Minefields in Acquisitions, Mergers and Buy-Sell Agreements

By Gardner Davis, Foley & Lardner LLP

Mergers and acquisitions activity in the pile driving industry is rebounding as the economy recovers from the recession and financial-market crisis of 2008 and 2009. Although business conditions and access to bank financing remain challenging, the stage is set for growth.

M&A activity increased significantly in the first quarter of 2010 as compared to the first quarter of 2009. For "middle-market" transactions, disclosed deal value increased more than 85% and the number of transactions was up 45%, according to data from Raymond James.

Many pile driving contractors are considering either selling their business or expanding through an acquisition. This article reviews the primary issues in negotiating and drafting an agreement for the purchase and sale of the privately held business.

The business owner will want to sign a confidentiality agreement with all potential purchasers before moving forward to share information about the firm and the negotiation process. The confidentiality agreement, frequently referred to as a "CA," may restrict the potential purchaser from hiring the firm's key employees in addition to restricting the disclosure or misuse of confidential business information.

Once the buyer and seller sign a confidentiality agreement, the potential seller will provide so-called "due diligence" materials regarding the company, including financial statements. The seller should be careful to restrict the information provided to a direct competitor, such as specific job pricing information, which could put the company at a disadvantage in future bidding situations.

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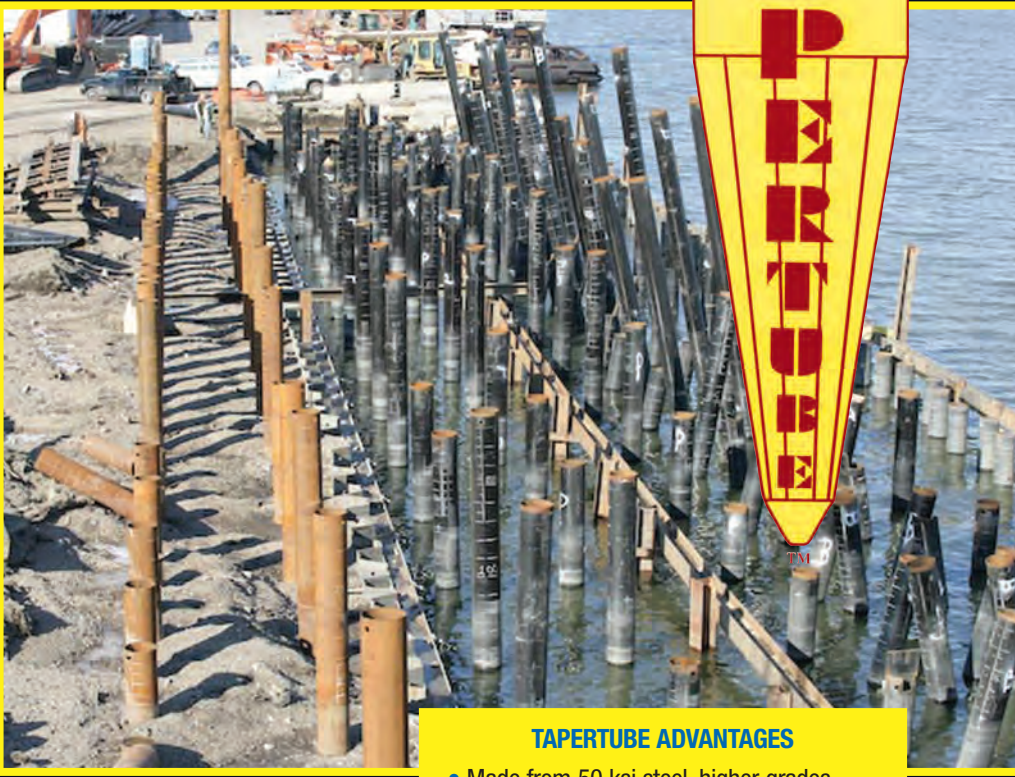
OF THE FUTURE...



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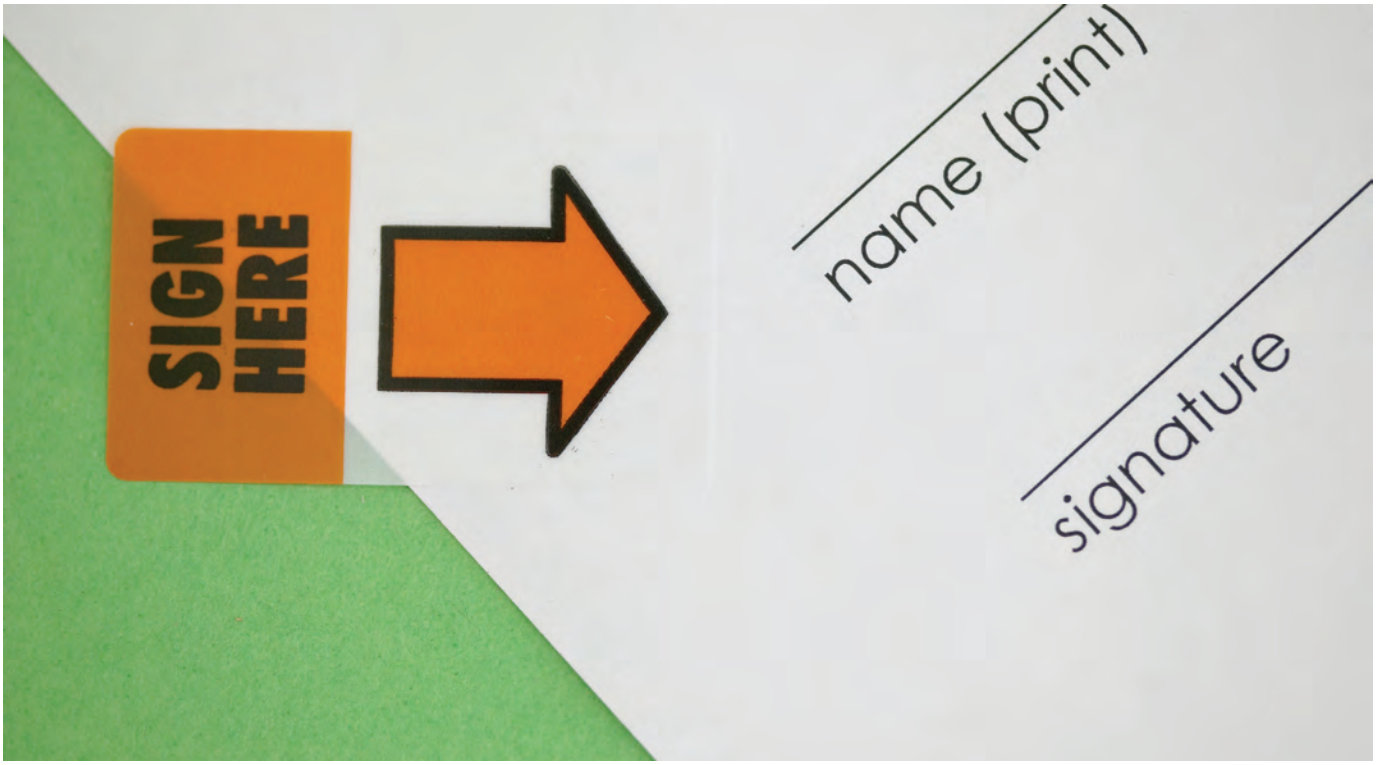

Once a potential buyer and seller reach a preliminary agreement regarding the basic business terms for purchase of the business, they will frequently enter into a letter of intent or "LOI". In the majority of cases, the letter of intent will not be a legally binding contract, but will express the parties' intention to negotiate a definitive purchase contract based on the terms set forth in the letter of intent.

Negotiation of the legally-binding purchase agreement is a substantial undertaking. The purchase agreement sets forth the business terms of the deal, the legal rights and obligations of the parties and the conditions for closing. The purchase agreement also allocates the risk between buyer and seller of potential problems related to the purchased business.

A threshold question is what assets are being acquired and what liabilities are being assumed by the purchaser? In many transactions, the seller will retain cash, accounts receivable and construction contracts which are approaching completion. The seller may also retain responsibility for warranty obligations on completed projects.

Primary advantages of structuring the sale of a business as a sale of stock or a merger are the ability to transfer contracts to the buyer without the need for obtaining the consent of the other contract parties, and the ability to keep licenses and permits in place in a relatively seamless transition.

Disadvantages of a stock sale or merger, as opposed to a sale of assets, are the risk that the buyer will be responsible for unanticipated liabilities of the business, and the failure to obtain a so-called "step up" in tax basis for the purchased assets.

The purchase consideration may be cash, stock (registered or restricted, common or preferred), a promissory note or some combination thereof. The purchase price may be a fixed amount or an amount subject to adjustment based on the value of "net assets" on the closing date.

The purchase price may also have a contingent payment or "earn-out" based on the post-closing earnings of the acquired business. Although an "earn-out" may help bridge the gap between a purchaser's and seller's views of the value of the business, it creates additional negotiating concerns about the calculation formula: Whether the purchaser will change the historical business model of the acquired business, who manages the operation of the business post-closing, and the effect of the sale on the business during the earn-out period. An "earn-out" is one of the most difficult provisions to negotiate in an acquisition agreement.

The buyer will frequently insist that a portion of the purchase price be placed in a segregated escrow account, held by a third party, to secure the seller's indemnification obligations and other covenants in the agreement.

Experienced deal makers understand that the stated amount of the purchase price is not the only factor when determining the best price. For example, the seller may prefer a proposal which has a lower purchase price if the deal contains limited representations and warranties, a generous "basket" and no escrow provision as opposed to a higher amount where the seller anticipates numerous warranty claims against a portion of the purchase price held in escrow.

The simplest and most efficient approach is to close the transaction at the same time that the parties sign the acquisition agreement. However, purchasers frequently do not want to invest the resources to be ready to close until the parties have a signed deal. Moreover, governmental approvals, third party consents and the need to arrange financing may delay the closing.

The deferred closing (i.e., closing after signing the acquisition contract) requires substantial additional provisions in the acquisition agreement to provide for operation of the business during the period between signing and closing, the conditions to the parties' obligations to close and how to treat unforeseen intervening events. Although delayed closings are very common, the simultaneous closing is generally in the seller's best interest because it provides a greater degree of certainty and simplifies the process.

In the case of a delayed closing, the parties will want to agree on an outside "drop dead" date to make sure that they will not be bound by an agreement for an unreasonably long period of time in the event of unforeseen delays or unexpected developments.

Acquisition agreements usually contain representations and warranties regarding the business being sold. Representations are statements of fact as at a given moment in time. Warranties are promises that, if a fact is not true, the promiser will make the promisee whole. Warranties also cover future situations.

The purchaser will usually make representations and warranties in the acquisition agreement to provide the seller assurance that the purchaser has the authority and ability to buy the business and to pay the purchase price. If the purchase consideration includes a promissory note or stock in a private company, the seller will want representations regarding the purchaser's financial condition, contingent liabilities, litigation and similar matters.

The seller's representations and warranties give the purchaser assurance that the seller does in fact own the business and assets and is able to sell them to the purchaser. The seller's representations and warranties provide the purchaser with important information about the business being acquired and often bring out information not discovered during the purchaser's due diligence investigation. In many respects, the customary representations and warranties provide an excellent checklist for the seller to examine various aspects of the business and convey the results to the purchaser in an organized manner.

The shareholders of the company being sold may join in the seller's representations and warranties, particularly where the selling company will have no assets after closing.

One of the most important seller representations concerns the accuracy of the company's financial statements. It is fairly standard to represent that financial statements are "prepared from and in accordance with the books and records of the seller in accordance with generally accepted accounting principles (GAAP) applied on a consistent basis and fairly present the financial condition and results of operations of the seller as of and for the periods indicated." It is important to distinguish between the representation that financial statements are prepared in accordance with GAAP and the representation that financial statements are "true, complete, and correct in all material respects," which is a much higher standard. In addition, GAAP does not require disclosure of all potential liabilities. Some purchasers will seek a representation that the closing balance sheet contains all liabilities of the seller, known or unknown, absolute or contingent. This is arguably an indirect guar-

antee that the business will not be subject to any future, unforeseen liabilities.

In situations where the seller has never been subject to a rigorous audit, the seller should be very cautious about making representations about GAAP. Experienced deal makers know that the application of GAAP usually results in a reduction in the earnings and net worth. Even in situations where the seller has been audited by a national accounting firm, disagreements may arise between the purchaser's accountants and the seller's accountants about what GAAP requires. Put simply, the seller should get the seller's accountants involved before agreeing to the representation.

The seller will usually seek to limit the scope and burden of the representations. One approach frequently adopted by sellers is to only require disclosure of "material" items. This makes preparation of the disclosure information simpler, but it puts the risk of minor problems on the purchaser. Different materiality standards may be used for different sections of the agreement.

The seller may also seek to limit representations with qualifications such as "to the best of seller's knowledge." This qualification limits the duty to disclose only to such information as is within the seller's knowledge. The inclusion of a knowledge limitation concerning threatened litigation is very common. Whether the seller can negotiate a knowledge limitation on other matters is merely an allocation of risk regarding the unknown. In situations involving a knowledge limitation, the definition of "knowledge" should be negotiated. The seller will sometimes argue that it cannot be responsible for the knowledge of all of its employees while the purchaser will argue that the seller should bear the risk of knowledge even by low level employees. A frequent compromise is to define the persons whose knowledge is relevant, such as officers and directors. It is also important to state whether knowledge includes constructive knowledge and whether any investigation is required.

The indemnification provision of the Purchase Agreement provides the purchaser's remedy for losses or expenses suffered as a result of the seller's breach of its representations, warranties or covenants. Either the selling company alone or the selling company and the selling company shareholders, jointly and severally, will customarily provide indemnification to the buyer. If the seller has numerous stockholders, the stockholders may wish to limit their individual liability for the seller's breach of a warranty. If the seller stockholders do not want to provide an indemnity, the purchaser may seek to provide that a portion of the purchase price be held in escrow for a period following closing to provide a fund for future indemnification obligations.

The seller or selling shareholders will usually seek to impose limitations on the potential indemnification obligation. The parties will frequently agree to a so-called "basket," which is either a threshold amount or a deductible for claims which must be satisfied prior to the seller having a payment obligation. If a threshold is built into the indemnity, the purchaser will be entitled to indemnification only if the damages exceed a specified amount. Once damages exceed that amount, the purchaser recovers from the first dollar of loss. Under the deductible approach, the purchaser will only be indemnified for losses that exceed an agreed minimum amount.

The seller will also usually seek a time limitation on the survival of representations and warranties and the indemnification obligation. The purchaser should ensure that the survival period is long enough to allow for discovery of important issues. In addition, the purchaser will want to be able to satisfy the deadline by merely giving written notice of the claim, not actually collecting the money. Certain representations and warranties with particularly long potential exposure, such as environmental liabilities or tax liabilities, may be singled out for a longer period of survival.

Finally, the parties will frequently agree on a "cap" which will limit the total, aggregate indemnification liability to a specific maximum amount. Caps frequently range between 10% and 20% of the purchase price or the entire net purchase price received by the selling shareholders.

In the final analysis, the key to a successful purchase or sale of a business depends on the honesty and integrity of the buyer and seller. The parties need to communicate clearly, make a sincere effort to listen to and address the other side's concerns and be prepared for unexpected problems and set-backs during the process. ▼

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