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Mergers & Acquisitions Process Overview: Part 4

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In Part 1 of this Mergers & Acquisitions Process Overview Series we discussed the triggers for buyers and sellers and the process by which they come together. In Part 2 we discussed the letter of intent, and in Part 3 we discussed the due diligence process. **In this Part 4 we will discuss the acquisition agreement.**

Generally, there are two frameworks for acquisition transactions: purchase of assets or purchase of stock or other equity. In either case, the acquisition agreement will include the following:

Description of What Is Being Acquired

If the transaction is structured as an asset purchase, there will be a comprehensive description of the assets being purchased and typically identification of those assets being expressly excluded (usually non-operating assets, vehicles or, perhaps real estate). In a stock transaction, the agreement will describe class and number of shares or other equity interest being acquired. Most commonly, the buyer will not assume any seller liabilities and will specifically exclude these or require that they be satisfied or otherwise accounted for at closing [e.g. working capital calculations that will either add to or be subtracted from the closing payment].

Purchase Price and Payment Terms

This will set forth the cash or securities being paid at closing and any deferred or contingent purchase price and the conditions for and timing of the deferred payment(s). If the agreement includes an escrow, the amount and timing for distribution from escrow will be included. If there is an escrow, there will typically be a separate escrow agreement with a third party custodian.

Seller's Representations and Warranties

Notwithstanding the buyer having conducted due diligence to satisfy itself regarding the seller's business, the seller and owners will be required to attest to and provide schedules of information regarding, at a minimum:

- Organizational structure, ownership and authority to proceed with the transaction;
- Accuracy of financial statements and tax returns and timely and current filing of all tax returns;
- Current assets may be separately scheduled with Seller attesting as to the condition and the sufficiency of the assets to carry on its business;
- Retirement and welfare benefit plans [ERISA] and absence of liabilities;
- Cyber security and absence of any data breach;
- Absence, or schedule, of any pending or threatened litigation;
- Absence, or identification, of any material changes in the seller's business;
- Absence, or identification, of any liens or encumbrances;
- Schedule of the seller's employees, compensation and employment terms or agreements;
- Identification of any broker or finder;
- Schedule of the seller's insurance; and
- Catch-all provisions that the seller has not excluded any material items from its disclosure schedule responses and that all such responses are complete and accurate.

Buyer's Representations and Warranties

These are generally are minimal and related to authority to proceed with the transaction. If equity is involved, there should be a separate subscription agreement addressing the details of the buyer equity being issued.

Conditions Precedent to Closing

- Regulatory compliance, if any
- Satisfaction of liens or encumbrances
- Absence of any material changes in the business and no new or threatened litigation

Covenants Prior to Closing

This requires the seller to conduct its business in the ordinary and usual course prior to closing.

Restrictive Covenants for the Owners and Seller

These prohibit competition with the buyer and prohibit solicitation of the seller and buyer's customers and employees.

Indemnification

This allocates the risk [cost of the risk] between and among the owners/seller on the one hand and buyer on the other hand associated with the business that is acquired not meeting the Buyer's expectations based on the seller's representations and warranties. Parties endeavor to limit/allocate the risk with:

- Baskets [no seller liability until the basket or threshold indemnified claim amount is reached and once reached this basket either acts as a deductible and seller is responsible for claims in excess of that amount; or once reached, seller is responsible for claims back to dollar one];
- Caps set the limit on the maximum seller liability [usually with exceptions for tax, litigation, ERISA or other known or specific liabilities];
- Indication as to when or whether the "materiality" of a claim will apply to determine whether a breach has incurred and/or whether materiality will be excluded in crediting claims toward the basket;
- Limitation on the time for claims to be made; and
- Offsetting liability by the amount of any insurance covering a given claim.

Negotiating the acquisition agreement may be good context for the expression: "Don't let perfect be the enemy of good."

Seller and buyer have a mutually agreeable deal summarized in the letter of intent. They are memorializing the deal in the acquisition agreement. As each party makes its way through the acquisition document, the thinking begins to shift from “good deal” to “perfect deal.”

From the buyer’s side, the perfect may be: “I’m paying you $x for this business and I expect $x of value with no diminution.” From the seller’s side, perfect may be: “You have looked at every document, email, text, agreement, financial statements, tax return that the business has ever generated so you know the business better than I do and I should not have any liability because something arises after closing.”

Fortunately, the baskets, caps, carve-outs for certain liabilities, allow each party to get back to a middle ground so that each party has no more than an acceptable risk. In many instances in which the business has a risk, the risk can be addressed with insurance and that benefits both parties.

For example, in insurance agency/brokerage transactions, it is common for the seller to obtain extended reporting (tail) insurance to address the risk associated with error and omission claims. Other tail coverage is available for employment practices liability and cyber insurance. If a transaction is large enough, it may support the purchase of representation and warranty insurance.

In Part 5, we will discuss the ancillary closing documents and post-closing matters.

If you are considering a purchase or sale we would be happy to work with you in the process. Please contact Bill Helbling or call us at 814-459-2800.



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