AN ENTREPRENEUR'S GUIDE TO THE M&A SALE TRANSACTION PROCESS AND DEAL TERMS

This article provides entrepreneurs considering an M&A sale transaction for their privately-held companies with an overview of the M&A sale transaction process and some of the significant deal points typically negotiated by the parties. While not a comprehensive review of all of the aspects and issues involved in doing an M&A sale transaction, it should provide entrepreneurs with a good idea of what to expect from the process and such deal points.

TERMINOLOGY. Transactions in which a company is sold are referred to as "mergers and acquisitions" or "M&A" transactions because such transactions typically involve either the *merger* of the company being sold (the "Target") into the Buyer (or a subsidiary of the Buyer) or the *acquisition* by the Buyer either of shares comprising a controlling interest in the Target from the existing stockholders of the Target, or all or substantially all of the assets of the Target. M&A transactions are different from equity "financing" transactions, in which a company raises money by selling new shares of its equity securities to investors (as opposed to existing stockholders selling their shares to the Buyer in an M&A transaction), even though equity financing transactions also involve the sale of stock in the company and can sometimes result in a change in control of the company.

THE M&A SALE PROCESS.

- **Timeline.** Although all deals are different, the M&A sale process for a privately-held company will typically take from three to six months from beginning to end, assuming no significant delays due to, for example, contractual consents, a "second request" in response to an "HSR" antitrust filing (discussed below) or other governmental or regulatory approvals.

- **Engaging an Investment Bank.** Once the Target's board has decided to proceed with a possible M&A sale transaction, the next step is often engaging an investment bank to assist with the sale process. Of course, a Target may proceed without an investment bank, particularly if it receives a "preclusive" offer at a price that the board thinks is unlikely to be matched in the marketplace. Usually the Target will contact a number of investment bank candidates, some of which will usually be known to the Target's management or controlling stockholders from prior deals. Each candidate investment bank will present an engagement letter with its proposed terms and conditions, which will be negotiated with the Target or its controlling stockholders. The negotiated terms of the engagement letter typically include: (1) whether the investment bank will be paid a cash retainer, how much, and whether it is paid over time during the engagement or in a lump sum upon signing; (2) the amount and structure of the "success fee" payable to the investment bank upon closing of an M&A sale transaction (often calculated using a graduated scale consisting of fees consisting of different percentages of the total purchase price amount apply to different purchase price amounts), (3) the cap on the investment bank's expenses that will be reimbursed by the Target, (4) whether the investment bank will also receive a fee if one of the potential Buyers it contacts decides to make a minority investment in the Target, rather than buying the Target, and the terms of such fee, and (5) the term of the agreement, including the length of the "tail period" after the end of the engagement during which the investment bank receives a fee if the Target does an M&A sale transaction or (if applicable) accepts a minority investment from an investor brought to the Target by the investment bank.

- **Teaser/Confidential Information Memorandum.** Once an investment bank is engaged by the Target, it will work with the Target to prepare a brief, 2-3 page "teaser" summary of the Target's business (which won't include any confidential information about the Target) and a comprehensive 10-20 page "confidential information memorandum" (which will include confidential information about the Target). The investment bank will supply the teaser summary to a group of potential Buyers that it has determined may be interested in the Target, to enable them to do a preliminary evaluation without being required to sign a non-disclosure agreement. The potential Buyers will include both "strategic" Buyers (i.e., other operating companies) and "financial" Buyers (i.e., private equity firms and hedge funds). If a potential Buyer is interested, it will sign a non-disclosure agreement supplied by the investment bank and receive the confidential information memorandum.

- **Management Presentations.** If a potential Buyer continues to be interested after reviewing the confidential information memorandum, it will usually arrange through the investment bank to receive an in-person or telephonic presentation concerning the Target's business from its management (typically with accompanying Powerpoint slides).

- **Due Diligence.** The next step is for the Buyer to do legal, accounting/financial and business due diligence on the Target.

Financial/Accounting – Buyers often hire an outside accounting firm to assist with due diligence of the Target's historical financial results and financial projections, but some Buyers will do their accounting/financial due diligence internally.

Legal – For Targets with significant patents, trademarks and other intellectual property, the Buyer will sometimes engage a specialist consultant to help with analysis of such intellectual property. For Targets that are industrial companies, legal due diligence will often include the Buyer hiring an environmental consultant to perform a "phase one" environmental analysis of the Target's current and former facilities.

Business – Business due diligence will typically include calls and possibly meetings between the Buyer and the Target's key customers and suppliers, which will usually be arranged by the Target or its investment bank.

Order – In terms of sequencing, to help control costs, Buyers will sometimes delay the environmental and other legal due diligence to last in the process, to avoid incurring those expenses in case the accounting/financial due diligence reveals issues that cause the Buyer to terminate the proposed acquisition. Sellers will sometimes request that the Buyer defer the key customer/supplier meetings to last in the process to minimize potential damage to those relationships if the Buyer elects to not proceed with the proposed acquisition.

Process – The legal and accounting/financial due diligence processes are usually administered by the Buyer's attorneys and accountants providing "due diligence request lists", to which the Target will respond either by supplying copies of documents, inviting the Buyer's attorneys and accountants to visit the Target's offices to review the documents on-site, or posting the documents on an online "virtual data room". Follow-up requests, either by way of calls or written "supplemental due diligence request lists" are common. The Buyer's due diligence process will typically continue after submission of its bid and preparation of the transaction documents, right up to the moment of closing.

- **Making an Offer.** Sometimes the investment bank assisting the Target with its M&A sale process will send out a "bid procedures" document specifying the manner in which potential Buyers should submit their bids. The bid procedures document is sometimes accompanied by a "form" purchase agreement (usually with extraordinarily Target-favorable terms), which each potential Buyer is required to mark-up and submit along with a letter summarizing the terms of its bid. Otherwise, the Buyer will typically make its offer by presenting to the investment bank an "offer letter", "term sheet" or "letter of intent" with the terms of its offer, which is not legally binding but will be heavily relied upon by the Target and its controlling stockholders in deciding on a winner.

- **<u>Selecting the Winner</u>.** The Target and its controlling stockholders will evaluate the bids received with the advice of the investment bank. The hope of the Target and its stockholders will be that a "bidding war" will start and, if there is more than one offer (or even if there isn't), the investment bank will try to get each of the bidders to improve its offer, and a "winner" will then be selected by the Target or its controlling stockholders. For venture-backed companies, the Target will typically create and circulate "waterfall" calculations showing the amount of transaction proceeds receivable by preferred stockholders (typically VCs) and common stockholders and optionholders (typically management) at different purchase price levels, which the parties will use in analyzing the relative attractiveness of the bids received. "Top line" purchase price amount is obviously a very significant factor, but other deal terms (discussed below) will also be important factors in deciding the winning bidder, as they can significantly affect the amount of proceeds that the Target stockholders ultimately receive in connection with the deal.

- **<u>Definitive Deal Documents</u>.** Once the winning bidder is selected, the Buyer and the Target will work with their respective lawyers to prepare the purchase agreement and other definitive transaction documents and proceed to closing the transaction. If a form purchase agreement was used as part of the bid process (as described above), that document will be used by the parties, sometimes with further revisions. Otherwise, the Buyer's counsel will typically prepare the initial draft purchase agreement based on the deal terms in the offer letter/term sheet/LOI, which will then be commented upon by the Target's counsel. Those comments will typically be conveyed in an "issues list" memo and/or a "blackline" of the draft purchase agreement (showing the Target's suggested changes to the initial draft document), which will then be negotiated in a series of calls and/or meetings between the parties and their counsel. A similar process will typically be followed for the other transaction documents (e.g., escrow agreement, employment agreements (if applicable) and Buyer equity documents (for deals with Buyer stock as part or all of the purchase consideration)).

<u>THE TERMS OF THE DEAL</u>.

- **<u>Deal Structure</u>.** M&A deals are usually structured as an "asset purchase," a "stock purchase" or a "merger." The parties will sometimes "punt" on deal structure for purposes of the offer letter/term sheet/LOI, but deal structure is very important as it can significantly affect the after-tax transaction proceeds that the Target's stockholders will receive in the deal, the Target's value to the Buyer, and the process for the transaction. The "default" deal structure is a stock purchase or a merger, with asset deals being in the minority for acquisitions of healthy operating companies (as opposed to acquisitions of all or parts of distressed businesses). Buyer concerns about assuming historical liabilities of the Target (which mitigate in favor of an asset purchase structure) and the tax impact of the deal structure on the parties are usually the main drivers for choosing a particular deal structure. Tax impact in M&A transactions is often a "zero sum game", where a deal structure that will be tax-beneficial to the Buyer will be tax-adverse to the Target's stockholders, and vice versa, but there are some exceptions, most notably doing a "tax-free" merger as discussed below.

Asset Purchase Structure – Either the Buyer itself or a wholly-owned subsidiary of the Buyer purchases specified assets of the Target's business (usually comprising "substantially all" of those assets), resulting in the Target business being housed in the buyer or its subsidiary and the Target entity becoming a "shell company" whose only assets are cash (which is used to pay creditors and the remainder distributed to stockholders) and any "excluded assets" that weren't purchased by the Buyer. The asset purchase structure offers some ability for the Buyer to leave behind with the Target shell company the pre-closing liabilities of the Target's business, which can be useful when buying Targets with outstanding litigation, environmental issues or other known or suspected liabilities. However, the asset purchase structure will trigger "anti-assignment" clauses in the Target's customer and supplier contracts and governmental permits/licenses, which can delay closing and make it more difficult to preserve the Target's business intact. Also, the "protection" for Buyers against the Target's historical liabilities from using an asset purchase structure can prove to be illusory where the Buyer will carry on the same business as the Target, using the same corporate name and operated out of the same facilities, due to application of "successor liability" theories. Finally, the asset purchase structure is often the least tax-advantageous of the three deal structures to the Target's stockholders, although often the most tax-advantageous to the Buyer.

Stock Purchase Structure – The Buyer purchases from the Target's stockholders all of, or a controlling interest in, the outstanding shares of the Target's stock, resulting in the Target becoming a subsidiary of the Buyer. Unlike an asset purchase, the stock purchase structure leaves the existing Target and its assets in place, so it's considered to be a "change of control" rather than an "assignment" and hence fewer consents will be required under the Target's customer and supplier contracts and governmental permits/licenses. However, the Buyer essentially "becomes" the Target, assuming all of the Target's historical liabilities, with the only protection being indemnification from the Target's stockholders under the purchase agreement (discussed below). Also, if the Buyer wants to own 100% of the Target, all of the Target stockholders will need to sign the purchase agreement, which can be difficult where there are a significant number of minority stockholders, some of whom may not be getting much (if anything) in the way of proceeds out of the transaction and, as a result, may not see the benefit in signing the purchase agreement. Finally, unless the Target stockholders do a "Section 338(h)(10) election" (which is only available if the Target is taxed as an "S-corp.", among other requirements), a stock purchase structure will usually be less tax-advantageous to the Buyer than an asset purchase structure.

Merger Structure – Either the Target is merged into the Buyer or the Buyer sets up a new wholly-owned subsidiary with which the Target is merged. If a subsidiary is used, either the Buyer subsidiary or the Target can be the surviving entity of the merger (this is referred to as a "forward" or "reverse" merger, respectively). The merger is effected by the parties filing "certificates of merger" with the secretary of state of each of the states in which the Target and the Buyer (or its subsidiary) are organized. The merger structure is like a stock purchase structure in that it's usually (but not always) considered to be a "change of control" rather than an "assignment", resulting in fewer consents being required under Target customer and supplier contracts and governmental permits/licenses (a "reverse" merger, in which the Target is the surviving entity of the merger, is the best type of merger in this regard). Like a stock purchase, the Buyer essentially "becomes" the Target, assuming all of the seller's historical liabilities, with its only protection from the Target's historical liabilities being indemnification from the seller stockholders under the purchase agreement. One of the main advantages of a merger structure is that, if a sufficient amount of Buyer stock is included in the purchase consideration (there are different percentages required by law depending on whether the merger is a "forward" or "reverse" merger), the transaction can be "tax-free" to the Target stockholders, which means that they can defer paying capital gains taxes on the appreciation of their Target stock until they subsequently sell the Buyer stock that they receive in the deal (they will need to pay taxes right away on any cash and other non-Buyer stock consideration received in the deal). Another advantage to a merger structure is that, unlike a stock purchase structure, the parties don't need to get all of the Target stockholders to sign the purchase agreement (usually either a majority or two-thirds in interest of the Target stockholders is sufficient).

- **<u>Purchase Consideration</u>.** The purchase consideration paid by the Buyer to the Target's stockholders can consist of cash, Buyer stock, "seller notes", earnouts and other deferred or contingent payments. As in most circumstances, "cash is king" in M&A transactions and, when evaluating acquisition offers, Target stockholders typically rank “all cash” offers ahead of those involving other forms of purchase consideration. However, Buyers will sometimes seek to “bridge the gap” between what they’re willing or able to pay and the valuation being sought by the Target’s stockholders by using non-cash consideration, particularly now that debt financing is much less readily available to fund acquisitions.

Buyer Stock – Buyer stock can be attractive as it can enable the parties to use the “tax-free” merger structure as discussed above, especially where the Buyer is publicly-traded and the Buyer stock comes with registration rights that enable the Target stockholders to obtain liquidity. Accepting Buyer stock requires the Target’s stockholders to analyze the Buyer’s business and capitalization and evaluate the likelihood that such Buyer stock will have value in the future. This analysis often includes: (1) the seniority of the Buyer stock upon a liquidation or sale of the Buyer (e.g., common stock vs. preferred stock), (2) voting rights of the Buyer stock (e.g., the ability to appoint directors or have “veto” rights on future equity financings and other actions), (3) restrictions on transfer of the Buyer stock (e.g., a “right of first refusal” requiring that the stock be offered back to the Buyer and/or its majority stockholders before it is transferred to a third party and “drag along” provisions requiring the minority Buyer stockholders to go along with a “sale of the company” transaction as long as they receive the same per-share consideration as the majority stockholders), (4) redemption rights requiring the Buyer to “buy back” the Buyer stock in the future, and (5) rights of holders of Buyer stock to receive Buyer financial statements and other information about the Buyer. Buyers will sometimes request that Target stockholders who are also members of Target management and will be continuing with the Buyer after the acquisition “keep some skin in the game” by “rolling over” some of their purchase consideration into shares of Buyer stock. Rollover stock differs from “incentive equity” like stock options and restrictive stock (which is issued to management members “for free”) in that the rollover stock typically isn’t subject to vesting over time and forfeiture upon termination of employment.

Seller Notes – “Seller notes” are promissory notes issued by the Buyer to the Target stockholders, under which the Target stockholders essentially finance part of the purchase price being paid by the Buyer. Using seller notes can be advantageous to the Target’s stockholders because, under certain circumstances, doing so can enable them to defer into future tax years part of the purchase consideration that they receive, which can reduce their overall tax burden from the transaction. Like Buyer stock, accepting seller notes requires the Target stockholders to analyze the Buyer’s business prospects because seller notes are usually “subordinated” to the Buyer’s existing senior debt facility, which means that they won’t be repaid if the Buyer’s business operations don’t yield sufficient cash to be able to repay both the senior debt and the seller notes. A negotiated point is often whether the Buyer is permitted to make principal and interest payments on the seller notes as long as it isn’t in default under the Buyer’s senior debt facility (as opposed to the Buyer being prohibited from making any payments on the seller notes as long as the senior debt is outstanding) – this will be governed by an “intercreditor agreement” entered into by the Target stockholders, the Buyer and its senior lender. Another negotiated point is whether the seller notes are backed by a “second lien” pledge of the Buyer’s assets (which is subordinated to the senior lender’s lien but senior to the Buyer’s trade debt and the claims of other junior creditors) or are unsecured. Finally, Target stockholders will often seek “acceleration” of the Buyer’s obligation under the seller notes upon a sale of the Buyer, arguing that it is not reasonable to expect the Target stockholders to assume credit risk for an unknown-to-them purchaser of the Buyer’s business.

Earnouts and Other Contingent Consideration – Earnouts give Target stockholders the right to receive additional purchase consideration if the “legacy” Target business meets specified financial performance or other criteria over defined periods of time after the acquisition closes. Since the Buyer will control the legacy Target business after the closing, a key negotiated point for Target stockholders, in addition to whether the earnout criteria are realistic, is whether the Buyer is required to provide funding, personnel and/or other operational support to enable the legacy Target business to achieve the earnout goals. Another negotiated point is often whether credit is given for "near misses" of earnout goals, either through "catch-up" provisions in subsequent periods or by breaking the goals into multiple segments that reward partial performance, rather than being "all or nothing" tests. Finally, Target stockholders will often seek "acceleration" of earnout benefits upon a sale of the Buyer, arguing, like in the seller notes scenario described above, that it is not reasonable to expect the Target stockholders to assume credit risk for an unknown-to-them purchaser of the Buyer's business. In addition to earnouts, sometimes deals are structured to give the Target stockholders the right to receive additional purchase consideration if specified events occur post-closing (e.g., recovery of proceeds in a lawsuit being brought by the Target), usually in situations where the Buyer and the Target stockholders disagree as to the likelihood of the event occurring, the Target stockholders insist that the event will create additional value for the Buyer, and the Buyer isn't willing to assume the risk of it not occurring.

- **Treatment of Stock Options and Other Target Incentive Equity.** Target incentive equity like stock options and stock appreciation rights (SARs) will typically either be "cashed-out" or "rolled-over" in connection with an M&A transaction, with cash-out of Target incentive equity being somewhat more common than rollover.

"Cash-out" of Target Incentive Equity – The parties will first determine the per-share amount of transaction consideration that will be paid to holders of Target common stock in the deal, usually by doing a "waterfall" calculation that applies the purchase price amount first to the Target's outstanding debt, then to its preferred stock liquidation preferences and finally the remainder (if any) to holders of its common stock. If that per-share transaction consideration amount is more than the Target incentive equity's exercise price, the incentive equity will be "in the money" and its holders will receive the excess in connection with closing of the acquisition, typically in cash (even if the transaction consideration consists, in whole or in part, of Buyer stock or other non-cash consideration). If that per-share transaction consideration amount is less than the exercise price of the incentive equity, the incentive equity will be "out of the money" and, depending on the terms of the relevant Target equity incentive plan documents, may be terminated in connection with closing of the acquisition.

"Rollover" of Target Incentive Equity – The Buyer exchanges the Target incentive equity for stock options or other incentive equity in the Buyer, typically using an exchange ratio that is based on whether the Target incentive equity is "in the money" (as described above) and the extent to which it is so, as well as the comparative per-share value of Target stock and Buyer stock. The accrued vesting on the Target incentive equity is sometimes carried over to the Buyer incentive equity received in the exchange.

Buyers will sometimes elect to cash-out (rather than rollover) Target incentive equity because rollover would result in "legacy" Target employees having Buyer incentive equity amounts that aren't consistent with the Buyer incentive equity amounts held by their peers in the Buyer's organization and they want those legacy Target employees to have a "fresh start" with respect to their Buyer incentive equity, sometimes including having restarted vesting schedules. If the Target's incentive equity will be cashed-out in connection with an M&A transaction, the Buyer will often plan to issue new incentive equity to legacy Target employees under its equity incentive plans, either in connection with closing of the acquisition or soon thereafter.

Incentive equity plans often provide that any Target incentive equity that is not "assumed" by the Buyer (i.e., rolled-over) in connection with an M&A transaction will become fully-vested upon the acquisition and, if not exercised before closing of the acquisition, will terminate upon closing of the acquisition. This is the best type of provision for purposes of doing an M&A deal, as it provides the parties with certainty concerning treatment of Target incentive equity in connection with the deal, especially any such incentive equity that is "out of the money". Buyers will often require the

Target to "clean-up" any "out of the money" incentive equity if the relevant Target equity incentive plan documents don't clearly provide for automatic termination by obtaining termination agreements from the holders as a condition to closing, which can be a time consuming and potentially expensive process.

- **<u>Purchase Price Adjustments</u>.** M&A transactions involving privately-held Targets often adjust the purchase price based on the difference (if any) between the amount of a specified financial measure of the Target as of the closing, as compared to a "goal" amount of that financial measure. These provisions are intended to compensate the parties based on changes to the Target's business that occur between the time at which the purchase price is negotiated (often based on a multiple of revenue or earnings) and closing of the transaction. "Net working capital" (i.e., current asset minus current liabilities) is the most frequently used financial measure but other measures are sometimes used such as "net worth" (i.e., assets minus liabilities) and "cash at closing". Adjustments based on "cash at closing" are intended to insure that the Buyer won't need to inject cash into the Target immediately after the closing to pay ordinary course operating expenses. However, a fair number of M&A deals are done on a "cash-free, debt-free" basis, which entails the Target stockholders delivering the Target to the Buyer at closing with no cash or borrowed money debt, and consequently the Target's cash at closing isn't included in the purchase price adjustment calculation.

Downward Only or Both Ways – Purchase price adjustments are either "downward only" (i.e., the purchase price is reduced if the financial measure is less than the goal amount) or "two way" (i.e., the purchase price is either reduced or increased, based on whether the financial measure is less or more than the goal amount), with the latter approach being more favorable to the Target's stockholders. Sometimes purchase price adjustments include a "buffer" around the goal amount, within which no adjustment is made.

Two Stage Process – Purchase price adjustments based on financial measures are often done in two stages: an initial adjustment is done at closing based on the Target's estimate of the financial measure and a post-closing adjustment is done based on the Buyer's calculation of the financial measure, with a dispute resolution mechanism in which the parties appoint an independent accounting firm to resolve any disputes that the Buyer and the Target's stockholders cannot resolve through negotiation.

Accounts Receivable Purchase Price Adjustments – M&A deals in which the Target's accounts receivable are a significant part of its value sometimes include a purchase price adjustment in which the Target stockholders compensate the Buyer for any amounts that it doesn't collect on those accounts receivable over a specified period after closing, despite it having used reasonable collection efforts, taking into account the "bad accounts" reserve included in the Target financial statements. Sometimes the Buyer is required to assign over to the Target stockholders any uncollected accounts receivable for which the Target stockholders compensate the Buyer. Buyers sometimes resist doing so based on concern that the Target stockholders will use collection methods that will damage the Buyer/Target's relations with its customers.

Satisfaction of Downward Purchase Price Adjustments – Sometimes, to secure the Target stockholders' obligation to repay the Buyer for any downward purchase price adjustment amounts, part of the purchase price is placed into a third party escrow until the post-closing purchase price adjustments occur. Alternatively, sometimes the Buyer is entitled to deduct any such downward purchase price adjustment from the escrow established for indemnification claims (discussed below) or to offset the downward purchase price adjustment against its obligations under any seller notes, earnout payments and/or other deferred or contingent purchase consideration.

- **<u>Representations and Warranties</u>.** The purchase agreement will usually include ten to twenty pages of detailed statements about the Target's business that are intended to cover all of the areas that could potentially create liability for the Buyer or otherwise reduce the value of

Target's business. These statements, which are called "representations and warranties", are usually phrased to require the Target to describe on "disclosure schedules" that it prepares and supplies to the Buyer any instances in which the Target's business deviates from a "perfect world" in which, for example, the Target doesn't have any issues with its financial statements, any environmental problems, any disputes with contract counterparties, or any labor issues. In addition, there are usually "list" representations and warranties, which require the Target to include in its disclosure schedules lists of, for example, all of its material contracts, all of its governmental permits, and all of its employee benefit plans. Representations and warranties serve the following important functions.

Due Diligence – First, because the representations and warranties (along with the disclosure schedules that accompany them) highlight all of the ways that the Target's business deviates from the "perfect world" and provide lists of important business items, they are an important part of the Buyer's due diligence process and sometimes reveal issues that give the Buyer grounds to renegotiate the purchase price or other deal terms, or cause the Buyer to rethink its desire to do the deal at all.

Certainty of Closing – Second, there is typically a "bring down" closing condition that entitles the Buyer to walk away from the deal (rather than close) if the Target's business changes between signing and closing and, as a result, the representations and warranties (which are made as of signing of the purchase agreement), don't continue to be true and correct as of the closing. As a result, the representations and warranties affect certainty of closing the acquisition (this is discussed in more detail below).

De Facto Purchase Price Adjustment – Third, in M&A transactions involving privately-held Targets, there is usually an indemnification provision that requires the Target's stockholders to compensate the Buyer for any losses incurred by the Buyer if the Target misrepresents its business and the representations and warranties aren't true, for example by not disclosing a breached contract, a tax problem, an IP infringement lawsuit or an environmental law violation, which effectively reduces the purchase price by the amount of any such losses (this is discussed in more detail below).

Qualifiers and Carve-Outs – A negotiated point in most M&A transactions is the extent to which the representations and warranties include "knowledge", "materiality" and "Material Adverse Effect" qualifiers or carve-outs. "Knowledge" qualifiers or carve-outs only hold the Target stockholders responsible for misrepresentations that the Buyer can prove the Target (through its management) "knew" about as of the time that the purchase agreement was signed or the transaction closed. Whether the standard is actual knowledge or "constructive knowledge" (i.e., knew or should have known), as well as which of the Target employees' "knowledge" counts for this purpose, will be negotiated points. "Materiality" and "Material Adverse Effect" qualifiers or carve-outs excuse the Target stockholders from responsibility for not disclosing items that are not "material" to the Target or would not result in a "Material Adverse Effect" on the Target. In certain instances, these types of qualifiers or carve-outs are appropriate but the Target's counsel will often try to include as many of them as possible in the representations and warranties, in order to minimize the Target's burden in preparing its disclosure schedules, enhance certainty of closing, and limit the Target stockholders' potential indemnification exposure. As a result, those qualifiers and carve-outs will typically be a negotiated point.

- **<u>Closing Conditions</u>.** Most M&A transactions involve a sequence of events in which the parties negotiate and sign the purchase agreement, there is a pre-closing time period in which the parties gather all of the third party consents and other items necessary to close and, once those items have been obtained, the "money changes hands" and the transaction closes. Other M&A transactions are "simultaneous sign and close" deals, in which the parties negotiate the purchase agreement and other transaction documents, gather all of the third party consents and other items necessary to close, and then sign the purchase agreement and other transaction documents and close the transaction. The latter approach exposes the Target stockholders to some degree of risk, since the Target will need to "go public" about the transaction by soliciting contractual consents from customers, suppliers and other third parties without having a legally binding contract with the Buyer to acquire the Target in place. In some cases (deals requiring an "HSR" antitrust filing and other regulatory approvals are prominent examples), doing a "simultaneous sign and close" deal isn't possible because a signed purchase agreement must be in place before the third party approvals necessary for closing can be solicited by the parties.

What Target Stockholders Want – Because M&A deals that are signed but fail to close can stigmatize the Target as being "damaged goods" and otherwise harm its business prospects, Target stockholders usually highly value certainty of closing. This means that Target stockholders usually want as few closing conditions as possible and want any such closing conditions to be relatively easy to satisfy.

What Buyers Want – Buyers, by contrast, often want to "lock in" the Target on the stated deal terms but preserve as much flexibility as possible in case circumstances change and they want (or need) to get out of the deal. Buyer also know that their leverage to get the Target to clean-up issues with its business discovered during the Buyer's due diligence process will evaporate once the deal closes, and so will often condition closing on the Target cleaning up those issues.

Types of Closing Conditions – There are two types of closing conditions in M&A transactions: those that are included in virtually all M&A transactions and, as a result, are relatively uncontroversial, and those that are the subject of negotiation by the parties.

HSR Act Antitrust Closing Condition – If the transaction meets the applicable criteria under antitrust law (which includes a minimum purchase price amount, among other factors), the Buyer and the Target will each be required to make "HSR Act" antitrust filings with governmental authorities once the purchase agreement is signed. The HSR Act filings provide a high-level description of the deal, which the governmental authorities will use to determine whether to request additional information (a "second request") and possibly file suit to prevent the deal from closing. The parties will request "early termination" of the "waiting period" under the HSR Act in which the governmental authorities must, if they are going to do so, make a second request. For transactions in which HSR Act filings are made, early termination of the HSR Act waiting period having occurred or expiration of the HSR Act waiting period without a second request having been made will be a closing condition. Since HSR either applies or it doesn't and, if it applies, it will be a closing condition, its inclusion among the closing conditions is usually not the subject of negotiation. What will be negotiated are the actions that the parties are required in the "covenants" section of the purchase agreement to take to obtain HSR approval, which can include forced divestiture of assets and restrictions on operation of the Target business by the Buyer after the closing (which are often strongly resisted by Buyers), among other things.

Other Non-Controversial Closing Conditions – In addition to HSR, no governmental orders or injunctions having been issued prohibiting consummation of the deal and repayment of the Target's bank debt and release of any associated liens on Target assets are usually among the non-controversial closing conditions.

Negotiated Closing Conditions – As noted above, the Buyer's obligation to close will usually be conditioned on the representations and warranties made by the Target's stockholders upon signing of the purchase agreement continuing to be true and correct as of the closing, with it being a negotiated point whether the standard for this "bring down" closing condition is "true and correct in all material respects" (a relatively tight, pro-Buyer standard) or "true and correct, except as would not constitute a Material Adverse Effect" (which is a looser, pro-seller standard). Additional closing conditions subject to negotiation by the parties sometimes include: (1) the occurrence of a

"Material Adverse Effect" to the Target business, (2) the Buyer having received the financing necessary to be able to pay the purchase price (a "financing contingency"), (3) the Target having received all consents triggered by the deal under its contracts with customers, suppliers and other third parties, and (4) receipt by the parties of all governmental approvals triggered by the deal. Financing contingencies are often vigorous resisted by Target stockholders but, with the recent significant reduction in availability of acquisition debt financing, have become more common. There is sometimes a "middle ground" on the "third party consents and approvals" closing condition in which the Target is only required to obtain the "material" contractual consents and governmental approvals listed on an agreed-upon schedule to the purchase agreement. It is sometimes a closing condition for members of the Target's management team to sign new employment agreements on terms acceptable to the Buyer, but doing so can have the unintended consequence of giving the individual management members undue leverage to request personal benefits under their new employment agreements at the expense of the overall transaction

"Clean-up" Closing Conditions – In addition to the "ordinary course" closing conditions listed above, Buyers will sometimes require that the closing conditions include clean-up of issues discovered in their due diligence of the Target. This sometimes includes "out of the money" Target stock options that don't automatically terminate in connection with the acquisition, as discussed above.

- **Non-Compete, Non-Solicit and Other Post-Closing Covenants.** In addition to covenants that govern the parties' conduct between signing and closing of the deal (most of which usually aren't very controversial), the purchase agreement will also typically include covenants that restrict the Target stockholders' conduct after the closing, which are frequently the subject of negotiation. These post-closing covenants typically restrict the Target stockholders' ability to disclose to third parties the Target's confidential information, as well as restrict their ability to enter into business in competition with the Target, to solicit the Target's employees and customers, or to make disparaging statements to third parties about the Target's business. The length of the non-competition and non-solicitation covenants are usually negotiated by the parties and state law imposes some bounds on the length of covenants that will be enforced by courts, but time periods of as short as one year after closing or as long as five years after closing are not unusual. These covenants are premised on the idea that the Buyer is entitled to some protection of the business that it purchased from the Target's stockholders in exchange for the purchase price that it paid. "Sale of the company" non-competition and non-solicitation covenants will sometimes be in addition to non-competition and non-solicitation covenants to which Target management members will become subject under employment agreements they enter into in connection with the deal. While superficially similar, the two sets of restrictive covenants are different because the "sale of the company" restrictive covenants in the purchase agreement are supported by the purchase price consideration paid by the Buyer and are, as a result, less likely than restrictive covenants in employment agreements to be struck down by a court as not supported by adequate consideration and therefore unenforceable. Institutional investors such as venture capital and private equity funds will sometimes vigorously resist being subject to non-competition and, less frequently, non-solicitation covenants, arguing that they are in the business of making investments and the reward from sale of a particular portfolio company will not adequately compensate them for being prohibited from entering into an entire area of business (either directly or through their other portfolio companies).

- **Indemnification (De Facto Purchase Price Adjustment).** As mentioned above, M&A transactions involving privately-held Targets typically include "indemnification" provisions requiring the Target's stockholders to compensate the Buyer and its affiliates for liabilities that they incur in connection with specified matters relating to the Target and its stockholders. Because such indemnification payments effectively reduce the purchase price paid by Buyer to the Target's stockholders and, as a result, inject a degree of uncertainty into the amount of proceeds that the

Target's stockholders will ultimately receive in connection with the deal, indemnification provisions are usually one of the key negotiated points in M&A transactions involving privately-held Targets. Indemnification provisions are very complex and include many points that are negotiated by the parties, but some of the most significant negotiated points are as follows.

Scope of Indemnification – The Buyer is typically indemnified for losses incurred after the closing resulting from breaches of the representations and warranties and covenants of the Target and its stockholders contained in the purchase agreement. Sometimes the Target stockholders also provide a "flat" indemnity to the Buyer for losses relating to the Target's pre-closing tax and environmental liabilities, which is in addition to indemnification for losses relating to misrepresentations in the tax and environmental representations and warranties in the purchase agreement (which essentially make a stock purchase or merger deal somewhat equivalent to an asset purchase deal with respect to these liabilities). In asset purchase deals, the Target (or its stockholders) is also usually required indemnify the Buyer for any losses associated with "Excluded Liabilities", which is typically defined as any liabilities associated with the pre-closing operations of the Target. In addition, potential issues are sometimes discovered during the Buyer's due diligence process that may or may not ultimately result in actual liability and, rather than reduce the purchase price or put additional purchase consideration into escrow, the Target's stockholders will agree to provide a special indemnity to the Buyer for any liability that results from the issue.

Who is "On the Hook" – In stock purchase and merger transactions, the Target's stockholders will typically be responsible for providing indemnity to the Buyer. In asset purchase transactions, sometimes the Target stockholders will provide the indemnity directly and sometimes the Target entity itself will provide the indemnity (with its obligation to do so guaranteed or otherwise backed by the Target's stockholders). Each Target stockholder is usually responsible for its *pro rata* portion of liability resulting from breaches of representations and warranties concerning the Target and the Target's covenants in the purchase agreement (which are sometimes referred to as the "company" representations, warranties and covenants), determined based on each Target stockholder's percentage ownership of the Target. Each Target stockholder is usually solely responsible for liability resulting from breaches of its own representations and warranties and covenants. However, sometimes Buyers are able to negotiate making the Target's majority stockholders "jointly and severally liable" for all such liabilities (i.e., the Buyer can collect the full amount from any Target majority stockholder), with each majority Target stockholder entitled to seek "contribution" from the other Target stockholders for any payments it makes to the Buyer in excess of its *pro rata* share of the liability. This is often the case where there are a few significant majority stockholders (such as venture capital firms and significant founding stockholders) and many minority stockholders with relatively small percentage interests (such as non-management stockholders and "angel round" investors who have since been diluted), based on the Buyer's argument that the majority stockholders are receiving the vast majority of the transaction proceeds and it shouldn't be required to "chase around" the minority stockholders.

Duration of Indemnification Obligations – The Target stockholders' indemnification obligations for breaches of "fundamental" representations and warranties such as the ability of the Target and its stockholders to enter into the deal, the Target having clear title to its assets, and the Target stockholders having clear title to their shares of Target stock, as well as for "Excluded Liabilities" in asset purchase deals and breaches of the covenants of the Target and its stockholders contained in the purchase agreement, typically extend indefinitely after closing. The Target stockholders' indemnification obligations for breaches of representations and warranties concerning tax, environmental, and employee benefit plans matters typically extend until expiration of the statute of limitations of the matters described in the representations and warranties. The duration of the Target stockholders' indemnification obligations for breaches of other representations and warranties is subject to negotiation by the parties, with periods of 1-2 years after closing being typical, sometimes based on the Buyer's argument that it needs to complete a "full audit cycle" including the Target's operations after the closing, although longer periods are sometimes negotiated.

Thresholds, Deductibles and Caps – The indemnification obligations of the Target stockholders are usually subject to either a "threshold" (i.e., the Buyer must wait to make an indemnification claim until it has indemnifiable losses at least equal to the threshold amount, but then receives full compensation for all losses "back to the first dollar") or a "deductible" (i.e., the Buyer is forced to absorb the first "X dollars" in otherwise indemnifiable losses and is only compensated for indemnifiable losses in excess of that amount). Deductibles are more favorable to Target stockholders than thresholds and the decision as to whether a threshold or deductible will apply in a given transaction will be the subject of negotiation by the parties. Threshold and deductible amounts can vary significantly based on the size of the transaction but amounts of 0.5%-2% of the purchase price amount are not unusual. In addition to the "overall" indemnity threshold or deductible, sometimes there is a "noise level" concept in which any individual indemnity claim must have losses exceeding a specified amount to be able to be brought by the Buyer. The Target stockholders' total possible indemnification liability is typically subject to a "cap", the amount of which will be negotiated by the parties but can be as low as 10-20% of the purchase price amount or as high as the full purchase price amount. Sometimes, there is also an indemnity cap for each individual Target stockholder in which that stockholder cannot be subject to indemnification obligations is excess of the amount of transaction proceeds received by it in connection with the deal. There is a somewhat recent trend towards making the indemnification escrow fund (discussed below) the "sole remedy" of the Buyer for indemnification, which effectively acts as a cap on the potential indemnification liability of the Target stockholders. This is particularly the case for M&A transactions in which the Target stockholders are venture capital and private equity funds that would like to be able to draw definite bounds around their potential indemnification liability and distribute the remainder of their transaction proceeds to their limited partners. Both the indemnity threshold/deductible and the indemnity cap are usually subject to "carve-outs" for losses relating to breaches of "fundamental" representations and warranties, covenant breaches, fraud and willful misconduct by the Target and its stockholders and "Excluded Liabilities" in asset purchase deals, although the matters carved-out from the indemnity threshold/deductible and cap are often heavily negotiated by the parties.

Indemnification Escrows and Other Indemnification Payment Methods – In order to secure the Target stockholders' indemnification obligations, part of the purchase consideration is sometimes placed into a third party escrow account (typically with a bank) for a specified time period after closing, which usually corresponds to the negotiated date on which the Target stockholders' indemnification obligation concerning "general" representations and warranties ends, as discussed above. A more Buyer-favorable approach is for the Buyer to simply "hold back" in its possession part of the purchase consideration for such time period. The percentage of the total purchase consideration that is placed into escrow or held back by the Buyer will be a negotiated point but 10-20% is typical. As noted above, a somewhat recent trend is for the indemnification escrow fund to be the Buyer's sole remedy for indemnification losses but more often that escrow fund is merely the Buyer's initial remedy, which the Buyer must exhaust before going against the Target stockholders individually for any additional amounts owed. If the purchase consideration includes non-cash consideration (i.e., Buyer stock, seller notes, earnout payments and other deferred or contingent consideration), which types of consideration (cash vs. non-cash) are placed into escrow or held back by the Buyer, the order in which such consideration is forfeited to satisfy Buyer indemnification claims (e.g., first Buyer stock, then seller notes, then earnout), and whether or not all of such non-cash consideration must be forfeited before the Buyer can go against the Target stockholders individually will be negotiated points. The valuation of Buyer stock for purposes of forfeiture to satisfy indemnification claims will also be a negotiated point – the alternatives consist of "pegging" the valuation at the price at which the Buyer stock was issued in the M&A transaction or allowing it to “float” by valuing the Buyer stock for such purpose at its fair market value at the time of the claim.

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This article does not constitute legal advice. If you have any questions about the matters discussed in this article, please don’t hesitate to contact John McDonald at (212) 704-6234 to discuss.
