Merger & Acquisition Focus

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Ask the Advisor

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Deal stars

DON'T TRY TO MERGE WITHOUT THESE KEY PEOPLE

Many people will contribute to the successful completion of an M&A transaction. But a few are particularly critical — from executives with long-term strategic vision to managers who mind the nuts and bolts.

You'll want to make sure that these key people in your organization are adequately prepared for the sometimes long and challenging M&A process and that they have the necessary professional qualities needed to overcome inevitable roadblocks. If one of these players isn't up to the task, he or she could slow progress, or even kill the transaction.

Cast of characters

Playing lead roles in most deals are the:

Owners or CEOs. Even if owners or chief executives allow professional advisors to represent them during much of the M&A process, they have the final say in whether the company is bought or sold and need to sign off on all major negotiation points.

Financial executives should have their fingers on the pulse of the current market and know whether tight credit is hampering deals.

CFOs. Financial executives are responsible for running the numbers and ensuring that a proposed deal — including negotiated terms — will achieve their companies' financial objectives.

Logistics heads. These individuals are tasked with making postmerger integration speedy, low-cost and as nondisruptive to company operations as possible.

Now let's take a closer look at each of these positions.

CEO: Framing the big picture

A buying company's chief executive begins the process by laying out a rationale for an acquisition. This rationale is particularly important if the company is public and its shareholders need to be convinced. The CEO should clearly articulate why the deal makes sense and be able to list the expected financial and strategic advantages to its key shareholders and board members. Note that CEOs shouldn't get bogged down in details. They should set short- and long-term goals and task employees with accomplishing them.

Selling owners have a slightly different role. They must make the decision to sell their business — in many cases, a company they founded. This requires a certain amount of emotional strength and flexibility. Once that decision is made, the owner wants to ensure that the business receives a fair deal price and, possibly, that he or she agrees with the buyer's plans for the business. Quick decision-making and responsiveness by selling owners usually is necessary if a deal is to cross the finish line in a timely manner.

CFO: Reconciling the numbers

Financial executives are the linchpin of an M&A deal. Buy-side CFOs must accurately assess the financial condition of any potential acquisition, and then recommend it (or not) to the company's CEO and board members. The position demands a good understanding of current market conditions — including the availability of deal financing — to be able to craft an offer the seller will accept.

Sell-side CFOs need a verifiable sense of their company's value and must be ready to push back if they believe a buyer is trying to lowball them. Like buy-side CFOs, a seller's financial executives should have their fingers on the pulse of the current market and know whether tight credit is hampering deals.

Logistics leaders: Making the deal happen

Whether a company charges its COO or a dedicated M&A coordinator with the job, logistics people are responsible for turning an abstract idea into reality. Most organizations will use several individuals to accomplish the many tasks involved in a merger. An IT manager, for example, must reconcile different technology systems. Operations leaders must decide whether offices, production facilities and transportation services can be consolidated and workforces combined — and how to execute such plans.

Logistics officials need to work closely with their financial counterparts. If a buy-side COO determines that integration will be long and costly, the CFO should factor such costs into the company's offer.

No "I" in team

Ideally, key people will complement and support one another. A CEO with big acquisition dreams needs to be brought back to earth if the CFO decides that the numbers don't add up. A logistics head tied up in minutiae sometimes can use a CEO's advice to focus on larger, strategic goals. The bottom line: For your deal to succeed, key people should play their assigned roles, but they also need to work well collectively.

Why business entity matters when structuring an M&A deal

Taxes may not be the most exciting part of an M&A deal, but if you fail to consider how taxes will affect the final price, you may be in for an unpleasant surprise at closing. Depending on whether your — or your prospective acquisition's — business is a C or an S corporation, either an asset or a stock sale may be more beneficial from a tax standpoint.

Stock deals for C corps

In an asset transaction, owners sell all or most of their company's assets to a buyer and then liquidate the company stock and what few assets and liabilities remain in the business. In a stock transaction, owners sell the company stock — including all of their business's assets and liabilities. Stock deals

are almost always preferable for C corporation transactions. Sellers pay tax on net capital gains from the stock only.

On the other hand, C corporations sold in asset deals are subject to double taxation. First the corporation pays taxes on gains from the sale of the assets, and then shareholders pay taxes on the after-tax amounts distributed to them by the company. Paying tax on the gain can be detrimental to sellers that have considerably depreciated those assets in their business. So this tax impact must be addressed during deal negotiations.

Buyers may opt to assign the highest market values to acquired assets (known as a step-up in the tax basis) via a Section 338 election. Generally, this results in tax benefits for buyers with an increased depreciation schedule and greater cash flow.

Greater flexibility for S corps

There are fewer tax differences between a stock and an asset sale for S corp owners. This is because S corps are considered conduit or flow-though entities by the IRS — meaning there's no federal tax on corporate profits. Instead, company profits from an asset sale flow through directly to stockholders' individual tax returns.

Therefore, double taxation generally doesn't apply unless the S corp has recently converted from a C corp status. In that case, 10 years must elapse before an S corp can be sold in an asset sale and treated as such for tax purposes. If the sale takes place before the 10-year anniversary, double taxation is triggered by an asset sale.

The benefit to both buyers and sellers in an S corp transaction is the option to deem a stock sale as an asset sale under a Sec. 338(h)(10) joint election. Treating an S corp transaction as an asset sale produces the same depreciation cash flow benefits as electing a C corp transaction as an asset sale. S corps, however, don't experience the same tax costs as C corp transactions because gains and losses from the step-up flow through to shareholders.

Stock deals are almost always preferable for C corporation transactions because sellers pay tax on net capital gains from the stock only.

This reduced tax burden normally makes an asset sale of an S corp the optimal transaction structure for buyers. Also, because of the beneficial depreciation schedule for the buyer, the seller may be able to negotiate a higher sale price.

Many considerations

Taxes are important when structuring an M&A transaction, but they are only one of many considerations. So before you prepare to go to battle for a tax-efficient deal, discuss other priorities — such as final price and postdeal plans — with your M&A advisor to help ensure the transaction as a whole will meet your needs. ■

INDEMNIFICATION CLAUSES

How to steer your merger clear of lawsuits

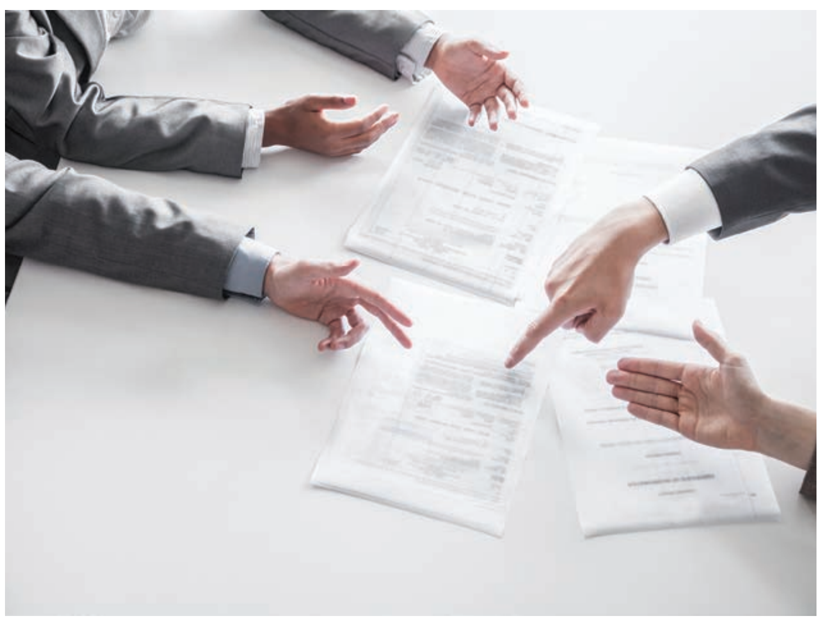
If a liability emerges after a deal closes, who's responsible: the buyer or seller? Indemnification provisions are designed to answer this question. They're a critical piece of an M&A deal agreement and, not surprisingly, hammering them out sometimes involves contentious negotiations.

Well-crafted clauses are important because, if they contain too few liability limits or provisions, a lawsuit can result. In the event of a postmerger liability, either party might claim breach of contract. So as you work with your advisors, spend some time thinking of as many worst-case scenarios as possible so they can be written into your indemnification clause.

Compromising on core issues

Indemnification provisions address any damages arising from postmerger breaches of representations, warranties and covenants. Generally, sellers seek immunity from all liabilities after their business has been sold. Buyers want sellers to be responsible for postsale issues that originated before the company was acquired. For example, buyers don't want to be liable if an employee who worked under the previous owner sues for discrimination.

Indemnity provisions, therefore, generally require both parties to compromise. Given the number of possible postsale claims, from tax liabilities to product-related suits to environmental issues, the parties need to set their priorities but remain flexible.



How provisions work

To protect the parties, indemnification clauses should be as precise as possible. For example, a seller might disclose during due diligence that it's being sued by an employee, with the understanding that it will be responsible for any costs related to that suit. But if a government agency follows up on the earlier lawsuit and sues the new owner, the seller would want to specify that it won't be liable for postsale litigation.

Typically, such a scenario isn't considered a breach of representation because the seller has disclosed the initial lawsuit. However, a buyer might try to insert language into the indemnification clause that would compel the seller to cover unpredictable risks associated with running the business postsale. So, if the buyer wants additional protections, it may have to compromise in other areas. (See "How long can this go on?" on page 6.)

How long can this go on?

One critical element of any indemnification clause is the "survival period." This describes how long after an M&A deal closes the buyer is able to bring a liability claim against the former owner.

Buyers understandably desire a long — even indefinite — survival period. Sellers, who don't want to feel anchored to their former business for too long, usually try to limit the period to three months. Tense negotiations can result.

But there are some standard survival periods that usually can satisfy both parties. For breaches of representations and warranties, survival periods typically range from six months to two years after the sale. However, buyers often push for longer survival periods for "fundamental" representations and warranties breaches. These are issues that threaten the livelihood of the newly merged organization, such as an undisclosed and massive tax obligation.

Sellers may be willing to accept longer survival periods for fundamental breaches if buyers relent on other fronts. For example, a buyer could agree to "antisandbagging" provisions, meaning that it can't bring an indemnification claim for breaches of representations and warranties if it learned about the breach before the deal closed.

Caps and other details

In addition to negotiating types of liabilities, M&A parties need to arrive at financial limits, or caps. Typically, caps are set as a percentage of the deal's overall purchase price.

The indemnification clause should state the amount of losses that trigger a claim. For example, the buyer may be responsible for covering liabilities under $10,000. Liabilities over $10,000 would fall to the seller. This prevents sellers from being hit by various minor charges — such as a $500 registration fee that the former owner forgot to disclose — but still protects buyers from substantial liability claims.

During negotiations, the parties also need to decide exactly who has to pay damages for an indemnification claim. For example, they might agree that the buyer will seek payments from any implicated third parties — such as a vendor — before approaching the seller for payment.

Then there are "mitigation provisions" that discuss a seller's recourse if the buyer doesn't work to prevent further damages. If property is damaged postsale because of something that's arguably the seller's fault, the mitigation provision would reduce the seller's obligation if the buyer didn't work to limit the damage. Take, for example, a situation where the previous owner failed to adequately insulate a warehouse and inventory was damaged. If the buyer knew that damage was ongoing and failed to prevent further destruction, it would be responsible for at least some of the damage.

Eye for details

Indemnification provisions can take a lot of work to negotiate. But even what appear to be minor details now could have major financial effects down the road. The better the parties are prepared, the more satisfied each is likely to be. ■

Ask the Advisor

Q. Why do I need a confidentiality agreement when selling my business?

A. Confidentiality or nondisclosure agreements are cornerstones of most M&A deals. Although it can be time-consuming to draft, sign and keep track of these multipart documents, they are one of a seller's best defenses during deal negotiations.

Staying safe

To properly assess your business, a potential buyer will need access to internal, often sensitive, information — from sales numbers to employment figures to growth projections. Although your prospective buyer is likely operating above-board, there's always a risk that, if deal negotiations fall apart, a buyer might use such confidential information for its own gain. For example, a former suitor could use what it has learned about your customers to lure them away.

That's where a confidentiality agreement comes in. This legally binding contract generally:

Defines "representatives." The document lists specific people in the buyer's organization who will represent it and be privy to confidential information. Each of the listed individuals may need to sign an individual confidentiality agreement as well.

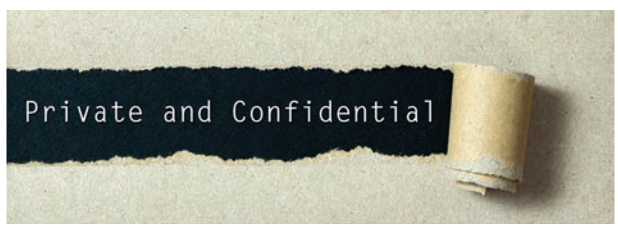
Classifies types of information. Buyer representatives may be given access only to information that's directly applicable to their role in the deal. So a CFO would be able to view financial information and an HR official would be allowed to interview specific employees, with strict limits on the type of questions that can be asked.

Clarifies return procedures. If a deal negotiation fails, all buyer representatives are expected to return the selling company's documents in a timely manner.

Provides remedies. The agreement will list the extent of financial and other penalties in the event a prospective buyer discloses proprietary information.

Specific protections

When drafting your confidentiality agreement, be as clear and succinct as possible. Among other things, it should forbid prospective buyers from speaking to other buyers about your company (whether indefinitely or for a set period). This makes it difficult for a buyer to use inside knowledge to launch a joint bid with another buyer, for example.



You should also include "standstill provisions." These are designed to prevent a potential buyer whose offer was rejected from later mounting a hostile bid using your confidential information.

Maximum security

To draft an effective confidentiality agreement, discuss with your M&A advisors what information needs protecting and how it can best be secured while still providing your buyer with what it needs. The clearer the language and the stricter you are about providing access to records, the more protection you'll have.

Everingham & Kerr, Inc.

Merger & Acquisition Advisors focused on the Lower Middle Market

Passing the Business Torch ... One Successful Transaction at a Time

Our Firm:

Everingham & Kerr (E&K) is a regional merger and acquisition advisory firm focused on implementing exit and growth strategies for lower middle market companies. Our client base includes private and publicly owned companies, investor groups, family businesses and entrepreneurs. Since 1988, the firm has successfully completed hundreds of transactions spanning virtually every industry sector.

Our Maxim:

Combining Experience, Teamwork and Persistence to Produce Superior Results.

Our Services:

Sales:

E&K provides representation to sellers of lower middle market companies including sales of entrepreneur and family owned companies as well as divestitures of business units of private and publicly owned companies.

Acquisitions:

E&K assists companies, entrepreneurs and corporate executives develop and execute customized acquisition strategies designed to result in successful transactions.

Transaction Consulting:

In some instances the parties to a transaction locate each other through informal industry or personal channels. These transactions include sales to unrelated third party acquirers, as well as management, family and partner buyouts. E&K is often engaged to structure these transactions and navigate the many issues requiring attention from the initial stages to the consummation of the transaction.

Business Valuations:

E&K provides a full range of valuation services to business owners for personal and corporate affairs. Supporting our belief that all owners should know the “real” value of their business, E&K offers the “Owner’s Planning Valuation”. This is an informal valuation that can be prepared in a cost-effective manner and updated periodically to assist owners with company and personal planning issues.

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