Mergers & Acquisitions
The Basics

Following is a Simplified Pictorial Presentation
of the Business Acquisition Process
taken from my book
"Buying and Selling a Business
A Practical Guide
to the Acquisition and Sale Process"

Its purpose is to provide a roadmap for those who may be new to the acquisition process and hope to gain an understanding of its most basic elements.

Types of Deals

Asset Purchase

Transfer "Certain" Assets to Buyer:

- Physical Assets (PP&E)
- Intellectual Property
- Present and/or Future Contract Rights Obligations
- Employees
- Rights & Claims (maybe)
- Receivables (maybe)

Not Transferred Unless Agreed:

- Present and/or Future Contract Rights Obligations
- Tax Liabilities
- Employees
- Employee Benefits Obligations
- Liabilities From Lawsuits (e.g., injuries, property damage, IP infringement, employee claims, etc.)

Stock Purchase

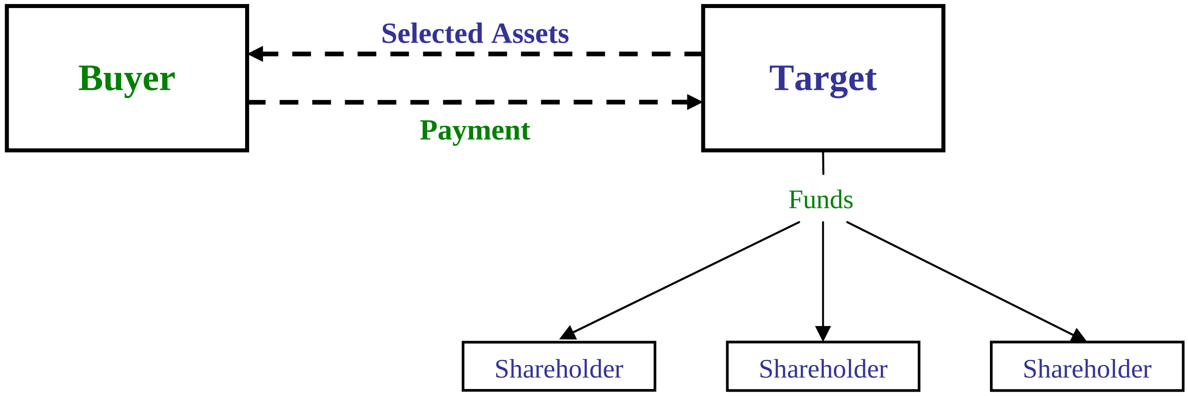
Entire Entity is Transferred

Therefore, Everything is Effectively Transferred Because it Remains With the Entity Purchased:

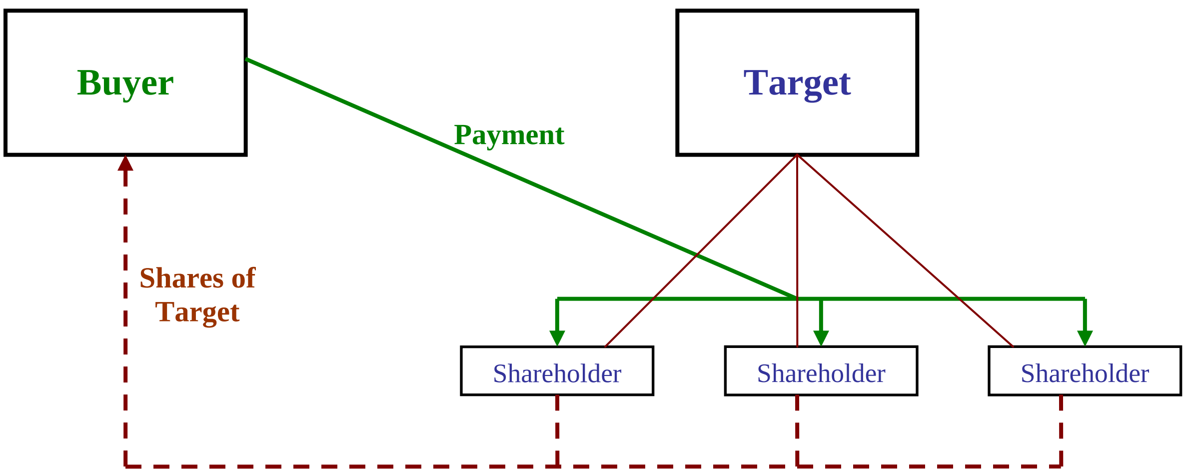
- Physical Assets (PP&E)
- Intellectual Property
- Employees
- Rights & Claims
- Receivables
- Present and Future Contract Rights and Obligations
- Tax Liabilities
- Employees
- Employee Benefits Obligations
- Liabilities From Lawsuits (e.g., injuries, property damage, IP infringement, employee claims, etc.)

Basic Acquisition Types (Transfers)

Asset Purchase



Stock Purchase



Post-Acquisition Effects

Asset Purchase

Buyer
(Grows and Assumes & Conducts Target's Business)

Target typically distributes proceeds & dissolves

Stock Purchase

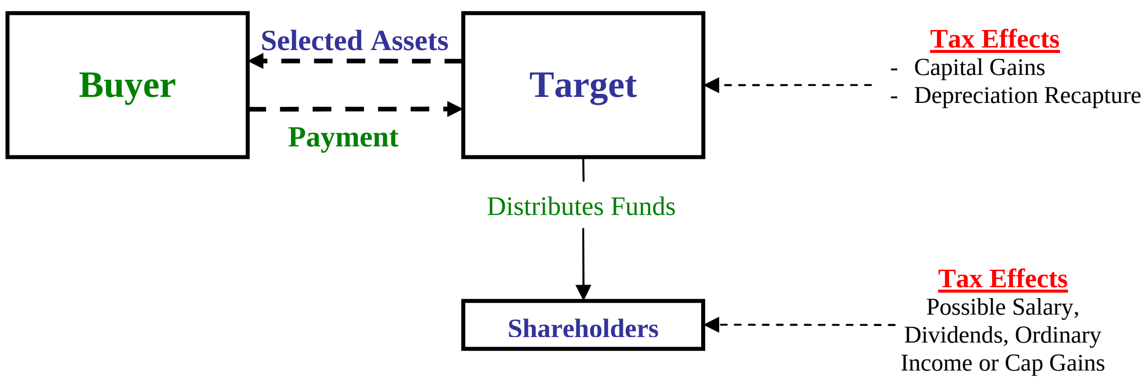
Buyer
(Continues, Now Also as Parent of Target)

Majority of Target's Stock Held by Buyer

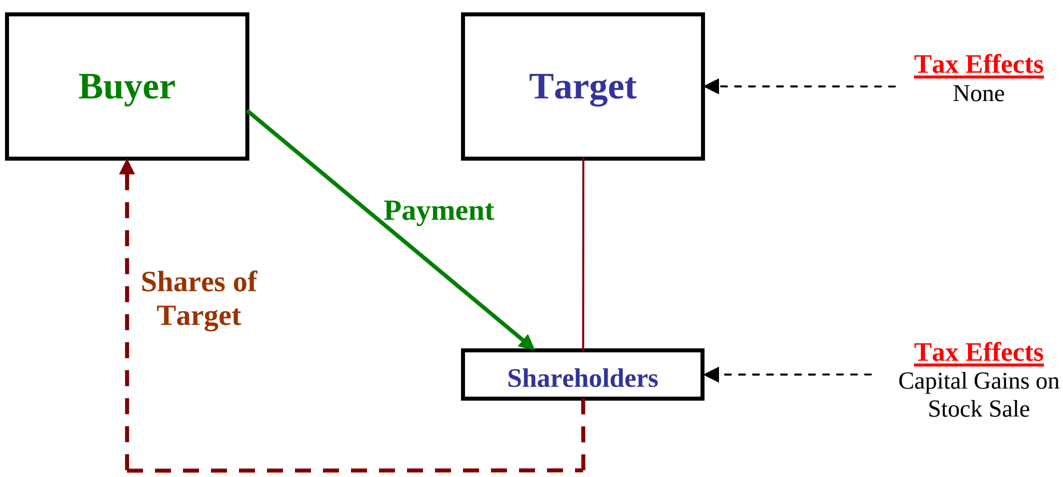
Target
(Becomes a Subsidiary of Buyer and Continues to Conduct its Own Business)

Typical Tax Effects

Asset Purchase



Stock Purchase



Getting Started

1. **Decide WHY you want to acquire, rather than expand organically:**

   Some Common Reasons:

   - **Established Market Presence (local recognition among general population)**
   - **Experienced / Valuable Management**
   - **Skilled Workforce**
   - **Favorable Customer Relationships**
   - **Location (possibly "grandfathered" zoning status)**
   - **Speed to Market (No "Buildout / Buildup" Requirements)**
   - **Favorable Contracts with Vendors, Suppliers and/or Customers**
   - **Valuable Non-Transferable Intellectual Property (Patents, Copyrights, Trademarks, Processes, Formulas, Industry Knowledge)**
   - **Non-Transferable or Difficult-to-Obtain / Long Turn-Time Licenses and Permits**
   - **Tax issues (e.g., NOL carryforwards)**
   - **Asset Values (e.g., cash, breakup values)**
   - **Integration Value (vertical integration, market rollup, elimination of competition, economies of scale)**

   Identify and Describe: You will need to be able to identify the key attributes and be able to explain their value in detail to the board, lenders and investors.

   Communicate: You must also communicate the reasons and their relative values to your acquisition team so that they can factor them into their negotiation strategies, due diligence reviews, and document preparation

   (write a memo outlining the reasons and why they are important)

   Adjust the reasons as you identify new issues during due diligence (e.g., it may take time to discover that the target maintains particular types of licenses and permits that are costly or take considerable time to obtain)

2. **Identify Potential Targets:**

   - **Talk to local business owners and brokers**
   - **Attend industry events like trade shows and sporting events**
   - **Read industry publications – many have classified advertisements**
   - **Talk with local professionals (e.g., attorneys and accountants) representing the types of businesses you are targeting**
   - **Cold Call (phone book)**

   Only a small percentage of potential targets will be worth acquiring in most cases

3. **Conduct an Initial Interview With Owner(s) / Officers & Directors:**

   - **You will likely have to sign a Confidentiality Agreement before the first meeting, though in some cases, the target's principals will not require it until you request disclosures of financials, tax returns, material contracts, etc.**

     (Note: It is a good idea to require that it be reciprocal, particularly if you anticipate a seller carryback of some or all of the purchase price – because the seller will require you to disclose material financial information if he/she/it is to agree to provide financing)

   - **Interviews vary dramatically depending upon the size and type of the business, the level of agreement (to sell) among the owner(s), officers and directors, local customs, financial health of the company, and other factors.**
   - **Attempt to determine the owner(s)' level(s) of interest in the current conduct of the business and the identities of the principal decision-makers**

4. **Review the Target's Internal Financial and Operational Information:**

   - **Use this review to determine whether the target is actually a realistic buy opportunity, and therefore worthy of spending more time/money on conducting further due diligence (is the value – what you determined you were looking for when you decided on your reasons for buying rather than growing organically - really there?)**

- **Do not expect to get every piece of relevant information initially.**

  You are likely to get only one or two years' worth of financials, a business plan, some summary asset information, and a few material contracts (e.g., leases). You will almost certainly have to go back several times with specific requests for further information.

- **Also use it to determine possible acquisition strategies (e.g., stock purchase, asset purchase, forward or reverse merger, partial buyout, hybrid debt/equity investment, etc.)**

5. If You Elect to Proceed, Conduct Follow-Up Meetings With the Target:

- **This is where you can expect to begin negotiating**

  (do not expect to complete the negotiations in one or two meetings – it typically takes several discussions and involves much more intense review of due diligence information)

- **Obtain additional due diligence information**

  (e.g., additional financial information, outstanding employment contracts, leases, litigation pending or threatened, and anything else that appears it might be material based on your initial review of the Target's financial and operational information).

- **Take Your Time. There is often a tremendous push to complete acquisitions speedily, which can result in material due diligence gaps, only some of which can be remedied through litigation.**

6. If an "Agreement in Principle" is Reached, Prepare a Letter of Intent:

- **Letters of Intent (LOIs) are typically non-binding (though be careful, if they don't expressly state that they are non-binding, you may be signing an enforceable contract)**

- **The LOI should set forth, at a minimum:**

  (a) the agreed purchase price (or a clear mechanism for determining the purchase price),

  (b) the means of adjusting the purchase price (e.g., for due diligence discoveries, such as differences, positive or negative, in earnings, assets, contract terms, customer, supplier and/or employee relationships, etc.)

(c) the method of payment (e.g., all cash, stock, earnout, secured or unsecured promissory note, consulting agreements, etc.)

(d) the period during which due diligence may be conducted (make sure you give yourself plenty of time to complete a thorough due diligence investigation, generate reports of the results, and communicate those results to the other members of your acquisition team (below), as it will be critical to incorporate the results of the investigation into the acquisition documents)

(e) closing contingencies (e.g., "completion of the transaction documents on terms reasonably acceptable to both parties")

Note: Expect to refer to the LOI throughout the negotiation, but remember that it is not intended to be a comprehensive agreement. It is merely a guideline.

7. Identify your acquisition team:

(a) Operations (engage key operations employees to evaluate the target's revenue generating capacity and expense structure)

(b) H.R. (pay particular attention to critical employees, payroll timing, pensions, retirement plan rollovers and health insurance)

(c) Accounting/Financial (federal state and local sales, use, income, and other taxes, loss carryforwards and limitations, purchase price allocation, possible depreciation recapture, 1031 exchanges, IRC §338(g) and 338(h)(10) elections, leaseback issues, as well as payables, receivables and payroll)

(d) I.P. (evaluate target's computer systems, data, security, and integration capability)

(e) Legal (securities issues, shareholder approvals, lien searches, real estate ownership, contract review, corporate verification, HSR compliance, environmental investigations, document negotiation and drafting, employment issues, and much more)

(f) Consultants (can be particularly helpful where specific industries lend themselves to particular types of risks – e.g., environmental, medical, engineering, pharmaceuticals, aviation, real estate)

8. **Commence Due Diligence in Earnest**:

Send Preliminary Due Diligence Checklist to Seller

Set up Acquisition Entity

Order UCC Searches
(NOTE – Get all surrounding counties – some judgments get entered in the wrong place)

Order Building Inspections Authorized by Purchaser
Need (in JRW's opinion) Inspections of:
- Bldg. Code Compliance
- HVAC
- Plumbing
- Roof
- Structural
- Environmental
- ADA
- Trade Fixtures & Equipment

Order Phase I Environmental Study

Get UCC Payoff Amts. (if any)

Get Record of Capital Expenditures for past 5 yrs. From Sellers & review for falloff in purchases

Order O&E on Real Property

Request Use Authority from Local City Planning & Zoning Comm., Condemnations or zoning changes pending or threatened, and any required improvements or use restrictions

Obtain List of Litigation Pending or Threatened from Seller

Obtain/review Real Property Leases – **GET:** Estoppel agreement From LL – no arrearages, claims, accrued amts. owing for utilities, improvements, etc.

Review Performance Contracts – (e.g., special events, in-store advertising, etc.)

Review Supplier Contracts
(e.g., food, beverages, bar supplies, linens, cleaning, glassware, Hobart & other equipment leases, satellite T.V., music, advertising, pay phones, security, waste disposal, uniforms, tickets, vehicles, equipment, parts, supplies, materials, furniture, fixtures, subcontractors, office supplies, copiers, faxes, phones, computers, computer programs, etc.)

Financial Statements
(Bal. Sheets, P&Ls, 10Ks, 10Qs, other material info.)

Obtain Employee List, Training Manual, Benefits (401K, equity), accrued vacation and sick leave, claims, seniority, key employees, contracts, hourly pay rates

Contract Workers' Comp. Insurance

List of Off-Balance Sheet Liabilities
(e.g., vacations, severance owed but not reflected)

Tax Returns (last 3 years)

Obtain and send Form 4506 (Tax Return request) from IRS

Obtain proof of ownership of all equip. owned
(Bills of sale, title certificates, deeds, etc.)

Review all licenses, permits, rights and authorities (Liquor license, business license, others)

Review all Assignments and Modifications of Leases

Review Adequacy of Facilities and Equipment

Get List of Assets sold / purchased in previous 12 months

Status of Lease and other Deposits

Non-Disturbance Agreement From Landlord

Review Attorney Audit Letters, if any

Obtain Necessary Insurance Policies

Review Insurance Claims O/S & histories

Review all Non-Compete / Confidentiality / Non-Solicitation Agreements

Review corp. docs.

Obtain Good Standing Cert. For the Business

Update List of Assets Per Inventory taken by Buyer

MUST – take initial inventory on date of LOI, compare it to prior records, then take follow-up inventory the day before closing.
Obtain I-9s and W-4s for all employees

Verify unemployment & withholding account info. – obtain most recent Forms 940 & 941

Set up Escrow Account if necessary

Draft Closing Payment Instructions for payment of o/s liabilities to be paid off at Closing

Obtain copy of Sellers' State Sales Tax License

Get Bank Account Statements – ensure necessary cash is on deposit for payroll withholdings

9. Negotiate for Leverage:

Extend the Payout Period Wherever Possible

- **Promissory Notes / Convertible Debentures**
- **Earnout Agreements**
- **Consulting Agreements**
- **Employment Agreements**
- **Holdbacks (keep it yourself, or at worst, put it in escrow)**
- **Stock Options / Vesting Schedules**

Keep as much of your money as you can for as long as you can, in case discrepancies pop up. Otherwise, it may all be gone by the time you need to collect.

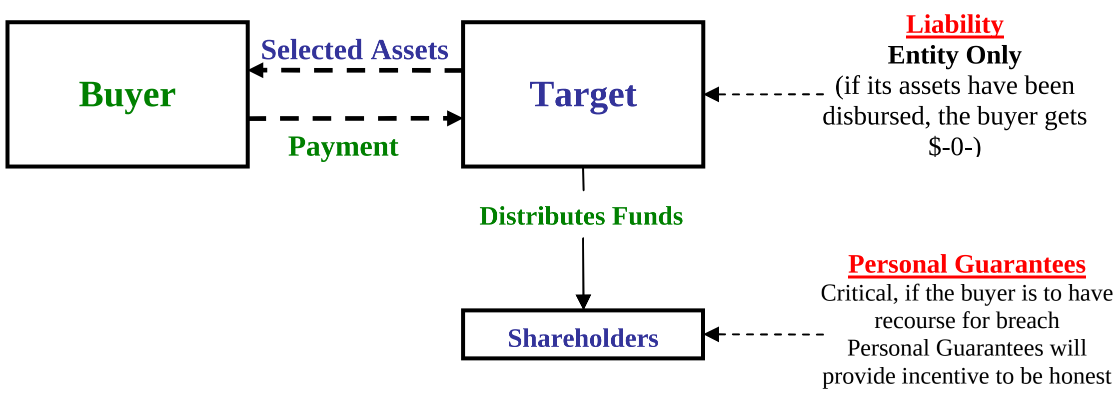
Use Contract Provisions Carefully

- **There are No "Standard" Contracts. Always be the drafter if possible. It is more expensive up front, but far less expensive in the long-run.**
- **Create Honesty Incentives. Include as part of the purchase price, equity and other forms of payment based on realization of financial goals and integrity of historical financials**
- **Representations and Warranties. Make these as broad as possible, and refuse to limit liability.**
- **Cross-Default all Payment Obligations (e.g., Leases – but remember, this works both ways)**
- **Guarantees. Require Sellers to personally guarantee reps & warranties wherever possible in asset deals, and refuse to limit them in stock deals**

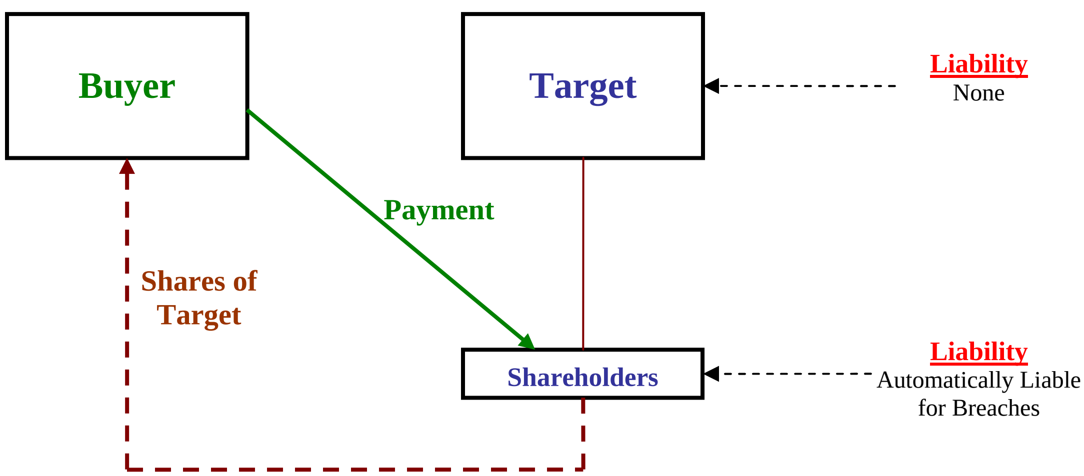
- **<u>Get Noncompetition and Confidentiality Agreements From Each Seller</u>. Incorporate the longest term possible ("5-50" Rule), and make them expensive to breach (liquidate damages if possible).**
- **<u>Stay at Home</u>. It is typically far less expensive to litigate in your home jurisdiction. Require payment of attorneys' fees**.

Liability for Contract Breaches

Asset Purchase



Stock Purchase



10. Police the Deal:

- **Take advantage of default deductions against payment obligations (know your rights)**
- **Post-Closing Financial Adjustments**
- **Monitor Representations and Warranties against actual results**
- **Indemnities from selling shareholders can be valuable leverage mechanisms**