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MERGERS & ACQUISITIONS HOW TO BUY OR SELL A BUSINESS

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- I. Evaluating Potential Buyers and Sellers.
 - A. Finding the right Buyer or Seller.
 1. Sellers' Considerations.
 - (a) Types of Buyers:
 - (i) Financial:
 - LBO, or leveraged buy-out. The buyer would borrow money (usually by selling bonds collateralized by the acquired business) to finance the acquisition.
 - Value investors. This is a buyer that purchases what it views as undervalued companies with a view to building further value and selling.
 - Asset sellers. This is a buyer that buys assets for re-sale, sometimes in a "bust-up".
 - Institutional/Investment Bank. These types of buyers buy companies strictly for investment/financial purposes. Usually, value or asset seller buyers who may see a higher value in the public markets for the company.
 - Roll-up. This is where an investor purchases multiple businesses in the same industry that will be combined into one larger operation.
 - (ii) Industry:
 - Competitors. Care must be taken when selling to competitors, as you don't want them to know your business inside and out if the transaction does not close.
 - Suppliers. Allows vertical integration to offer a full line of products/services.
 - Customers. A customer may want to purchase your business in order to take the product/service you have been providing in-house or to vertically integrate.

- (iii) Working executives:
 - Management Buyout. This is often leveraged.
 - Family. If inter-generational, be sure to consider estate planning issues.
 - ESOP. An Employee Stock Ownership Plan.
 - (b) Price. What is the buyer willing to pay?
 - (c) Deal Structure. Is the buyer proposing an asset or stock purchase? What are the other material parts of the deal proposed by the buyer?
 - (d) Financial strength of the buyer. Can the buyer close the deal?
 - (e) What legacy do you want to leave and what do you want your future role to be.
 - (f) Concern for employees.
 - 2. Buyers' Considerations.
 - (a) Financial concerns. What will the return on investment be? What form will the consideration take?
 - (b) Efficiencies that can be realized. A buyer may want to combine businesses in order to achieve economies of scale.
 - (c) Corporate culture. Are the cultures of the buyer's and seller's organizations compatible?
 - (d) Integration issues. One of the primary reasons that acquisitions fail is due to the failure to integrate properly the acquired business after closing.
 - (e) Why is the business for sale? Does it have deteriorating prospects?
- B. Valuation Methods - public/private - valuations generally are higher in public markets than in private markets.
 - 1. Multiple of Revenues or Earnings/EBITDA/Cash Flow.
 - (a) trailing;
 - (b) projected; or
 - (c) annualized.
 - 2. Comparable Companies. Research should be done to determine what comparable companies in the industry have been selling for.
 - 3. Book Value = Stockholders' Equity on balance sheet. This usually produces the lowest price.
 - 4. Other opportunities. This can be based upon, for example, the value of subscribers, access to distribution channels or other factors.
- C. Packaging the Company.
 - 1. Pro forma financials - the seller should present financial statements to the prospective buyer that:
 - (a) reflect increased combined revenue opportunities;
 - (b) eliminate expenses that will be eliminated after closing, such as:
 - (i) overlapping G&A;

(ii) one-time expenses;

- (iii) excess compensation and perks; and
 - (iv) non-recurring expenses;
- (c) reflect cost-saving efficiencies; and
- (d) have a sound basis for all assumptions.
- 2. In order to get the most value you will want to make your company look as good as possible, but be careful about puffery. False or misleading statements can provide a basis for the buyer to attempt to renegotiate the price later, so make sure all assertions are reasonably defensible.
- 3. A well-packaged business plan/offering document usually is necessary. Be sure to have a clear and concise executive summary that will immediately impress the reader.
- 4. Always be organized, efficient and responsive

II. The Process.

How to Make the Deal Work

A. Strategy.

- 1. Assemble your team:
 - (a) CFO
 - (b) Accountant
 - (c) Lawyer
 - (d) M&A Advisor?
- 2. A well conceived integration strategy is necessary. A checklist should be developed by the buyer (with the help of the seller) as early in the process as possible. This will increase the chances of the acquisition being a success.
- 3. Learn and understand the other party's corporate culture.
- 4. Participation of the CFO is necessary to identify, document and quantify synergies.
- 5. Set deadlines - the longer the transaction takes, the more problems can arise.
- 6. Keep employees informed of non-confidential information through e-mail and company newsletters to reduce employee frustration and enhance retention.
- 7. Keep accountants involved - do tax planning early in the process.

Documents

B. Confidentiality Agreements.

- 1. Sign a confidentiality agreement before disclosing any information.
- 2. Be careful about disclosing competitive information.

3. Prohibit the solicitation of your employees, customers and suppliers during the due diligence process and thereafter until closing (and for one to two years after any collapse of negotiations).

4. If you are receiving confidential information, include exceptions for disclosure or use of information:
 - (a) that is already in your possession;
 - (b) which is or becomes generally available to the public through no wrongful act of yours;
 - (c) which is or becomes available on a non-confidential basis from another source that is not subject to an obligation of confidentiality with respect thereto;
 - (d) which is independently developed by you without the use of any confidential information; and
 - (e) which is required to be disclosed to comply with applicable law, subpoena or court order.
5. This generally is not the place for no-shop, break fee or related terms.

C. Letter of Intent.

1. Sellers will want to avoid signing a letter of intent if they are in discussions with multiple buyers, as they will not want to grant exclusivity to any one buyer. Buyers will want to sign a letter of intent to gain exclusivity and to assess the seriousness of the Seller.
2. A letter of intent will usually be signed before due diligence begins, but not always. The more due diligence that is done prior to the execution of the letter of intent, the fewer grounds the Buyer will have to back out or renegotiate.
3. The letter of intent should outline the basic terms of the transaction.
4. The letter of intent may include a no-shop provision, which would prohibit the seller from soliciting, and possibly even discussing any other offers for the business.
 - (a) The Board of Directors of a seller should be concerned with accepting a no-shop provision, because they have a fiduciary duty to the shareholders to maximize shareholder value. If a better offer is presented for the business, the Board may have to consider it anyway, despite damages to the Buyer for breach of contract. The Seller will often ask for a break fee.
 - (b) If a seller accepts a no-shop provision, it should consider asking for a downpayment. A “fiduciary out” provision is also typical.
 - (c) In Delaware, a tight “no-shop” is probably unenforceable unless it is reasonable for the Board to conclude that it has gotten the absolute best offer available.
5. Break fees. If the Buyer asks for a no-shop provision, the Seller should ask for a downpayment and a break fee. This would be an amount of money payable by the Buyer if it decides not to proceed with the transaction. Buyers may also ask for a break fee if a Seller’s “fiduciary out” provision is exercised.

6. The letter of intent is typically non-binding, except for certain specified provisions, including clauses relating to no-shop, break fee, expenses and confidentiality, if any.
7. A letter of intent can be a binding contract if it addresses all material terms and does not have “non-binding” language. Some circumstances may make this desirable, such as when it is important to lock up a deal.

Due Diligence - Usually, the buyer does extensive due diligence on the seller and the seller does only a little due diligence on the buyer. If the seller is taking stock as part or all of the purchase price, however, the seller should do more extensive due diligence on the buyer.

D. Business.

1. Interview officers and key employees.
2. Analyze in detail the operations and cash flow of the target company.
3. Interview major customers and suppliers, if allowed.
4. Evaluate corporate culture.

E. Financial.

1. Review financial statements for at least three years - audited yearly, if available, and unaudited interim. At a minimum, review in detail the following:
 - (a) Revenues;
 - (b) Collectibility of Accounts Receivable;
 - (c) Accounts payable aging and accrued liabilities;
 - (d) Unusual expenses; and
 - (e) Contingent liabilities.

F. Legal.

1. Order “good standing” certificates from the state of incorporation of the target company and any other states in which the target company transacts business.
2. Order UCC, judgment and tax lien searches on the target company to determine if there are any outstanding liens or judgments against the company.
3. Order Credit Report.
4. Review Certificate of Incorporation and Bylaws. Beware of preemptive rights or other possible obstacles.
5. Review corporate minute and stock record books. Account for all stock certificates.
6. Review all material contracts, and note especially the following:
 - (a) “Change of control” provisions for stock/merger deals. A consent will be required in connection with the closing in respect of these contracts. This can be critical for any major contracts.

- (b) Termination provisions. Note whether any material contracts will be terminable by a third party due to the closing.
 - (c) Liabilities. Note any liabilities that the business may be subject to that for which a buyer would become liable.
- 7. Litigation. Review the status of all current litigation to which the target company is a party, and assess the likelihood of the target company being liable to a third party. Also probe as to whether or not there is any threatened litigation or any facts that could form the basis for a lawsuit against the target company.
- 8. Environmental. The environmental laws are very broad, and extend to successors to businesses. Review in detail all operations of the target company at any site on which it did business, whether or not it actually owned the property.
- 9. Labor and Personnel.
 - (a) Determine any severance obligations that will arise in connection with the sale.
 - (b) Ascertain whether any employees (likely high-level employees) have golden parachutes or change in control provisions in their employment contract that would be triggered by the sale of the business.
 - (c) Review all employee benefit plans. They will need to be coordinated.
 - (d) If there are unions involved, review any impact that the sale will have on the collective bargaining agreement.
 - (e) Check whether or not there are any Worker Adjustment and Retraining Notification statutes that apply. These would generally only be applicable to larger businesses (in excess of 100 employees) and would require advance notice to employees of the transaction.
- 10. Intellectual Property.
 - (a) Confirm title to patents, trademarks and copyrights.
 - (b) Make sure that all intellectual property was created as a “work for hire” or that proper assignments were completed to assure that the target company owns the intellectual property.
 - (c) Evaluate the strength and value of the intellectual property.
- 11. Governmental Matters.
 - (a) Determine if Hart-Scott-Rodino is applicable (See IV E. below).
 - (b) Check whether any governmental permits need to be assigned, and whether or not they are assignable.
 - (c) Determine if any other governmental consents are necessary.

III. Structuring the Transaction.

A. Assets or Stock.

1. Tax considerations - generally, the seller prefers a stock sale and the buyer prefers the purchase of assets.
 - (a) Assets:
 - (i) Double tax for C Corps - the corporation is taxed on the gain from the sale of the assets (purchase price less tax basis) and the shareholders are taxed when the proceeds are distributed (as a dividend);
 - (ii) There may be sales tax payable on the sale of some assets (e.g., equipment, not-for-resale goods); and
 - (iii) The buyer will get a stepped-up basis in the assets.
 - (b) Stock:
 - (i) No double tax for C Corps - shareholders will get capital gains treatment on the difference between the basis in their stock and the amount for which the stock was sold;
 - (ii) No sales tax;
 - (iii) The buyer will get a carry-over basis in the assets;
 - (iv) Internal Revenue Code Section 338(h)(10) election available to treat stock sale as asset sale for tax purposes; and
 - (v) A stamp transfer tax may be payable in connection with the sale of the shares. This amount should be relatively nominal.
 - (c) Generally, the purchase price will get capital gains tax treatment, while employment, consulting and non-competition payments will be treated as ordinary income for tax purposes.
 - (d) A merger is a form of stock sale that allows tax-free treatment of the purchase price paid in stock even if the purchase price is paid partially in cash. In a non-merger stock sale, the entire purchase price would be taxable if any "boot" (cash or other non-stock consideration) is paid.
2. Liabilities:
 - (a) Assets - Liabilities stay with selling company as primary obligor; buyer may assume all or only specified liabilities.
 - (b) Stock - Liabilities transfer with the stock; seller has less risk of having to pay undisclosed liabilities (the buyer will demand an indemnity in this case).
3. Accounting considerations:
 - (a) Purchase accounting. This has been the primary, and is now the only, method of accounting for an acquisition. In the purchase method of accounting, the goodwill of the acquired company has

been required to be amortized over time, thus producing a drag on earnings. The FASB is changing the accounting rules to no longer require acquired goodwill to be written off over time, but rather to require goodwill to be tested for impairment at least annually, thus avoiding the automatic write-off and corresponding drag on earnings.

- (b) Pooling. This method is no longer to be used for newly commenced acquisitions. Pooling allowed a company to combine, or pool, its financial statements with that of an acquired company and avoid the amortization of goodwill described above.

4. Other considerations:

- (a) More third party consents are usually required in an asset transaction in order to properly assign contracts.
- (b) A stock sale is usually simpler, unless liabilities uncovered in due diligence scare a stock buyer.
- (c) Bulk sales laws will need to be complied with or an indemnity given, if applicable (generally if large amounts of inventory are being sold). Compliance requires notice to all creditors.

B. Payment in Cash, Note or Stock.

1. Deferred payments or notes:

(a) Installment Reporting

(i) Installment reporting is generally available for deferred purchase price paid in the form of a note, allowing tax to be paid as payments are received. Exceptions to the ability to use installment reporting include:

- Disposition of personal property by a person who regularly sells or otherwise disposes of property of the same type of property (i.e. inventory).
- Disposition of real property that is held by the taxpayer for sale to customers in the ordinary course of the taxpayer's trade or business.
- Sales of publicly traded securities or commodities.
- Recaptured depreciation.

(ii) Installment obligations in excess of \$5,000,000 (other than personal-use property, farm property, and timeshares and residential lots) will be subject to an interest charge.

(iii) If an installment obligation is transferred, gain or loss results to the extent of the difference between seller's basis in the obligation and the amount realized.

- (b) Deferred payments can be used by the buyer as leverage in post-closing disputes, where the deferred payments can be withheld until the dispute is resolved.

- (c) For seller, the notes should be collateralized by the business being sold.

2. Stock:
 - (a) Sellers should avoid stock in private companies because it may never be liquid, unless the seller gets:
 - (i) A put right, which would give the seller a right to sell the stock at a certain price; or
 - (ii) Demand registration rights, which can force the buyer to go public.
 - (b) All stock received as part of the purchase price should have registration rights; consider value guaranty; seller may be subject to a lock-up.
 - (c) If the seller is getting stock, investigate the solvency of the buyer and consider getting personal guarantees from the principals.

C. Fixed or Contingent Purchase Price.

1. Earn-outs.
 - (a) Useful in resolving valuation disputes - buyer should always cap.
 - (b) If seller accepts an earnout:
 - (i) stay on to manage;
 - (ii) require proper financing and support for growth;
 - (iii) maintain separate accounting;
 - (iv) mechanics/detail are critical;
 - (v) categorize earn-out as contingent purchase price so you get capital gains tax treatment; and
 - (vi) all payments should be accelerated in the event of termination without cause or if there is a breach by the buyer.
2. Closing date audit and adjustment for balance sheet deals.
 - (a) Seller usually prepares baseline balance sheet, subject to challenge.
 - (b) Dispute resolution provisions - use accountants instead of investment bankers to save costs.

D. Employment Agreements. The following issues should be considered in connection with the execution of an Employment Agreement:

1. "Cause" definition. An employee will want the definition to be as narrow as possible, while the employing company will want it to be as broad as possible. Examples are as follows:
 - (a) A broad definition, which would benefit the employing company, might include language defining cause to include "any act of dishonesty," "the commission of any crime," or "the failure to perform assigned duties."
 - (b) A narrow definition, which would benefit the employee, might include language defining cause to include "the conviction of a

felony” or “the willful failure to substantially perform employees duties after written notice.”

2. Term. The term should be specified.
3. Duties. The duties of employee should be specified. The duties should be the same level duties as employee was performing previously, to avoid being assigned lower-level duties and then being fired for cause if employee refuses to perform.
4. Payments received under an employment agreement will be taxed as ordinary income, as opposed to getting capital gains tax treatment on amounts paid as part of the purchase price.

E. Consulting Agreements.

1. Differs from an Employment Agreement in that you are not a full time employee. You will receive a 1099 as opposed to a W-2.
 - (a) time commitment is usually less;
 - (b) chain of reporting usually more flexible; and
 - (c) can be structured to not require much or any work.
2. The payments received will be taxed as ordinary income.

F. Non-Competition Agreements.

1. Any amount of the purchase price that is allocated to a Non-Competition Agreement will be taxed as ordinary income. A seller will want to avoid allocation to a non-compete, while a buyer will argue that allocating to the non-compete makes it more enforceable.

IV. Definitive Documentation.

A. Representations and Warranties.

1. Survival - the length of time the representations and warranties will survive after closing is generally one to three years, except title to stock or assets (survives forever), tax (statute of limitations) and environmental (statute of limitations). The Buyer should insist on at least one full audit cycle.
2. Escrow part of purchase price for breaches - the buyer may want a portion of the purchase price to be held in escrow so there will be some assets readily available if there is a breach of a representation or warranty by seller.
 - (a) Is Seller/principals able to stand behind representations? If the entity and/or persons giving the representations will not have the

assets to satisfy a claim post-closing, it is more likely that the buyer will demand an escrow.

- (b) Representations and warranties insurance is available to insure against breaches of representations and warranties.
3. Who should give the representations and warranties? A sole owner or a majority owner that operates the business should be required to give the representations in addition to the company itself. An inactive minority owner usually does not need to give the representations and warranties regarding the company, although they should represent that they own the shares if it is a stock sale.
4. Standard representations and warranties. The number of representations and warranties, as well as the specificity and detail contained therein, will vary significantly depending on the nature and complexity of the transaction. The following are some of the more standard representations and warranties:
- (a) Organization - that the party is duly organized, validly existing and in good standing.
 - (b) Capitalization - that the capital structure of the party is as stated therein.
 - (c) Authority - that the party has the corporate power and authority to enter into the various agreements to be executed in connection with the transaction and to consummate the transactions contemplated by such agreements.
 - (d) Financial statements - that the financial statements were prepared in accordance with generally accepted accounting principles consistently applied and present fairly the financial condition and results of operations of the party.
 - (e) Undisclosed liabilities - that the company has no liabilities other than those disclosed on the financial statements of the company.
 - (f) Absence of certain changes or events - that none of the specified events have occurred within a specified period of time (since the date of the last audit). This representation is intended to assure the buyer that the business has been run in the ordinary course.
 - (g) Taxes - that all required tax returns have been filed and are correct and all taxes shown thereon as payable have been paid.
 - (h) Intellectual property - that the party owns the specified intellectual property and such intellectual property does not infringe on the rights of others.
 - (i) Compliance - that the party is in compliance with all laws and with all contracts to which it is a party.

- (j) Brokers' and finders' fees - that no broker's or finder's fees are payable in connection with the transaction.
- (k) Employees; employee benefits - that the employees are given the salary and benefits indicated.
- (l) Litigation - that the party is not subject to any pending or threatened litigation or similar proceedings.
- (m) Environmental matters - that all environmental laws are being and have been complied with.
- (n) Major customers - that the major customers of the business do not intend to cease doing business with the company.
- (o) Agreements, contracts and commitments - that all of the specified agreements are in effect and will not be breached or terminated by the transaction.
- (p) Change of Control payments - that no amount will be payable to anyone as a result of the sale of the business.

- (q) Title to properties and related matters - that the business owns all of the property that it purports to own.
- (r) Material suppliers; inventories - that none of the material suppliers to the business intend to cease doing business with the company.

5. Other Representations.

- (a) A buyer may also request representations as to:
 - (i) Financial projections: This should be avoided by seller if at all possible, or at least given only "to the best knowledge of seller."
 - (ii) Information provided to buyer. Sellers should not give any representations as to documents or information provided to buyer during the due diligence process, unless specifically identified in the purchase agreement.
 - (iii) Disclosure. A buyer will request, and it is generally acceptable to give, a representation that the representations do not contain an untrue statement or omit any statement necessary to make the representations not misleading.
- (b) The seller should receive a representation from the buyer that the buyer does not know of any breach of any of seller's representations and warranties. This prevents seller from being liable for something the buyer knows about. This representation is especially appropriate when the buyer has done extensive due diligence.

B. Indemnities.

1. Basket - This is the amount that indemnity claims must exceed before any liability to indemnify arises. This minimizes wasted time over minor matters or small amounts. The amount can vary considerably. There are two types of baskets, as follows:
 - (a) dollar one (true basket/threshold) - If the claims for indemnification exceed the agreed-upon amount, all claims for indemnification would be paid; and
 - (b) excess (deductible) - If the claims for indemnification exceed the agreed-upon amount, only those claims in excess of the agreed-upon deductible amount would be paid.
2. Cap - This is the amount that the aggregate of all indemnity claims against a party cannot exceed. This amount is typically the amount of the purchase price.
3. Who controls litigation/settlement negotiations?
 - (a) Generally the indemnifying party controls.
 - (b) Include a provision that no settlement shall be made to the detriment of the other party without their consent.

- C. Simultaneous Contract and Closing or Deferred Closing.
1. Hart-Scott-Rodino (See IV E. below). If H-S-R approval is necessary, there will be a deferred closing.
 2. If there is a deferred closing, there will be restrictions on what the Seller can do between the time the definitive agreement is executed and the closing. Generally, the business must be run in the ordinary course between contract and closing.
 3. Any necessary consents and financing will be obtained between the signing of the contract and closing, if there is deferred closing. Otherwise, they will need to be obtained even before the contract is signed.
- D. Conditions to Closing - In the event of a deferred closing, the following are some possible closing conditions:
- (a) Typical conditions.
 - (i) The representations and warranties of each party must be true and correct as of closing.
 - (ii) All covenants contained in the purchase agreement must have been complied with.
 - (iii) There are no suits, proceedings or investigations pending or threatened regarding the transaction.
 - (iv) There has been no material adverse effect on the business.
 - (v) All necessary third-party and governmental consents have been received.
 - (b) Other non-typical conditions.
 - (i) Buyer has completed and is satisfied with its due diligence of seller.
 - (ii) Buyer has obtained necessary financing.
 - (iii) Transaction-specific conditions.
- E. Hart-Scott-Rodino.
1. Generally, a pre merger notification filing is required if:
 - (a) as a result of the transaction, the acquiring party will hold in excess of \$200 million of the acquired party's stock and/or assets; or
 - (b) as a result of the transaction:
 - (i) the acquiring party will hold more than \$50 million of the acquired party's stock and/or assets (but not in excess of \$200 million); and
 - (ii) either party to the proposed transaction has total annual net sales or total assets of at least \$100 million and the other party has annual net sales or total assets of at least \$10 million.
 2. File after execution and before closing if deferred closing.
 3. 30 day waiting period.
 4. Can request early termination of waiting period, which generally will be granted if the proposed transaction poses no threat to competition.

5. Filing fee ranging from \$45,000 to \$280,000, depending on the size of the transaction.

V. Closing

A. Closing deliveries.

1. Main Agreements. These may not all be applicable, and there may be others, depending upon the nature of the transaction.
 - (a) Purchase Agreement.
 - (b) Escrow Agreement - in the event that the seller will be required to leave some money in escrow to secure against breaches of representations and warranties.
 - (c) Employment/Consulting Agreements - in the event that any of the principals/key employees will be staying on with the business.
 - (d) Non-Competition Agreements - in the event that the buyer wants to prevent the seller/principals/key employees from competing with the business after closing.
2. Secretary's Certificates - the Secretary of each party will certify as to the following:
 - (a) Certificate of Incorporation;
 - (b) Bylaws; and
 - (c) Resolutions of Board and Shareholders, if applicable.
3. Officer's Certificates - generally, each party will provide this certificate certifying that the conditions precedent to closing and the covenants of such party have all been performed or complied with.
4. Opinions of Counsel - the amount of detail will vary, but generally opinions are intended to provide comfort to the other side regarding various legal matters.
5. Third-party and governmental consents.
6. Stock and minute books if a stock transaction.
7. Representation letter if Seller receiving stock - this will be necessary in order to make sure that there is a proper exemption under the securities laws for the issuance of the shares.
8. Financials - recent financials will usually be delivered at the closing and may be certified as being true and correct by the CFO.
9. Good standing certificates - this confirms that the parties are duly incorporated and in good standing.
10. Assignments of copyrights, patents and trademarks - these are necessary so they may be properly transferred in the Copyright Office and the Patent and Trademark Office.
11. Website URL assignments - separate form for this.

VI. Post-Closing

- A. Key business/integration issues - must be planned pre-closing:
 - 1. management information/financial accounting/computer systems.
 - 2. cultural differences.
 - 3. coordinating sales channels.
 - 4. cross-training sales forces.
 - 5. restructuring offices.
 - 6. brands.
 - 7. lines of authority for continuing former owner(s).
 - 8. inform customers and coordinate any necessary transitions.
- B. Make any necessary governmental filings, including filing of copyright, patent, trademark and website assignments.
- C. Closing date audit and adjustment for balance sheet transactions.
- D. Payment of earnout and/or deferred payments.
- E. Working for the buyer.

Nothing contained herein constitutes legal advice.