain that successor liability can be avoided. Consequently, the key is to avoid as many of the factors as possible, while still achieving the objectives of the acquisition. Or make sure there is adequate indemnification supported by a third-party credit.
Letters of Intent

At some point during the process, one or both of the parties will want a more concrete understanding of the terms of the transaction that is being discussed. A seller will want to know whether the buyer has in mind a price and structure of a deal that will be acceptable, will be reluctant to continue to disclose its business secrets and will want to know whether it should look for other buyers or simply go back to business as usual. Similarly, a buyer will eventually want to know whether there is a possibility of a deal acceptable to the seller before it continues to invest time and expense in the due diligence investigation and further negotiations.

Whenever negotiations result in a sufficient outline of terms to encourage the parties to move toward a binding acquisition agreement, the question will likely arise as to how to document the understanding that has been reached. A common suggestion is a letter of intent (sometimes called a memorandum of understanding or an agreement in principle) or term sheet setting forth the preliminary understandings such as they are. The letter of intent is generally a more formal document that is signed by the parties, whereas a term sheet is often simply an outline of the terms that may be signed or initialed by the parties. The businesspeople doing the negotiations quite often push for some document of this sort, for a variety of reasons, including just wanting to see in print what they think they have accomplished to date.

Experienced M&A counsel will have a variety of reactions to this suggestion. Many lawyers and commentators will counsel strenuously that a letter of intent can only create exposure, is the “handiwork of the devil” and should be avoided at any cost, urging their clients to proceed to a full-blown acquisition agreement. Other equally experienced counsel, either out of resignation to their client’s desires or confidence in their own ability to craft a letter of intent with sufficient clarity to protect against the risks, will view the benefits and reasons for the letter of intent sufficient to justify its use.

The Gentleman’s Agreement*

There is an oft quoted characterization of a gentleman’s agreement that captures some of the concerns of counsel cautioning against letters of intent:

A gentleman’s agreement is an agreement which is not an agreement, made between two persons neither of whom is a gentleman, whereby each expects the other to be strictly bound without himself being bound at all.


Deciding Whether to Use a Letter of Intent

There are a number of reasons cited for using a letter of intent.

• It is quicker and easier to prepare and therefore easier to read and more readily understood by the clients, and can assist the parties and counsel in avoiding misunderstandings at an early stage.
The M&A Process

- It sets forth the major terms to be reflected in an acquisition agreement and can therefore facilitate the preparation of the agreement.
- The buyer may need a letter of intent to pursue financing as banks, equity investors, and other financial institutions sometimes will not proceed with an investigation and the desired commitment letter until a letter of intent has been signed.
- In certain transactions, a letter of intent allows the process of obtaining government approvals or clearances to begin. For example, a letter of intent, even one devoid of substantive terms, will permit Hart-Scott-Rodino filings to be made so that the time period starts running.
- Often buyers are reluctant to commit to substantial expenses for due diligence, environmental consultants, accountants, or financing commitment fees without having a signed letter of intent. Businesspeople believe that sellers and buyers, even though they may not be legally bound, feel a great moral obligation to observe the terms and conditions set forth in a letter of intent at later stages in the acquisition process.

The buyer and seller may have different objectives and interests in deciding whether to use a letter of intent. Note the relative bargaining strength and position of the parties at this stage. The buyer will want to pin down the seller on price as a starting point and then negotiate binding terms that attempt to lock up the target, such as no-shop or exclusivity clauses, breakup fees, and expense allocations. The seller, on the other hand, will likely never have more leverage than it has at this stage of the courtship. This is clearly the case if there are a number of interested buyers. Once the seller says yes to the price, its leverage will in all likelihood only go down as the process plays out. No buyer is going to volunteer a higher price upon gaining a better impression of the target after due diligence. Now is the time for the seller to use this leverage to negotiate for as many favorable deal points and address as many potential skeletons as it can before it signs onto the price. On the other hand, the buyer may attempt to defer decisions on difficult issues because it will generally be in a stronger position once the seller signs a letter of intent. After the letter is signed, the seller may mentally consider that the deal is done and be more amenable to compromise. This result may be particularly likely if there is a no-shop provision in the letter of intent so the seller is unable to explore other opportunities.

There are issues particular to a public company seller or buyer after signing a letter of intent. The letter may increase the pressure to make a public disclosure regarding the potential transaction if it would be material to the public company. Often, a seller will be concerned about the damage to its business by a premature disclosure as there will be concern by the seller’s employees, suppliers and customers.

Terms to Include in a Letter of Intent

The common practice is that the business terms included in a letter of intent are not binding on either party. Accordingly, caution should be taken to make certain that a letter of intent is written in such a way as to be absolutely clear which terms are not to be binding. Most often the non-binding sections describe the business points of a deal and include a description of the assets or stock to be sold, the liabilities to be assumed in an asset deal, and the purchase price and payment terms. They often include certain conditions to closing, provisions pertaining to employees and benefits, and the timing of the process. Sometimes they also include an outline of the indemnification rights and limitations, including caps, baskets, deductibles, and survival periods and a provision with regard to escrowing part of the consideration.
The binding provisions of a letter of intent often provide for the following:

- the confidentiality of the proposed transaction and any information that is turned over by the seller to the buyer, unless already covered in a confidentiality agreement;
- the right of the buyer to have access to the target, and its personnel, properties and records;
- a no-shop or exclusivity provision, which provides a period of time in which the buyer has the exclusive right to negotiate with the seller;
- a break-up or termination fee should the business ultimately be sold to a different buyer;
- the responsibility of the parties for certain costs and expenses; and
- the non-binding nature of all the other provisions.

While there are certain common themes and practices in the process, every deal is different and specific to the parties involved. Virtually every letter of intent is subject to variation depending upon the facts and circumstances of the proposed acquisition and the parties involved and there is no such thing as a standard letter of intent applicable to all proposed acquisitions.

With these apparent benefits to letters of intent, why do so many attorneys caution clients about their dangers and some adamantly urge avoidance? There is a legion of cases where a letter ostensibly believed by at least one of the parties to be non-binding resulted in significant exposure and damages. Accordingly, it is extremely important to be careful and precise in the drafting of a letter of intent. Even where the letter is carefully crafted, the parties’ course of conduct and the “done deal syndrome” can overcome the caveats of the letter and convince a judge or jury that there was a meeting of the minds.

### The $10 Billion Letter of Intent

The poster child for caution in letters of intent remains *Texaco, Inc. v. Pennzoil Co.*, involving Pennzoil’s and Texaco’s fight over the acquisition of Getty Oil Company and its valuable oil reserves. Pennzoil had negotiated with the Getty family and the Getty Trust, the controlling shareholders of Getty Oil, to buy a controlling interest in Getty Oil. Representatives of the Getty shareholders entered into a Memorandum of Agreement and issued a press release that stated that a definitive agreement was contemplated. Neither document contained a disclaimer of a binding agreement or legal obligation. There was also considerable done deal talk and conduct. The next day Getty announced an agreement to sell to Texaco at a higher price, which indemnified Getty against liability to Pennzoil. A Texas jury rendered a verdict of $7.53 billion in contract damages and $3 billion in punitive damages in favor of Pennzoil against Texaco at a time when Texaco’s entire net worth was only $9.5 billion. While the punitive damage award was lowered, the case remains the most noted letter of intent case and features many of the issues found in such cases:

- binding effect of preliminary documents;
- reference to later definitive agreement;
- done deal syndrome; and
- parallel negotiations and abrupt termination.