THE ART OF M&A

FOURTH EDITION

A Merger Acquisition Buyout Guide

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PREFACE

"The art and science of asking questions is the source of all knowledge."

Attributed to Adolf Augustus Berle Jr. 1895–1971

As we go to press in early 2007, we are looking back on a banner year for M&A. Nearly 30,000 companies announced transactions worth more than $3 trillion, showing solid growth on all continents and in most industries.[1] Where there is growth, there is change, and where there is change, there will be questions.

The Art of M&A: A Merger/Acquisition/Buyout Guide, Fourth Edition, attempts to provide accurate, practical, and up-to-date answers to more than 1,000 questions dealmakers may have in this new environment. Like the three editions before it, this one is organized in question-and-answer format, moving from general to specific questions in each topic area.

What is your burning question of the moment? It may be as basic as "What is a merger?" or it may be as arcane as "After a Section 338 acquisition, must the purchaser retain the acquired company as a subsidiary?" Whatever you want to know, you are likely to find the answers here—or at least a useful source reference.

ACKNOWLEDGMENTS

The Art of M&A first saw the light of day two decades ago as the joint effort of an entrepreneur and a law firm. The entrepreneur was Stanley Foster Reed, founder of the journal *Mergers & Acquisitions.* The law firm was Lane & Edson, PC. Alexandra Reed Lajoux served as project manager for the first edition, and as coauthor of later editions. Because of the growing complexity of deal structures, for this fourth edition Reed and Lajoux have recruited an

additional author, H. Peter Nesvold, whose Wall Street experience enhances the quality of this edition.

This new edition still retains the expertise of Lane and Edson attorneys and many other experts cited in the earlier editions. The following acknowledgements emphasize contributions to this fourth edition.

Chapter 1, Getting Started in Mergers and Acquisitions, and ***Chapter 2, Planning and Finding,*** still contain wisdom from Dr. Robert H. Rock, President, MLR Holdings, Philadelphia, and his colleagues. Other notable experts whose views are featured here include Robert Baker of Tekacq M&A, Houston, Texas; Edward A. Weihman, Dresdner Kleinwort Wasserstein, LLC, New York; Malcolm Pfunder, of Counsel, Gibson Dunn & Crutcher; Gerald Wetlaufter, professor of law, University of Iowa; Clive Chajet, Chajet Consultancy, New York, New York; and Mark Feldman, Versa Systems, Inc., Fremont, California. ***Chapter 3, Valuation and Pricing,*** still benefits from the expertise of Al Rappaport, Principal, The LEK/Alcar Consulting Group, La Jolla, California, and various partners at Wesray Capital Partners, New York City.

Chapter 4, The Art of Financing and Refinancing, owes its greatest debt to the wisdom of J. Fred Weston, Cordner Professor of Money and Financial Markets at the University of California, Los Angeles. With Alexandra R. Lajoux, he coauthored another book in this series, *The Art of M&A Financing and Refinancing: Sources and Instruments for Growth* (1999). ***Chapter 5, Structuring Transactions: General, Tax, and Accounting Considerations,*** contains updated versions of some material that has appeared in Alexandra R. Lajoux and H. Peter Nesvold, *The Art of M&A Structuring: Techniques for Mitigating Financial, Tax, and Legal Risk* (New York: McGraw-Hill, 2004). The authors also remain indebted to experts cited in previous editions of this book, including Martin Ginsberg, professor of law, Georgetown University, and Jack S. Levin, Lecturer, University of Chicago Law School—and by extension their law firms. Professor Ginsberg's professional firm is counsel to the law firm of Fried, Frank, Harris, Shriver & Jacobson; and Professor Levin, through his professional firm, is a senior partner with the law firm of Kirkland & Ellis. Anyone involved in merger transactions should consult their biennial two-volume book *Mergers, Acquisitions, & Buyouts: A Transactional Analysis of the Governing Tax, Legal & Accounting Considerations* (New York: Aspen Law & Business, 2006). Advice also came from Neil Falis, Towers Perrin, New York.

Chapter 6, The Due Diligence Inquiry, benefits greatly from the expertise of Charles M. Elson, corporate director and director of the John L. Weinberg Center for Corporate Governance at the University of Delaware. This chapter has a checklist that includes elements suggested by Dan L.

Goldwasser, a shareholder practicing law with the firm Vedder Price Kaufman & Kammholz PC, New York. ***Chapter 7, Negotiating the Acquisition Agreement and the Letter of Intent,*** and ***Chapter 8, Closing,*** build on the basic wisdom of the original edition, but include updates from the authors.

Chapter 9, Postmerger Integration and Divestitures, is adapted from Alexandra Lajoux, *The Art of M&A Integration,* Second Edition (New York: McGraw-Hill, 2006). As such, the chapter owes a debt to the experts quoted in that book. Of special note are the following experts: Manuel Sanches and Larry Dell of E-Know, Arlington, Virginia; Jim Jeffries, M&A Partners, Dallas, Texas; J. Frederic Weston, cited above as the main expert consulted for Chapter 4; Robert Bruner, Dean, Darden School of Business, University of Virginia.

Chapter 10, Special Issues for M&A in Public Companies, as well as ***Chapter 11, Workouts, Bankruptcies and Liquidations,*** owes a general debt to the law firms of Weil Gotshal & Manges and Jones Day, thanks to the ongoing publications that keep the authors educated on trends in securities law, bankruptcy law, and legal trends in general. ***Chapter 12, Structuring Transactions with International Aspects,*** owes a debt to Van Kirk Reeves, Reeves & Porter, Paris, France; and Riccardo Trigona, an attorney in Milan, Italy.

In closing, the authors extend sincere thanks to the top-notch professional editorial and production team that made this book possible, including Dianne Wheeler and her predecessor Stephen Isaacs, as well as Daina Penikas, Christine Furry, and Kay Schlembach.

NOTES

1. For a detailed report on trends, see Thomson Financial's "League Table" report at www.thomson.com.

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CHAPTER 1

Getting Started in Mergers and Acquisitions

A little learning is a dangerous thing;
Drink deep, or taste not the Pierian spring;
There shallow draughts intoxicate the brain,
And drinking largely sobers us again.

Alexander Pope
"An Essay on Criticism"

INTRODUCTION

Perhaps nowhere else does Pope's maxim prove more true than in the merger/acquisition/buyout area. The purchase or sale of a business enterprise is one of the most complex transactions one can undertake. It can be a make-or-break decision for many executives of major corporations, and for many small business owners, the sale of a business is a once-in-a-lifetime thing. They *must* know what they are doing.

More than 40 years ago, in the fall of 1965, the senior author of this book launched the first issue of *Mergers & Acquisitions* (*M&A*) magazine, prefacing it as follows:

> **Dedicated to the Ever-Renewing Corporate Society**
> As we take part in this third great wave of merger and acquisition activity in America, we are struck by the rate of economic growth, and by the speed with which corporations are merging and being formed. Research indicates that at present rates one out of every three corporations will either merge or

> be acquired during the next ten years. This makes change the condition by which we grow and develop.
>
> Each day here in the United States one thousand new businesses are born. Some drive for the heights like a great Fourth of July rocket and end in a burst of color—a hasty life, beautiful but short . . . A few, carried on a quick tide of youthful energy and special knowledge, will grow great and strong and eventually wise and will become a shelter for the less strong and the less wise.
>
> *This is the ever-renewing corporate society.*[1]

As this prologue shows, *M&A* magazine was founded with one clear goal in mind: to show buyers and sellers of companies how to create strategies—and shelter—for continual growth in a world of constant change.

Reed and Lajoux had this same purpose in mind when they teamed up with the law firm of Lane & Edson, P.C., to produce the first edition of this guidebook at the height of the leveraged buyout movement in the mid-1980s (featuring Reed as coauthor and Lajoux as project manager).

However, as deals structures changed under the weight of hundreds of legal precedents and new accounting rules, a major revision in the basic text proved necessary and subsequent editions followed. This fourth edition captures all the latest trends and technical changes. The year 2006 closed with more than 30,000 completed deals valued at a total of $3.8 trillion, according to Thomson Financial. This represents a significant increase over the $1 trillion spent on some 15,000 completed deals noted in the previous edition of this book seven years ago.

Clearly, M&A is here to stay: the buying and selling of companies remains a common option for many companies. Yet we can't emphasize enough how complex and dangerous the merger process can be.

As in all past merger movements, there are always some major disasters. The urge-to-merge dominates the thinking of many successful executives who suffer a special form of the winners' curse and eventually overpay, or worse, overleverage themselves to fund a major entry. These mistakes and others can bring "deals from hell" in the words of Robert Bruner, dean of the Darden School of Business.[2] Often divestiture is the cure.[3]

To strike lasting deals, acquirers and sellers large and small must drink at the ever-renewing spring of M&A knowledge. To drink deep, they must recognize first that there is something called an *acquisition process,* with many crucial stages and many key players. To carry out any one stage well requires solid grounding in the entire process. In the spirit of Pope's caveat, this book sets forth the basic elements of the acquisition process as it is conducted today, reflecting the technical requirements, the negotiating points, the language, and the objectives of those who actually do these deals or help others to do them.

Each of the players plays a different role, and so we have tried to reflect the differing perspectives of buyer and seller and the contrasting views of two main types of buyer: (1) the operator-buyer, making what are called "strategic" acquisitions supplementing or complementing existing operations; and (2) the investor-buyer, making "financial" acquisitions in order to operate the target as an independent, nonintegrated entity in order to repay acquisition debt and eventually resell it or take it public.

BASIC TERMS

Following are some general definitions for those without a background in the basics.

What is a merger?

The word *merger* has a strictly legal meaning and has nothing to do with how the combined companies are to be operated in the future.

A merger occurs when one corporation is combined with and disappears into another corporation. For instance, the Missouri Corporation, just like the river, merges and disappears *legally* into the Mississippi Corporation. Missouri Corporation stock certificates are turned in and exchanged for Mississippi stock certificates. Holes are punched in the Missouri certificates and they are all stuck in the vault. Missouri Corporation has ceased to exist. Missouri is referred to as the *decedent,* while Mississippi Corporation would be known as the *survivor.*

All mergers are *statutory* mergers, since all mergers occur as specific formal transactions in accordance with the laws, or *statutes,* of the states where they are incorporated. The Missouri Corporation must follow Missouri law and the Mississippi Corporation, Mississippi law. However, there are rarely major differences between states. (Outside the United States, of course, there are differences from country to country.)

The postdeal manner of operating or controlling a company has no bearing on whether a merger has occurred. It is misleading for a prospective acquirer to state to a prospective seller, "We don't do acquisitions; we only do mergers," implying that the two groups will be equal partners in enterprise, when in fact, and by statute law, one corporation is owned, and without an agreement by the stockholders to the contrary, is *controlled,* by another.

A corporate *consolidation* is a special legal form of merger. It's like the Monongahela and the Allegheny rivers, which meet at Pittsburgh to form the Ohio River. Monongahela and Allegheny shares are turned in for shares in

the Ohio Corporation, which was formed for the specific purpose of receiving them. The Monongahela and Allegheny corporations cease to exist after the consolidation. In that case, rather than *survivor,* Ohio Corporation is usually called the *successor.* (Do not confuse the legal word *consolidation* with the operating word *consolidation,* which has recently gained currency to describe the process of rollups, making a series of acquisitions in one industry—like buying up golf courses one after another—and *consolidating* their operations.)

What is a corporate acquisition?

A *corporate acquisition* is the process by which the stock or assets of a corporation come to be owned by a buyer. The transaction may take the form of a purchase of stock or a purchase of assets. In this book, we often refer to the acquired corporation as the *company* or the *target.*

What's the difference between a merger and an acquisition?

Acquisition is the generic term used to describe a transfer of ownership. *Merger* is a narrow, technical term for a particular legal procedure that may or may not follow an acquisition. For example, Mississippi and Missouri shareholders agree to merge, and the merger is effected by Mississippi calling in Missouri stock in exchange for Mississippi stock or cash.

Much more common is an acquisition in which no subsequent merger occurs. For example, Mississippi acquires a significant amount of Missouri stock, even enough for a merger, but Mississippi decides that Missouri Corporation should remain permanently as a separate, corporate subsidiary of Mississippi Corporation, although no one may know it except the lawyers. Or Mississippi acquires all or most of Missouri's assets, paying for them with cash or Mississippi shares, leaving Missouri as a shell corporation with no operations and its stockholders unchanged. It has one principal asset: Mississippi shares.

In a merger, who gets to be the survivor? Is it always the larger company?

No. For tax and other reasons, sometimes big Mississippi Corporation might be merged into little Missouri Corporation with Missouri the survivor. Size of operations, net worth, number of employees, who winds up as chairman,

even the name selected, have nothing to do with which company is the corporate survivor.

What is a short form merger?

When all or substantially all of the stock of one corporation is owned by another corporation, a simplified, *short form* merger is generally permitted under state law without a vote of stockholders. Other than short form mergers, all mergers require an affirmative vote of stockholders of both corporations, and all sales of all or substantially all the assets of a corporation require the affirmative vote of the selling but not necessarily of the buying corporation's stockholders.

What is a leveraged buyout?

A *leveraged buyout* (LBO) is a transaction in which a company's capital stock or its assets are purchased with borrowed money, causing the company's new capital structure to be primarily debt. An acquisition of all of the selling corporation's stock, usually by a new corporation created by the buyer for that sole purpose, will be immediately followed by a merger of the buyer's new corporation and the target company, so that the assets of the acquired corporation become available to the buyer-borrower to secure debt.

There are several types of leveraged buyouts:

- *Management buyouts* (*MBOs*), in which a key ingredient is bringing in the existing management team as shareholders.
- *Employee buyouts* (*EBOs*), in which the employees, using funds from an employee stock ownership plan (ESOP), most of which will have been borrowed, buy out the company's owners.
- *Restructurings,* in which a major part of the acquired assets is subsequently sold off to retire the debt that financed the transaction.

What is a recapitalization?

This is not an acquisition but can make a company look as if it had just gone through a leveraged buyout. In a *recapitalization,* or *recap,* a public company, principally for takeover defense, reconfigures the right side of its balance sheet, adding more debt and reducing its equity through a buyback of its shares. It is an extremely effective maneuver for cash-rich or creditworthy

targets to discourage prospective acquirers who have counted on the target's cash and credit to finance their deal.

What is a hostile acquisition or takeover?

An acquisition resisted by the target's management or board of directors is considered hostile. This book addresses some issues relating to hostile takeovers in Chapter 12 on public company acquisitions. In general, however, this book focuses on friendly transactions.

What are friendly transactions, and how will this book treat them?

Friendly transactions are negotiated deals struck voluntarily by both buyers and sellers. The vast majority of acquisitions are of this variety. They are based on mutual accommodation of the interests of two or more parties that believe they will be better off together than apart if they can just work things out.

Working things out involves exploring the answers to many serious questions: Does combining our companies make strategic sense? What can we do together that we could not do separately? Exactly what does each party bring to the table, and how much is it really worth? How much should we pay or be paid? Which company should be the buyer, and which the seller (in an acquisition involving two companies of similar size and market value)? What sort of investigation should we make of each other? What should the obligations of the parties be under the acquisition agreement? What kind of financing can be obtained? How much control will a financing third party want? How do we bring all the parties to a closing?

The objective of this book is to acquaint the specialist and the nonspecialist alike with the basics of the friendly negotiated acquisition, including the financial, legal, accounting, and business practices and rules that govern deals done today. It is also intended to give the reader some feel for the way that today's deals are being negotiated.

The chapters of the book follow the basic sequence of the acquisition process, from planning, finding, and pricing through financing, structuring, investigating, and negotiating acquisition agreements right up to the closing. Much of the content of these chapters is advanced and sophisticated material; it wouldn't be very useful if it was not.

We chose the question-and-answer format for the book for one reason: as

Socrates said, asking the right question is as important as getting the right answer. There is much myth surrounding the M&A process. The authors have worked hard to dispel those myths as they and various specialists ask and answer the down-to-earth, difficult questions. At the same time, this book is designed to be read straight through for those who are involved in or intrigued by the merger/acquisition/buyout process in which, annually, many billions of dollars change hands—not only in the purchase of huge companies or of major interests in them, but in the tens of thousands of smaller companies that are bought and sold from Peoria to Paris.

To find a particular piece of information in this book, use the index. If you have a term for a specific point—if you want to know about *fraudulent conveyance* or the *Herfindahl-Hirschman Index,* for example—look it up directly in the index. If the point has a number but not a name—for example, *Section 338* or *Rule 10b-5*—look it up under *Section* or *Rule* in the index. If you want to review a broad area of the acquisition process—for example, *financing*—look that up in the index and there you will find the book's entire coverage of that area, organized alphabetically by each aspect of financing that appears in the book. Run your eye down the headings until you see where to start reading.

Throughout the book, where legal cases contribute important precedent, we have provided brief descriptions in the text. Cases appear not only in the index but are listed in alphabetical order in the table of legal cases in the back of this book. The most important cases in the merger/acquisition/buyout area are fully described in the landmark case summaries, also found in the back of this book.

CONCLUDING COMMENTS

We can't claim comprehensiveness in all areas. After all, there are not that many universalities or even commonalities to the merger process—especially those that involve the growing and constantly changing field of transnational agreements and financings.

What we *have* delivered, however, is a sourcebook in readable form where the entrepreneur and the professional alike can find not only the *answers* to a myriad of M&A-related questions, but also the *questions* that must (or at least should) be asked about the M&A process. Such thirsting for knowledge is good.

Drink deep!

NOTES

1. Stanley Foster Reed, "Dedicated to the Ever-Renewing Corporate Society," *Mergers & Acquisitions* 1, no. 1 (Fall 1965).
2. Robert F. Bruner, *Deals from Hell: M&A Lessons That Rise Above the Ashes,* (New York: John Wiley & Sons, 2005). Dean Bruner cites the merger of AOL and Time Warner, which led to $100 billion in losses reported in 2003, and the acquisition program of Tyco International, among other bad deals.
3. On January 13, 2006, Tyco International announced that its board of directors had approved a plan to separate the company's current portfolio of diverse businesses into three separate, publicly traded companies: Tyco Healthcare, Tyco Electronics, and the combination of Tyco Fire & Security and Engineered Products & Services (TFS/TEPS). On February 7, 2006, activist investor Carl Icahn joined with Lazard Frères CEO Bruce Wasserstein to call for the breakup of Time Warner into four companies, and to buy back $20 billion in stock. They threatened to contest the reelection of directors. Response was swift. Ten days later the company's board agreed to the buyback, and promised to nominate more independent directors and cut costs by 2007. The company's 2006 annual report reflects these changes. For more on spin-offs, see Chapter 14.

CHAPTER 2

Planning and Finding

INTRODUCTION

This chapter addresses the first two stages in the merger/acquisition/buyout process: deciding what to buy and then finding it. In the first stage, the potential buyer determines the characteristics that it wants in a company. In the second stage, it seeks to identify specific companies that meet or approximate its criteria.

There are two kinds of buyers: those that are looking to buy something to operate as part of a larger whole, and those that are looking strictly for a stand-alone investment.

The typical buyer of the first kind is already an operating company with at least one, and perhaps several, core businesses. This strategic buyer wants to direct its acquisition efforts to strengthen, extend, and build up its existing operations in its current lines of business.

In the second case, the typical buyer is a financial acquirer—usually an investor group—that may not care at all about interrelationships with its other holdings. Its primary concern is whether the company will generate enough cash flow to repay the purchase price and permit it to turn a profit on the transaction. In some cases, the profit may be derived through dividends. In others, it may be gained through resale in whole or in parts to another buyer or buyers, or to the public in a stock offering. In most cases, this buyer will want to minimize the interrelations of the companies it owns so that each can be refinanced or disposed of without affecting the others.

These two types of buyers might be differentiated as opportunity makers versus opportunity takers. Buyers in the first category are primarily plan driven—they're looking for strategic investments, things that fit. Buyers in the second category are deal driven—they're looking for value, things that can be financed.

This chapter will be of most interest to the first type, the operator-buyer that takes time to plan. The deal-driven buyer, on the other hand, will be impatient to move on to Chapters 3 and 4. Such a buyer is likely to have a much narrower field of concern: price and its best friends, cash flow and financeability. The deal-driven buyer can buy and make good use of just about any company if the price is right and can be borrowed.

The portions of this chapter relating to finders and brokers and searching for specific acquisition candidates should be of use to both the plan-driven and the deal-driven buyer. In fact, the deal-driven buyer can probably benefit from a review of strategic planning considerations. After all, it's hard to price an acquisition without some kind of plan. If one can't see the company's plan, the buyer must make one—especially if the buyer has investors backing it.

This chapter also addresses general government regulatory issues affecting acquisitions. Review of any potential restrictions on acquisition decision making, particularly those relating to antitrust, should be performed as a part of the initial planning process. It is also an important part of due diligence, discussed in Chapter 6. It makes no sense for either a plan-driven or a deal-driven buyer to evaluate and search out a candidate unless it can legally acquire that company and operate it afterward without regulatory hassles or lawsuits.

STRATEGIC PLANNING FOR OPERATING COMPANIES

What is strategic planning?

Planning means thinking ahead about how to accomplish a goal. To say that a plan is strategic implies that it results from some process of leadership. (The Greek root, *strategein,* means the general of an army.) A strategic plan will typically be based in a study of the situation, will require some consensus from a group, and will involve a number of steps over time. Furthermore, it will typically show awareness of an opposing force such as a competitor who wants the same thing the planner does—for example, customers. Most corporate strategies are based on the idea of competition—doing better than others

who are selling in the same market, whether by having lower costs, choosing a better product or service, or providing the product or service in a superior way. These are the three generic strategies identified by Michael Porter of Harvard University in his classic book, *Competitive Strategy.*[1]

How can strategic planning help the corporate merger/acquisition/buyout process?

The question really should be asked the other way around. How can the merger/acquisition/buyout process help to fulfill the strategy? Before pursuing any strategy, decision makers should recognize an organization's mission (why it exists) and vision (what it is striving to become). Strategy is the path to fulfill the mission and reach a vision. Merger plans vehicles for moving down the path.

The best merger plans are based on an analysis of strengths and weaknesses. The M&A process should target only industries and companies where an acquisition will both exploit strengths and shore up weaknesses. In the process, the M&A staff becomes an opportunity maker, but it pursues only those opportunities that will fit with its chosen strategy.

Planning of this sort greatly reduces the cost of analyzing randomly submitted opportunities. Do they fit at all? If so, how well do they fit? A truly sophisticated strategic plan will measure quantitatively how well or how poorly potential opportunities fit into it, and, given a number of competing opportunities, it will rank them against each other by degree of desirability to a team of senior managers and trusted advisors.[2]

For many years, under the banner of diversification, strategic planning systems abounded. Some prepackaged ones segmented a company's operations into market-share/market-growth categories and yielded such classifications as *star* for high-growth/high-share, *dog* for low-growth/low-share, *cash cow* for high-share/low-growth, and *wildcat* for low-share/high growth. The strategy was to redeploy revenues from cash cows to wildcats. (Many other such matrix approaches to diversification were also popular, especially General Electric's nine-element construct.) These concepts, originally developed and successfully promulgated worldwide by the Boston Consulting Group (BCG) nearly a half century ago, have been widely taught and used. Why? Because they were certainly better than the random processes that had gone on in previous decades, during which many deals were made for noneconomic reasons—fads, friendship, or family ties.

But now, at the end of the new millenium's first decade, these simple four-element and nine-element matrixes have been supplanted by multivariate analyses. Rather than four or nine, there are literally hundreds of variables that may be considered when contemplating a growth-by-acquisition strategy. Only the systems approach to strategic planning can encompass them all, isolate the key variables, and use them to develop strategic plans that will work.

Before deciding to enter a new area of business, strategic thinkers will make industry forecasts and study the fit of the proposed acquisition with their present operations. Furthermore, because strategic planning requires choices, any opportunity, no matter how hot, should always be forced to stand trial against other potential entries. This means taking a formal inventory of opportunities and then methodically comparing them.

The plan resulting from strategic thinking, once installed, acts as a disciplining force on everyone at the decision-making level. Instead of hundreds of in-house and out-of-house ideas and acquisition suggestions coming up for detailed evaluation at great expense, any proposed area of entry can simply be matched against pre-agreed-upon criteria that describe the company's strategy. If it doesn't meet the majority of those criteria, it is turned down with little executive time diverted away from day-to-day business.

Strategic planning can also help in the divestiture process. In any multi-profit-center operation, strategic planning that does not automatically produce candidates for sell-off or shutoff is probably not truly strategic. It is necessary in any strategy to weigh what you are doing against what you could be doing with your resources. If the potential is greater in new areas of opportunity, the old lines of business should be converted to cash by selling them off, possibly at a premium to a firm where they fit, and the cash should be redeployed to new lines through internal or external development. Controlling this continuous redeployment process is what strategic planning is all about.

Are there various levels of strategy?

Yes. As mentioned, strategic planning revolves around the reallocation and redeployment of cash flows from lower-yielding to higher-yielding investments. This process takes place at many different levels in any large company and even in small companies.

What are the typical strategic planning levels?

It depends on whether an organization is organized by division, product, or function. (See Appendix 2A.) Larger, more mature companies are organized

by divisions. Such companies can have as many as six levels for planning. (See J.T. Smith Consultants case at the back of the book.)

Enterprise strategy generally is developed at the board-of-director level. Thus a strategy might develop at the enterprise level to *expand* the enterprise by making a major horizontal acquisition—acquiring a major competitor of about the same size or bigger. Alternatively, the board may opt to temporarily *contract* the enterprise by selling off major lines and later reallocating cash flows into entirely new and higher-yielding lines unrelated to historic lines. A good example would be Primark Corporation, formed in 1981 as a holding company to diversify Michigan Consolidated Gas Company. Over the next six years it acquired businesses in trucking, mortgage banking, aircraft leasing, and other operations. Then in 1987 it spun off most of its operations and moved into high-powered computer-system integration. In 1992 Primark acquired Datastream of London, and in 1995 it acquired Disclosure.

Corporate strategy calls for putting together under common management several groups of strategic business units (SBUs) that have some common operating elements—technology, marketing, geographic location, and so on. These megagroups are formed via the group strategy described in the following. Cash flows from the group members are reallocated internally to maximize long-term return. The group is also constantly seeking new investment opportunities that fit with the group's commonalities. In some decentralized companies, the group may administer its own M&A activity independent of headquarters.

Sector or group strategy calls for assembling, under one corporate or operating group, SBUs that share some commonality. Then, as in the corporate strategy, cash flows are allocated and reallocated back to the individual business units or into new internal or external investments.

Business unit strategy deals with assembling under common management those product lines that have some commonalities—most often manufacturing or marketing. Cash flows are reinvested back into the most promising of the units after comparing the potential return that could be realized from the acquisition of new product lines or start-ups.

Product-line strategy deals with product life cycles—supplementing or replacing mature or aging products with new products.

Functional strategy deals with alternative methods of manufacture—for instance, changing from aluminum die casting to plastic injection molding, or switching from wood to fiberglass or aluminum for a line of boats. It should also include plant relocation—looking for lower labor rates, cheaper rents, more employee amenities, proximity to raw materials, and so forth.

How should a company begin to plan strategically?

Planning begins with the board of directors, which sets the tone. Directors should ensure that managers make M&A decisions only in accordance with a plan, and should impose discipline on the implementation of that plan.

What precisely is the board's role in strategy generally, and in M&A specifically?

Boards have a vital role in strategy. Ideally, an acquirer's board will be constructively engaged with management to ensure the appropriate development, execution, and modification of the company's strategy, including any parts of the strategy that involve growth through acquisition or shrinkage via divestiture.[3] The nature and extent of the board's involvement in strategy will depend on the particular circumstances of the company and the industry in which it is operating. While the board can—and in some cases should—use a committee of the board or an advisory board to analyze specific aspects of a proposed strategy, the full board should be engaged in the evolution of the strategy.

Strategy development is a cooperative process involving the board and management. They should jointly establish the process the company will use to develop its strategy, including an understanding of the respective roles of management and the board. Moreover, both management and the board should agree on specific steps for strategy development. To participate in the strategic thinking process, boards should be prepared to ask incisive questions—anticipating, rather than reacting to, issues of major concern.

What substantive elements should go into a corporate strategy, and how should they be determined?

At the beginning of the strategy process, there should be a full and open discussion between management and the board concerning the substantive elements that are going to be considered in the development and execution of a winning strategy.

Internally, such elements might include:

- *Mission and/or vision statements*—written intentions that can be a valuable guide to strategy.

- *Core competencies*—what the organization can do because it has certain people or processes.
- *Core assets*—tangible and intangible assets owned or controlled by the company. See Appendix 2B for a list.
- *Culture*—how the organization behaves and what its people believe. Understanding this system enables planners to understand how a particular strategy will play out when implemented.[4]

Externally, the substantive elements in a strategy might include:

- *Business environment*—best-case and worst-case scenarios for the business.
- *Customers*—mix of product and service price and quality that current and potential customers want.
- *Competitors*—others providing similar services, and how the company matches up.
- *Suppliers*—contracts and bargaining power.
- *Alliances*—possible affiliations with customers, competitors, and suppliers.

A strategic plan proposes ways to build on strengths and offset vulnerabilities in these internal and external elements. One way to do this is to buy other companies, or to sell divisions. These choices require an effective strategic planning process.

How can a corporation develop an effective strategic planning process?

To begin the planning process, the board might appoint a *corporate strategy policy group,* whose first job should be the preparation and issuance of a *corporate strategy procedures guide.*

The guide should outline who is responsible for what in the corporate planning hierarchy, and the responsibilities of each person involved. Furthermore, it should include a philosophical statement about internal versus external growth. Approaches will vary based on culture or situation. A company with a successful track record expanding organically may want to continue operating this way, and have a policy against acquisitions. Another company—particularly one with deficits in internal assets—might seek to grow aggressively by buying others.

Most companies fall somewhere in the spectrum between these two

extremes. Some alternate the two approaches over time, with years of intense acquisition followed by years of integration, which was the case for Ikon Office Solutions, a copier supply distributor.[5] Other companies consciously balance external and internal growth on an ongoing basis, as exemplified by LarsonAllen, a professional services firm.[6]

When companies do make acquisitions, their guide should define the level at which M&A search-and-screen activity is to take place, where structuring, financing, pricing, and post-acquisition operating decisions will be made, and other matters pertinent to the merger process.

Note three basic components in the flowchart in the J.T. Smith Consultants case at the back of the book: the internal development program, the external development program, and the organization design and development program. The last is necessary to ensure that the organization will be able to implement their external and internal development programs when moving from idea to reality.

Can a company achieve profitable growth by a series of acquisitions in its own industry—and if so, how?

Certainly. Nondiversifying growth by acquisition is quite common and often successful in many industries, particularly fragmented industries in which there are many local independent operators, as in breweries, camera retail, car rental, home health care, funeral homes, home oil heating, plumbing, real estate, software, trucking, and warehousing. Synonyms for this type of growth include *bundling, buildup, rollup,* or, more formally, *serial consolidation.*

An acquirer can achieve growth in this mode by buying one company at a time. After a buyer has bought one firm, it is used as a base for building a much larger business through acquisition add-ons in the same or a related industry. A case in point is SAIC, a research and engineering firm that has acquired many information technology firms.[7]

For operating companies looking for synergies, the best way to evaluate any proposed acquisition is the present value of the future earnings stream to be developed under a business development plan that includes the proposed new acquisition. If there is more than one candidate under consideration, and a choice must be made, they should be compared to each other. The present value of a plan for A is rated against the present value of the plan for B. This classical process, when applied to the purchase of capital goods such as machine tools, is called making an alternative capital investment decision.

What is the wheel of opportunity/fit chart approach to strategic planning?

The wheel of opportunity/fit chart (WOFC) is a step-by-step method for creating a strategic plan by asking and answering these fundamental questions:

- What are our strengths and weaknesses?
- What are our alternative opportunities for acquisitions?
- What are our priorities for building on strengths and correcting weaknesses?
- How do our opportunities fit with our priorities?

As a supplement to this discussion, readers should look at the J.T. Smith Consultants case in the book's appendix, in which a sample wheel of opportunity/fit chart appears.

The WOFC process begins after the board of directors, the CEO, and the person in charge of planning make a basic commitment to the strategic planning process in general and to the WOFC process in particular.

Having decided to construct a WOFC, they then ask the unit, group, company, or profit center performing the analysis to assemble its top people to create a business development plan by consensus. This group should include the line chiefs because they are responsible for profit and loss. For example, for an enterprise-level WOFC, the CEO, COO, and any executive vice president with profit and loss responsibilities would certainly be expected to attend, in addition to the vice president of finance, the comptroller, the vice president of marketing, and the regional (or sector) main operating heads. The number of participants is important. If there are more than 12, the process seems to drag out. If there are less than seven people, however, not enough differentiation in viewpoints comes through. Nine or 10 has proved optimum. The vice president of planning or, if there is none, someone designated as facilitator coordinates the program and then writes up the findings as the definitive plan.

After the group is formed, it goes through three phases:

- First, candidates are entered on the wheel of opportunity from the files of opportunities that have been assembled for evaluation.
- Second, the group develops a set of criteria for selecting between these and future alternative acquisition opportunities, using the strength and weakness analysis developed by the fit chart.
- Third, the group differentially rates the alternative acquisitions on the wheel against each other, using the scoring criteria developed in the fit chart. This prioritizes the search process.

Before the first formal meeting, each of the participants should get blank sheets for strength analysis, weakness analysis, and wheel of opportunity, as shown in the J.T. Smith Consultants case. These sheets can be hard copies to be filled out with pencil, or electronic files to be filled out online.

The purpose of this first informal review is to make sure that the group understands each proposed entry. The group should strive to consider all reasonable candidates at this stage, discarding only those that are clearly inappropriate.

This is a very sensitive area; some contributors may have spent years developing a concept, and will be hurt if the opportunity is summarily dismissed without going through the fit chart process.

After all opportunities have been identified, those of the same or a similar nature are combined. Then a final list is prepared and redistributed to the group as a package.

How does the wheel of opportunity work?

A wheel of opportunity has six facets, which are grouped into three modes. Each facet sets forth a different type of acquisition to be considered. This helps managers and advisors visualize the universe of acquisition opportunities surrounding any company or division.

What are the basic types of strategies described in the wheel of opportunity?

There are three basic strategic modes: horizontal integration; vertical integration; and diagonal integration, referred to as diversification.

What is horizontal integration?

This might be called the shoemaker strategy. Derived from that sage advice, "Shoemaker, stick to your last," it dictates that you should expand in the businesses that you know. Before considering any other external growth opportunities, you should weigh the advantages to be realized by buying out a competitor and integrating its operations with yours. This can be accomplished by merging with a single competitor of similar size (a merger of equals), or by buying up many smaller, cookie-cutter companies in the same industry (a rollup). Companies like Ritz Camera, Avis Rent-A-Car, and Ryder systems were all built acquisition by acquisition. (The senior author of

this book helped the founder of Ryder build his company, one phone call at a time.)

What is vertical integration?

Vertical integration occurs when a company buys a supplier (vertical backward integration) or customer (vertical forward integration) to achieve economies in purchasing or sales/distribution. Regulators monitor vertical integration because it can reduce competition. Shareholders may oppose vertical integration as well, since it can reduce price competition (the company can get locked into high internal costs when outsourcing might be more economical).

What are the advantages of vertical integration?

Quality control is one of the prime advantages of a vertical integration strategy, whether buying up or down the supply line. Where there is a high level of technology, especially in emerging fields, vertical integration can pay off in an increasingly better product produced at increasingly lower cost because parts and materials can be produced to exact tolerances—neither overengineered, which cuts into profit margins, nor underengineered, which creates assembly and service problems.

Product planning, research and development, product engineering, and in some cases distribution and service functions are all aided by vertical integration. Inventory control in times of tight money, just-in-time (JIT) deliveries, and reduction in sales costs are other positive results of vertical integration. And in times of shortages, owning a supplier has saved many a company from failure.

A vertical ROI (return on investment) analysis can help decide which way to move—backward, forward, or both.

An interesting example of a company using vertical ROI analysis is Sherwin-Williams. This century-old paint manufacturer—producer of Dutch Boy, KemTone, and so on—was having trouble making money manufacturing paint. But its customers—distributors and retailers—were doing well.

In the house paint industry, there are five levels of activity: raw material extracting, processing, manufacturing, distributing, and retailing. Sherwin-Williams made profits in the extraction stage—mining titanium dioxide—and at the distribution and retail level, but because competitive conditions in the industry forced it to make intensified investment in plant and facilities, it received little return at the manufacturing level. In response to these findings, 30 years ago Sherwin-Williams converted itself from a manufacturer of paint to a man-

ufacturer, distributor, and retailer of household paints and the equipment to apply it. Today the company has roughly 3,000 retail paint stores with sales of more than $7.7 billion.

However, there are dangers in this mode. The transfer pricing of goods from a subsidiary to a parent is an invitation for accounting trickery to protect an acquisition from the reality of proper costing processes. That is why activity-based costing (ABC) is a near necessity in long-term support of this acquisition strategy.

What is the diversification mode?

The *diversification mode* is composed of two kinds of activity: *product* or *service extension* and *free-form diversification.*

What is a product/service extension?

It is adding a new product or service that can be sold in your present geographic areas, generally to your present customers. A good example of this is the January 2006 announcement by Katun Corporation that it would acquire the toner and developer product assets of Nashua Corporation.[8] Katun supplies products compatible with computers made by original equipment manufacturers (OEMs)—which buy computers in bulk, customize them for a particular application, and sell them under their own name. In particular, Katun Corporation is the world's largest supplier of OEM-compatible imaging supplies, photoreceptors, and parts for the office equipment industry.

What is free-form diversification?

It is an entry in a field of activity and in a geographic area where the acquirer has no present operations. This is the highest-risk category in the M&A field, because the buyer will be new to the industry and market.

The primary purpose of the classification scheme is to make it possible to discover, through the device of the fit chart, not only which of the six particular kinds of entries score the highest, but which modes hold the most potential.

How do you fill in the wheel?

This discovery process occurs in a series of steps.

Step 1. Horizontal integration. Enter on the opportunity wheel the principal market (geographic) areas served by present product lines or

services, and list the company's principal competitors and their market shares, if known. Note also growth in the market area if known.

Step 2. Market extension. Enter all future potential new geographic markets for the present principal line or lines by logical geographic breakdowns. If known, enter growth rates for sales of the company's products or services in each potential new geographic market.

Step 3. Vertical backward integration. Enter suppliers by industry and by name.

Step 4. Vertical forward integration. Enter the names of principal customers by industry and individually.

Step 5. Product or service extension. List all of the possible products or services that could extend present lines in present geographic territories. (What do current customers buy from others that the company can supply?)

Step 6. Free-form. List opportunities that don't fit in the other categories. Try not to anticipate the fit chart. As mentioned, don't reject too many ideas.

(Try not to anticipate the fit chart. As mentioned, try not to reject too many ideas at this stage. It is best to leave rejection to the controlled and dispassionate process of the fit chart. The utility of the fit chart construct will be demonstrated when a few random opportunities are injected and subsequently rejected when the entries are quantified.)

An opportunity wheel can be constructed in this manner for any company or operation doing anything anywhere. Next comes the fit chart, which will show how efficient these potential entries might be relative to each other.

How does the fit chart work?

The fit chart classification scheme makes it possible to discover not only which of the six particular kinds of entries score the highest, but which modes hold the most potential.

There are three stages in developing and using a fit chart:

1. The first step is to identify what company traits can help the acquirer succeed in the marketplace. If the company traits can help offset weaknesses, we call them *complements.* If they exploit or reinforce strengths, we call them *supplements.*
2. The second step is to select the principal complements and supplements and weight them according to their relative importance.

3. The third step is to rank acquisition opportunities by their ability to maximize the desired complementary and supplementary effects.

Note: It is always easy to discover potential opportunities that are heavily complementary or supplementary. The goal is to discover opportunities that have values on *both* sides. Entries that complement weaknesses and at the same time supplement strengths are the key to successful growth by the M&A process.

What are some examples of company weaknesses or strengths to consider for M&A planning?

There are hundreds—including many that are specific to a particular time for a particular industry. During an economic downturn, a primary complement for manufacturers might be a firm that produces something the salesforce can add to present lines that aren't selling. On the supplement side there may be entries such as "What industries can use our proprietary technology in high-temperature hard coatings?" and "What can we buy that can use our famous trademark to boost its sales?"

The best way to think of these is to take an inventory of strengths and weaknesses.

- Exhibit 2-1 shows how a company might list its weaknesses and strengths. It is based on the notion of assets. So what is an asset? For starters, anything the accounting profession and securities regulators say must be reported on the balance sheet (cash, land, inventory, and the like). But as accountants and regulators themselves recognize, a company can have nonfinancial assets that are not presently recorded on the balance sheet. This is the main point of the Enhanced Business Reporting Consortium. For a more complete list of assets, see Appendix 2B.
- Exhibit 2-2 lists risks a company might face. Not surprisingly, the risk-based list is almost identical to the lists regulators require—namely the categories required in the Management Discussion and Analysis (MD&A) section of the annual report. The list of risks is also similar to the suggested framework published by the Enhanced Business Reporting Consortium, which was recently launched by the American Institute of Certified Public Accountants.[9] Either or both of these can be useful in generating a list of desirable acquisition candidates.

In the end, the lists should make sense to management.

EXHIBIT 2-1

Sample Checklist of Assets for Use in Complement/Supplement Analysis

An asset checklist can help companies see what they may need in an acquisition, whether complementary (to correct an asset weakness) or supplementary (to reinforce an asset strength).

PHYSICAL ASSETS

What equipment, inventory, materials, land, or buildings does our company have?

- Are any of these a source of weakness? Can we correct it through a complementary acquisition? For example, if our equipment is outmoded, can we buy a company with more modern equipment?
- Are any of these areas a source of strength? Can we build on it through a supplementary acquisition? For example, if we have had success buying and developing farmland, can we buy a company that has land in need of development?

FINANCIAL ASSETS

What are our financial assets?

- Are our ratios weak? Can we correct this via a complementary acquisition? For example, if our debt-equity ratio is too high, can we buy a company in our industry that has a low debt-equity ratio to compensate?
- Are our ratios strong? Can we build on this via a supplementary acquisition? For example, if our interest coverage (earnings before interest and taxes minus interest charges) is high, can we buy a company that can benefit from this strength (because it is overleveraged but otherwise desirable)?

INTELLECTUAL ASSETS

- Do we have a notable weakness in our nonfinancial assets? For example, do we lack adequate patents in our core technology? If so, can we buy a company with the kind of patents we need?
- Do we have a notable strength in our nonfinancial assets? For example, do we have strong brands? If so, can we buy a company with good products that need brand recognition?

EXHIBIT 2-1 (Continued)

HUMAN ASSETS (PEOPLE)

- Do we have a notable weakness in our human assets? For example, do our workers lack the technological skills we need in our industry? If so, can we buy a company that has experience training and employing such workers?
- Do we have a notable strength in our human assets? For example, is our sales and distribution team successful? If so, can we buy a company with products they can sell and distribute?

ORGANIZATIONAL ASSETS

- Do we have a notable weakness in our organizational assets? For example, do our workers lack the technological skills we need in our industry? If so, can we buy a company that has experience training and employing such workers?
- Do we have a notable strength in our human assets? For example, is our sales force successful? If so, can we buy a company with products they can sell?

ORGANIZATIONAL ASSETS (SYSTEMS/ACTIVITIES)

- Do we have a notable weakness in our organizational systems or activities? For example, are our distribution channels insufficient? If so, can we buy a company with the channels we need?
- Do we have a notable strength in our organizational systems or activities? For example, do we have superior systems for design and production? If so, is there a product line we could buy that can benefit from those systems?

EXTERNAL RELATIONSHIP ASSETS

- Do we have notable weaknesses in our external relationships? For example, are our labor relations poor? If so, can we merge with a competitor that has strong relations with the appropriate unions?
- Do we have notable strengths in our external relationships? For example, do we have an excellent reputation for customer service? If so, can we buy a company and enhance its value by training its employees in our service culture or transferring our customer-oriented employees to its workforce?

EXHIBIT 2-2

Sample Checklist of Risks for Use in Seeking Complementary Acquisitions

RISK: VULNERABILITY TO BUSINESS CYCLES

- Seasonal or annual factors (buy company with summer products to offset winter products)
- Long-term economic factors (buy company with boom products to offset bust products)
- Product life cycles (buy company with slow-growth products to offset fast-growth products)
- Random factors (buy company with diverse range of products to offset variety of risks)

RISK: HIGH TURNOVER

- Disruption caused by short employee tenure (buy company with stable workforce)
- Intellectual capital drain from retirement, poaching of stars (buy company with star talent)

RISK: TECHNOLOGY CHANGE/MALFUNCTION

- Core products are prone to technology change (Buy technology-rich company)
- Information systems prone to cyberattack (Buy firm with capability in IT security)

RISK: COMPETITIVE DISADVANTAGE

- Open entry (buy competitor to reduce chances of new competition)
- Closed exit (buy company outside industry to enable industry exit)

RISK: STAGNATION/GROWTH

- Low growth in sales (buy to increase sales)
- Low growth in profits (buy to increase profits)

RISK: POOR INVESTOR RELATIONS

- Excessive leverage (buy debt-free firm to lower debt-equity ratio)

EXHIBIT 2-2 (Continued)

- Volatile earnings (buy company with countertrend)
- Poor lender relations (buy company with strong lender ties to offset weak lender relations)
- No access to equity markets (buy company that is listed or has a more prestigious or secure listing)
- Poor financial image (buy high-prestige company to counteract low or no reputation)

RISK: POOR MARKET/MARKETING

- Low market share (buy company to offset low market share)
- Low price (buy competitor with higher prices to offset low prices)
- Single customer type (e.g., if a defense supplier, buy nondefense company)
- Weak marketing approach (buy company with superior marketing)
- Inadequate shelf space (buy company that gives more shelf space)
- Incomplete product line (buy company that completes, bundles with, or competes internally with a product line)
- Low customer appeal (buy a company with good service reputation to offset a negative one)

RISK: REGULATORY/LEGAL PROBLEMS

- Regulatory burden (buy company in nonregulated industry to offset necessary but burdensome issues of compliance)
- Poor union relations (buy company in nonunion industry to offset exposure to strikes)
- High market concentration (buy company in nonconcentrated industry to offset any problems of antitrust)
- High tax bracket (buy a company offering legitimate tax advantages)
- Weak patent/trademark/copyright protection (buy a company with patent protection processes)*
- Insufficient technology (buy a company to offset lack of technology)

*For an excellent book on patent protection processes, see Julie L. Davis and Suzanne S. Harrison *Edison in the Boardroom* (New York: John Wiley, 2001).

What is synergy?

Synergy literally means the process of working together. It is the proverbial two-plus-two-equals-five effect that drives, or should drive, most M&A activity. The term is used most often in the case of complement-driven mergers in which candidates give each other some previously missing element. But synergy also happens in supplement-driven mergers where two companies are playing on similar strengths. In the horizontal integration area, there is a lot of synergy in the merging of two hardware stores in the same block, or two Ford retailers in the same small town, as total inventories necessary to carry the same total level of sales can be reduced substantially.

The purpose of a fit chart is to quantify the *relative* synergies of the opportunities inventory, to quantitatively differentiate the fit and thus the profit potential offered by various competing entries.

Should the process start with supplements or complements?

It can be done either way. Some managers and many planners tend to be concerned solely with complements ("We have to do something about this problem of ours"), and others tend to be concerned solely with supplements ("Where else can we apply our special technology?"). Not surprisingly, many programs of diversification take either one approach or the other, depending on the psyche of those making the plan. In the long run, each is doomed to fail—especially where weaknesses have been ignored or downplayed.

The basic concept of the fit chart is to form a strategy that answers two basic questions: What do we lack that can be supplied by the acquisition? What strengths or assets, human and physical, do we have that are transferable to the acquisition? Anyone can find industry entries heavily weighted on one side or the other. The trick is to find entries *with high values on both sides.* With work, they can always be found—and that's where the money is.

Are there any general rules to guide the creation of fit chart variables?

Yes. Here are a few guidelines taken from past WOFC programs:

- Don't overdo it with technology. Raising the level of technology will not automatically raise the return on capital, as many mistakenly believe.

- Don't overdo it with financial variables. The classic equation, $S/C \times P/S = \text{ROC}$ (where S is sales, C is capital, P is profit, and ROC is return on capital), will suffice for this stage of the planning process. One of the major decisions facing acquirers is to discover where profits come from in present operations. Is it from turning capital (S/C) or from generating high-margin sales (P/S)? A business can make money either way, but it is rare to make it both ways. Operations are usually either turns driven or margin driven. A turns-driven buyer should probably stay in businesses where profits are turns driven, and a margin-driven operator should stay in margin-driven operations. Other financial variables, such as above-market returns based on patent protections, are generally impounded in the purchase price as part of the deal's net present value (NPV).
- Financial variables often cause trouble because some people believe that certain kinds of businesses are inherently more profitable than others. This is simply not true over time. High-margin mining businesses at 65 percent gross profit go broke while the chain grocer gets rich at 5 percent. The difference is in the risk profile: one is high, the other low. When a low-margin operator acquires a high-margin operator or vice versa, there's usually trouble because they won't have an operating fit.
- Think through the real meaning of labor variables. For example, some executives may want to get away from the union by seeking a nonunionized company as a complement. They believe that their unionized operations are a weakness. But often, after much discussion, these same managers will decide that, because they know how to get along with labor, how to forestall a strike, or how to take one comfortably, they can bid for and buy companies in labor-sensitive industries at bargain prices. Their perceived weakness turns out to be a strength.
- Be honest in assessing your own merger management skills. Only after days of honest introspection do managers begin to see that many of their past acquisition failures were caused by poor management fit between acquirer and acquiree. There is more to fear along the production axis than along the marketing axis. It is probably easier to teach an engineer marketing than to teach a salesman engineering.
- Look for seasonal supplements. "In the winter, when the marine park closes, the staff teaches skiing at our ski resort." "We're

cash-poor all summer while we make Christmas tree light strings. Now we make garden light strings." These kinds of entries can make money for years.

- Be careful of transitory benefits from transaction structure. In tax-driven deals, when the short-term benefits run out, what's left may be a long-term loser. Many an LBO or MBO uses post-acquisition asset sales to show a profit. But when those are gone, owners must fall back on operations for earnings and cash flow to pay off debt—and some don't make it. Without permanent operating synergies (and savings), most acquisitions are bound to fail.

How do you weigh the relative importance of complements and supplements and narrow the list to the most important?

The WOFC uses the Delphi process, introduced in the 1960s as a method of forecasting the future.[10] The theory behind it is that the collective, intuitive judgments of a group of experts in an area with many unknowns (such as technological change) are superior to quantitative extrapolations of known trends.

How does the Delphi process work?

In the Delphi process, a series of questions formulated by monitors is put to a panel of experts. The monitors study the answers and group them into four quartiles of opinion, and send back anonymous abstracts of the upper and lower quartiles to the panel of experts. The experts all read the abstractions and respond again, hopefully modifying their opinions in accordance with the group wisdom. These answers are again abstracted and grouped, the upper and lower quartiles are again distributed (still without identification of contributors), and the new, usually modified opinions or estimates are fed back to the experts. The process goes on until some kind of a consensus is reached.

In the fit chart process, in order to discover the potential profit drivers, one can use an instant Delphi process. Each participant is given 1,000 points to distribute to a set of variables—complements and supplements (see the case in the back of the book). The anonymous allocations of each participant to each of the variables are tallied and summed. These averages are then made known to the group. The persons giving the lowest and highest scores to each variable are now identified from the tally sheets as either high or low without giving their actual ratings, and these attendees must defend their positions. These decisive players may be joined by others in the low or the high quartile depending on

how structured the inquiry system is. Each variable is discussed in an adversarial fashion.

It is not at all uncommon in the Delphi process to uncover vast differences in opinion about basic operating and strategic philosophies right at the very top of the organization—major differences that have never been discussed, much less resolved.

If the lows wish to caucus and bring out a joint position, they are allowed to. The highs can do likewise. Middle-value people are not allowed to participate in the discussion because, in effect, they have not taken a position. They soon learn that if they want to participate, they'd better take a stand. The lows and the highs battle it out verbally until debate is cut off by the facilitator. Thus, each variable is treated in discussion, after which the participants again spread their points. Variables not scoring an average of some minimum number of points (e.g., 25) are dropped from consideration.

The process continues for as many as five rounds. Experience shows that it is seldom necessary to go beyond the third round before consensus is reached. At the last round, a final cutoff figure for dropping variables is set (it might drop to 20 points), the points dropped are proportionately reallocated, and the final, average number per variable, a true consensus in numerical form, is then posted on the fit chart for all to see.

Exactly how is each opportunity ranked?

The easiest thing about the WOFC process is its way of distributing the values to the acquisition opportunities. The final value ascribed to each variable represents the maximum score that any of the acquisitions being considered can achieve as to that variable. (Most acquisitions would presumably achieve lower scores.) Say that candidates promising to reduce shop overhead, a quite common complementary goal for manufacturers in tough times, gets a consensus value of 200 points. Say that the target opportunities can utilize 100, 50, 25, and 0 percent of the acquirer's excess shop capacity. The opportunity scoring 100 would get the full 200 points, the one scoring 50 would get 100 points, the one scoring 25 would get 50 points, and the one scoring 0 would get 0 points.

When all of the values have been distributed, they are summed and ranked.

Can the WOFC process be used to identify sell-offs?

Yes, most certainly. The converse of the foregoing analysis is the sell-off decision, which can also be made using the WOFC. All present and potential

product (or service) lines are put in their proper sector and, in effect, rated against each other. If the WOFC process has been institutionalized, present operations are rated against potential acquisitions. The lower-rated operations are sold off and the funds reallocated to the acquisition of new, higher-ranking candidates.

After completing the WOFC, what's next?

All of the information generated in the WOFC process, including all of the voting sheets, should be bound in a report and the final results summarized into a strategic statement, which is the first page of the strategic plan or the business development plan. This serves as a guide for the search-and-screen process that follows.

IN-HOUSE SEARCH

When does a search-and-screen program begin?

The search-and-screen program begins once the acquiring company has completed its strategic self-evaluation and has developed its acquisition strategy. It is now ready to start some search activity. The first step is to identify the target industry and isolate specific acquisition candidates that might meet the fit chart criteria.

How should it be organized?

There are two primary ways to make acquisitions: (1) centralize leadership of the company's entire acquisition program at corporate headquarters, or (2) decentralize leadership of the phases of the process at different levels of the organization. For example, strategy may be developed at headquarters—the enterprise or corporate level—while search and screen may take place at a lower level, with pricing, legal, and negotiation controlled by corporate. Whichever approach is taken, as mentioned, plans must be developed by the people who must make them work. Acquisitions dreamed up at corporate headquarters and imposed on the subsidiaries have a good chance of failure.

How long does a search-and-screen program last?

For strategic acquisitions, it depends on the scope of the program and how much in-house data is available on the subject. Normally, to produce a few

viable candidates, a search-and-screen program takes a minimum of six months. At the end of six months, some negotiations should be under way. However, don't be surprised if the process takes longer, because many candidates will not be ready to sell at first. If the buyer is interested in only a few targets and those targets are not immediately available, it could take years for the seed its inquiries planted to germinate in bona fide negotiations.

What are the primary steps in completing a full search-and-screen program?

- Define target industries as derived from the fit chart program.
- Find publications, Web sites, and associations that are dedicated to the target industries, especially those that report on M&A activity in those specific industries.
- Develop an industry situation analysis. This analysis determines an industry's pricing and current profitability structure, growth, maturity, cyclicality, seasonality, and other economic indicators.
- Develop a clear nomenclature so that everyone involved is communicating properly.
- Compile a list of industry players. These are the companies that are moving and shaking in the field.
- Assemble a list of industry gurus. These are the people who know almost everything worth knowing about an industry sector. Employees of these companies (for example, purchasing agents, plant managers, or engineers) are ideal contacts.
- Assign staff to explore online resources. Numerous lists of varying and changing quality exist, and the best way to proceed is to start fresh. Go to an online search engine, and type in "companies for sale." Immediately, you will see page after page of resources, some new, some established. For example, check www.businessesforsale.com, www.mergernetwork.com, and mergerplace.com.
- Join the trade associations in the industries and get active in their chapters and trade shows.
- Start building specific company target files.
- Screen targets using fit chart data.
- Contact principals.
- Begin developing preliminary post-acquisition integration plans.

- Obtain a price expression from any potential sellers.
- Get Dun & Bradstreet (D&B) and credit reports if targets are stand-alones.
- Begin the negotiation process. Get expressions of preliminary price and terms.
- Engage in the due diligence process and make a business integration plan for the targets.
- Move toward closing your chosen transactions, while remaining open to alternatives.

The importance of each of these steps will vary depending on whether the acquirer is an opportunity maker or an opportunity taker.

How does an opportunity maker operate?

The opportunity maker is typically an operating company searching for an acquisition with particular operational characteristics in one or two specific industries. This practitioner seeks the proper industry player that best complements or supplements current operations and overall long-range plans.

For example, if the opportunity maker's core business is the distribution of industrial laboratory supplies, it may make strategic sense to integrate vertically backward into self-manufacturing of high-profit-margin items that the company currently purchases from suppliers and then distributes. (In the entertainment field it is this strategy that is currently driving the megamergers.)

The opportunity maker will typically develop acquisition criteria through the fit chart process or something like it, so it knows what it is looking for. Now it is just a matter of finding it. Most companies, including subsidiaries of large companies, are listed in many different databases. Most are classified by SIC (Standard Industrial Classification) code and are easily identified. Some are classified by sales, net profit, and net worth ranges to fit some preset criteria. Standard & Poor's (Compustat) and D&B both offer excellent databases for this purpose.

As part of this approach, the opportunity maker would be wise to sift through the literature—both published and nonpublished technical databases and news reports—for data to confirm or add to the results. The U.S. government has an abundance of free or low-cost data about industries and even about specific companies that are rarely used by the M&A searcher.

How does an opportunity taker work?

For the opportunity taker, the deals are finance driven rather than operations driven. The opportunity taker establishes a network of intermediaries, including finders, brokers, and investment bankers, to pinpoint companies, such as corporate spin-off fire sales, that appear to be bargains. The opportunity taker approach tends to be random, unstructured, and unplanned, yet it is this very flexibility that allows opportunity takers to seize an opportunity when it presents itself. If they have cash or can raise it, they can move quickly and sometimes can pick up really good deals. For example, sometimes a large company with immediate cash-flow problems will sell off its *best* operation because it can be done quickly. Like the opportunity maker, the opportunity taker needs to be on the alert for opportunities.

How should an effective literature search be conducted?

Each acquirer will want to develop its own procedure, but the following steps are mandatory for the vigilant researcher:

- *Create prospect lists.* Develop contact lists to conduct one-on-one telephone interviews with the leading players. Send out direct mail questionnaires.
- *Attend industry trade shows.* You can physically see the target products or services and talk directly with potential acquisition candidates in some cases. Also, most trade shows attract industry gurus. They seem to know before management when something is going to be sold off. For expansion by serial consolidation, trade shows are the place to start. Many a management buyout, leveraged or not, has been started right on the exhibit floor.

How does the researcher compile a list of industry players?

It takes a combination of sources, in person, in print, on the telephone, and, of course, online. Here are just a few of the steps to consider:

- Join the target industry's trade association(s) and obtain the membership directories. Network with association members, and the staff of the association.

- Take advantage of the free information available because of securities disclosure rules affecting public companies. Look to annual reports, SEC filings (10-Ks, 10-Qs, prospectuses, and proxy statements at www.sec.gov), press releases, product literature, catalogues, company case studies, and executive speeches. The U.S. Treasury also has good data based on tax filings (www.irs.gov/taxstats/index).
- Also, if publicly held targets are of interest, don't overlook the reports of securities research firms. There are hundreds of such firms worldwide, many affiliated with major brokerage houses. They are listed annually in *Nelson's Directory of Investment Research.*
- Other sources for public companies include the *Value Line Investment Survey* (www.valueline.com), Standard & Poor's publications (www2.standardandpoors.com), *Directory of Corporate Affiliations* (www.lexisnexis.com/dca), and various Moody's publications (www.moodys.com) will also serve.
- Use reference books such as *Thomas Register* (www.thomasnet.com) and trade periodical buyer's guides. These reference books normally group companies by the product or service sold. For example, the researcher looking for companies that manufacture fluid-bed dryers should start by referencing fluid-bed dryers in *Thomas Register.*
- Study special industry research reports by independent research firms. Prospectuses for these studies are listed and indexed by subject in *Findex* and are also on Lockheed's Dialog database (http://library.dialog.com). These Bluesheet prospectuses contain the study's table of contents, which usually discloses the names of key industry players. Another good source of specialized industry information is Frost & Sullivan (www.frost.com). Also, both trade association and industry and company reports are invaluable information centers for industry data. These normally cover an entire industry's structure or a particular product or market segment's structure. They can be expensive—sometimes in the $25,000 range—but the publisher will send you a précis that in itself can be very valuable in helping to evaluate whether to make an entry.

How can a buyer find information on private companies?

A good starting place is Dun & Bradstreet's *Million Dollar Directory,* which lists both public and private companies. Dun & Bradstreet also has online services at www.dnb.com/us/.

If D&B does not have financial information on a particular private company, it is extremely difficult to obtain the information without getting it directly from the company itself. However, many states, especially those with extractive activity, require both public and private businesses, whether incorporated or not, to file annually various types of information, including year of establishment, names of principal owners, key personnel, number of employees, annual sales, principal lines of business, plant size, and import/export activity. Sometimes asset, liability, and profit information must also be submitted.

Some states compile the information through their chambers of commerce or their economic development programs and publish it via private companies such as Harris InfoSource, www.harrisinfo.com, formerly Harris Publishing Company, of Twinsburg, Ohio. Harris has state, regional, national, and industry editions. Private companies rarely give out financial information such as balance sheet and profit and loss numbers. Even when they have done it for credit purposes, many do not keep it up to date. Even smaller public companies fail to update. Gross sales information is often four to five years old. Normally D&B will give some numbers, such as the number of employees. Thus, to get a ballpark figure for a potential target's annual sales volume, the buyer can generate a sales-per-employee number and apply. Service company information is harder to come by than manufacturers' as their trade organizations, if they exist, often do not collect hard numbers.

How does the researcher develop a contact list of industry gurus?

The World Wide Web—and in particular, search engines such as Google—has revolutionized research. By typing in the name of a particular industry, one is immediately led to seminars, publications, and other sources of information. One can pick up their names at trade shows and meetings of technical societies. Most such gurus publish articles about their specialties in technical journals and the trade press. For books, the largest collection is of course at the Amazon Web site (www.Amazon.com), which lists some 5 million titles accessible by subject. For articles, the best place to start is the *Business Periodicals Index* (BPI), which lists tens of thousands of technical and nontechnical articles arranged by industry. LexisNexis also offers an in-depth service for searching articles by subject matter—actually counting the number of times a given word or phrase (for example "iron and coal") appears.

In many cases, a trade association maintains a list of consultants who specialize in their industry. Also, list brokers, such as National Business Lists, may have special contact lists for your industry.

As with research on industry players, don't stop at the printed word. Developing a contact list requires a great deal of hard-slogging telephone work, such as conducting target industry surveys.

When conducting target industry surveys, what is the best approach?

Superior results come from talking to users over the telephone and going over a questionnaire with them. A *user* is someone who makes decisions to buy, or use, a product or a service. Talking to these users is especially helpful. Many a good lead has been developed this way, as a major user might help you target a company and might even be interested in helping you finance the deal! Such conversations are easily started: "Who there buys high-capacity filter presses?" Talk to both the end user and the purchasing person.

One caveat: the direct approach works well *once you know the industry.* If you don't know what a filter press looks like, do some research. When placing that call, make sure to have more up-to-date information than the industry player. Trade information in a telephone call. Key personnel generally open up and talk about their own company if they learn something new about the industry from you.

A second word of warning: It may take many hours and even days to gain a sense of the industry. Don't start your learning curve in a conversation with a seller. Learn the industry on the peripherals. Talk to customers first and discover what they are looking for.

What information should be accumulated in a target's file?

After completing basic research, the potential acquirer needs to decide whether moving into this industry is desirable. If that decision is positive, the buyer puts together a target profile on each of the acquisition candidates. This may entail a technology and manufacturing audit to make sure the target's process will survive in the future. A marketing audit may be highly revealing and may support a premium price for the company. These audits are the very beginning of the buyer's due diligence. (See Chapter 6.)

Other information that goes in the target company's file includes annual reports, 10-Ks, D&B credit reports, company fact books and product catalogues, press releases, print advertisements, published articles and executive speeches, and director and officer profiles. *Forbes, Fortune,* the *Wall Street Journal, Financial Week,* and many other publications do summary articles

on industries, especially emerging high-tech industries. Researchers can obtain much of this information and more using Internet search engines such as Google.

At this time the potential buyer must rank targets. What is the best way to do this?

If the buyer's team is using the fit chart or a similar approach, it should now run specific targets through the fit chart and rate them against the buyer's specific weaknesses and strengths (as complements and supplements). The first company evaluated may have a strong marketing force and weak technology, whereas the fifth in line may have the opposite. That might lead a strong marketer to the decision to buy number five, believing that it can be integrated into its own strong marketing and distribution channels.

Who should be contacted at the target company?

Callers should start at the top. The principals contacted may include the CEO, the CFO, or the COO. In a wide-ranging search, the target's directors, outside counsel, accountants, and bankers—both commercial and investment—can also be contacted. Contacting a target's outside counsel is usually unproductive. First, attorneys, because of attorney-client confidentiality, are not supposed to give out any information; and second, they have their own agendas. They may want to initiate the deal so that they will continue to be retained, and will try to discourage you. The same thing, to a lesser extent, applies to the target's accounting firm.

Try to structure any conversation with a principal officer or owner so as to avoid a direct turndown. One technique that has been honed to a fine art by executive headhunters is to call target executives and ask if they know of an executive who might be available. They might then offer themselves. It works the same way in an acquisition search. Tell a prospective target that you are considering making an entry in the industry either by a de novo entry (a start-up) *or* an acquisition and ask if they know anyone for sale. That is sure to get their attention; their response might just be, "Well, if the price is right, *we* might be for sale."

If the acquisition proposal involves a relatively small subsidiary of any relatively large company, the contact person should be the senior vice president of corporate planning or corporate development—but don't call the division head unless it's public knowledge that the unit is on the block. Even then, it's best to deal with planning at either the corporate, sector, or business unit

level rather than with the executives who might be intimately affected by a sale, and may, in fact be trying to buy the operation themselves.

What should the caller say—and not say?

The target company's nonowner management will be impressed with any expertise demonstrated by the caller. The target profile will give the buyer more information leverage because the target will often know very little about the buyer. To set the management more at ease, the buyer or its agent should provide some useful information about itself or the target's management.

The ultimate goal of the initial conversation is to set up a meeting to discuss working together or teaming up through a possible business combination. The business combination could be a merger, acquisition, or joint venture. The more broadly you define it, the better. No mention of price should be made at this stage.

Where should buyer and target representatives meet at this early stage?

The parties have to agree on a mutually satisfactory meeting place. Visiting the target may start the rumor mill, and that can hurt a deal. On the other hand, the buyer can get a better feel for the target's operations and personnel if it is at least eyeballed. But the usual practice of a large group of suits visiting a target should be discouraged.

An alternative would be meeting at the offices of an investment banker or law firm, or in neutral territory, such as a conference room at a hotel. Try not to meet in airline clubs, hotel lobbies, restaurants, or other public places—it starts the rumor mill and can create competition for the target.

A good cover for meetings is the prospect of a joint venture or a supplier or customer relationship. This plays very well where a company is not on the block, but be careful of any out-and-out misrepresentation.

Having agreed on a meeting place, it will benefit the buyer to have obtained the target's financials prior to the meeting. (We assume you already have all of the sales literature, D&B reports, and, if it's a public company, the 10-Ks.) The target may ask you to sign a confidentiality agreement at this point. By all means do so, but make sure you are protected. (See Chapter 7 on acquisition agreements.)

With such information in hand, an agenda for the meeting can be easily set. (And it's important to have a written agenda at least for your side so that all of the important subjects will be covered.)

Also important is to recast the target's historical financials into a more easily read form such as common-size, trended, and industry comparisons. When these are done, it is easy to compile a list of questions identifying the financial and operating anomalies for discussion.

What are common-size, trended, and industry comparisons?

These are invaluable techniques for identifying problems and isolating areas for potential profit improvement. As such they can be an important tool in the negotiation process and can influence price.

Instead of looking at absolute numbers, common-size and trended analyses uncover hard-to-detect anomalies that may exist in a company's balance sheet or income statement. Common-size financial statements utilize a common denominator such as net worth for balance sheets; all the components are entered as percentages and are easily compared year to year. The operating statements use net sales as a base and the cost components as percentages of that base. Trended analyses use an appropriately selected base year or period that represents 100 for all items of the balance sheet and income statement. All dollar amounts for each item on the balance sheet and income statement in years subsequent to the base year are expressed as a percentage of the base year amounts. The anomalies become immediately apparent as areas for further investigation and become part of the negotiating process because they must be explained.

For example, if accounts receivable and inventory combined accounted for 50 percent of total assets during the first year and increased to 62 percent the second year while sales only increased a meager 2 percent, the company may be boosting sales by serving customers who have poorer credit. As a result, the buyer will want to double-check the collection period for accounts receivable by interviewing customers and suppliers. Although this is a point of stress for sellers—especially the customer interviews—and generally can take place only at advanced stages in the negotiation, the buyer should let the seller know that it is something that is expected.

What else can be accomplished at the first meeting with a target?

The meeting should give the buyer a sense of the company and its operations, whether there are any skeletons in the seller's closets that may preclude a deal, and whether the chemistry is right if there are to be any continuing management relationships. The meeting should give the target management a

sense of the buyer and its management and the benefits to target managers if they are to stay and to owners if they are to continue to own.

There must be *reasons* for combining companies corporately and operationally. In most cases these are discussed in the early meetings, unless the buyer wants to keep plans confidential. However, if the target is a public company, this is a sensitive area; whether and how a company discloses or conceals future plans can trigger legal exposure.[11]

For public companies, it is good to have copies of any financial analysis performed by investment bankers, even if issued by a regional house. Also ask the sellers if they ever had a management consultant in to run a survey. If they did, ask to see the report, no matter how old it may be. Ask to see the outside auditors' management letters or reports. Find out if the company has changed auditors within the past five years, and if so, get permission to talk to the old auditors.

It is important in this meeting for the seller to avoid making exaggerated claims. When representations are made that later prove untrue, buyers can sue, citing fraudulent conveyance, also called fraudulent transfer.[12] (For more on fraudulent conveyance, see Chapter 4.)

BROKERS AND FINDERS

Much of the preceding material describes in-house search processes, but many companies seeking to expand by the M&A route—especially the opportunity makers—use finders and brokers. A broker or a finder exists to help locate businesses that might suit the acquisition criteria of a buyer.

What's the difference between a broker and a finder?

A *broker* is an agent and a legal fiduciary with all the responsibilities and restrictions that those terms imply in law. Brokers may represent only one side in a transaction. The rules governing their behavior have been established over the past five centuries by the common law. Many M&A matchmakers have lost their fees because they were ignorant of these rules. Generally, brokers represent sellers and as fiduciaries must try to get a top price for a company. There can be civil or even criminal lawsuits if the broker favors buyers over sellers in a transaction or secretly takes money from a buyer to knock down the price.

Finders, as opposed to brokers, are not agents of or for anyone. They are not fiduciaries. Unlike brokers, they represent the deal rather than one of the parties. Finders can be paid by both parties or by either party, even without the knowledge of the other. Finders, however, must be careful not to negotiate, for

it is the act of negotiation that takes them out of the finder class, creates an act of agency, places them squarely in the broker category, creating fiduciary responsibilities and putting them under regulatory supervision. Depending on the locale, a business opportunity or business chance broker's license may be required. Payments to a finder, if that person is deemed an unlicensed broker, can cause an entire transaction to violate securities laws, giving investors a right to undo the deal.[13]

How is negotiation defined?

Generally, if the finder merely introduces the prospective purchasers and otherwise acts only to maintain contact between the parties to make the introduction effective, no negotiation will be deemed to have taken place. If, however, the finder gets involved in determining the purchase price and stands in the place of the buyer or seller, a court may decide that the finder negotiated. In a few states, the courts have stated that they cannot see how a finder can operate *without* negotiating, and automatically lump finders in the brokers category.

What is an intermediary?

People who are foggy about the distinction between brokers and finders try to solve their dilemma by billing themselves as *intermediaries.* This straddling category can be risky because intermediaries are supposed to negotiate, and a *negotiating intermediary* is an agent of one party or the other in a contemplated transaction unless both sides have agreed—usually in writing—that the negotiation is in their common interest. Clients of brokers who turn into intermediaries should be cautious; the intermediary, depending on the language of the agreement, may be relieved of the fiduciary duties of a broker.

Are business brokers and finders regulated, and if so, by whom?

In general, the act of the brokering and finding of businesses is not regulated. The fact that some investment bankers or stockbrokers have passed exams run by the National Association of Securities Dealers (NASD) or that they are regulated by the Securities and Exchange Commission (SEC) does not apply to their work finding and brokering the sale and purchase of businesses—even very large businesses.

What does matter is regulation by state and local authorities, including local real estate boards, of acts of business brokerage. This includes the

licensing and regulation of business opportunity and business chance brokers. Generally, such brokers deal with independent retail service businesses, such as bars, car washes, dry cleaning shops, gas stations, and taxi licenses.

Many states have passed laws regulating the activity of such brokers, or allow cities and counties to enact local ordinances to regulate their activity. Often state regulation is combined with the regulation of real estate brokerage activity, usually through the acts of examination, licensing, inspection of the broker's premises, and so on. Lawyers, contrary to popular belief, are seldom exempted from the requirement to be licensed as business opportunity brokers if they negotiate the sale of a business and collect a success fee as a result.

No state has yet regulated the activity of the nonnegotiating finder, with the possible exception of New York. In a long series of tortured court decisions and supporting legislation, New York law has said, in effect, that no finder can perform the act of finding without negotiating. Finders are, therefore, ipso facto agents and brokers involved in the transfer of property, and, in order to comply with a specific provision of New York's statute of frauds, anyone (except attorneys) dealing in the transfer of property must have an agreement in writing to collect a finder's or a broker's fee.

Other states have similar statutes of fraud, but do not bar collection under general concepts of contract law. They rely on concepts such as *quantum meruit,* in which the services of the finder, even in the absence of a written contract, must be valued and paid for so as not to unjustly enrich a buyer or seller from the services provided. In New York State, however, *quantum meruit* recovery not supported by a written contract is strictly barred. As a result, many frauds have been perpetuated on unknowing finders and brokers. Even major investment banking houses have been cheated out of legitimately earned fees for failure to have a verbal fee agreement reduced to writing.

Many states try to regulate finders and brokers if real estate is involved in the transaction—even if the real assets, which include leases, are only a tiny fraction of the assets transferred. Prodded by real estate brokers, many suits result. Most are lost by the state and the brokers, but once in a while one slips through, especially when an out-of-state finder or broker does deals across a state line. In this case it is extremely important that the finder or broker not perform any act that a court could consider to be negotiation, and make sure that the principals do all of the negotiating and acknowledge it in writing.

What about fees?

Fees are not regulated by anyone. They are what the traffic will bear. In the 1920s, the investment bankers were happy to get straight commissions for

the shares exchanged. But when the conglomerate merger boom began in the 1950s, Lehman Brothers dreamed up the Lehman scale, also known as the M&A formula, or the Wall Street rule. This is a sliding scale—generally the 5-4-3-2-1 formula: 5 percent of the first $1 million of the price of the transaction, 4 percent of the second, 3 percent of the third, 2 percent of the fourth, and 1 percent of the balance. In recent years, some finders have been charging 10 percent, or asking for a retainer.[14] Alternatively, some use a fee scale that is based on Lehman, but with some difference. Variations include the double Lehman, of 10-8-6-4-2, and the stuttering Lehman of 55-44-33. Commission amounts for a $5 million transaction would be $300,000 (overall percentage 6 percent) under the double Lehman; $201,000 (overall percentage 4.2 percent) under the stuttering Lehman; and $150,000 (overall percentage 3 percent) under the traditional Lehman.

Many finders who bill themselves as investment bankers, though they have only a Web site and a phone number, try to get Lehman scale for their services, but usually are forced to settle for a flat fee or to sue. Some have successfully sued and collected very large fees using the Lehman scale.

Fees are sometimes modified by the type of deal. If it is a hostile deal, the bankers might be involved for many months or even years. Hostile deals carry much larger fees than friendly deals, especially when they are successful. If the deal is complicated, fees can be even higher. In hostile deals, many a tendering corporation has failed to reach a final fee agreement with the bankers, lawyers, consultants, accountants, and others that may be involved until after the deal is closed, and then there are problems, which sometimes wind up in court with a judge or jury making the fee decisions. Juries are particularly tough on finder's and broker's fees that are legally due; they find it hard to believe that the simple act of introducing a potential seller to a potential buyer is worth a large sum.

The fee payment often depends on the final price paid in the deal. But determining the final price in a complicated, highly leveraged deal with equity kickers such as detachable warrants and rights, simultaneous spin-offs or spinouts, or sales of subsidiaries can be very difficult, and can lead to disagreements about the price of the transaction. As a result, more and more fees are negotiated ahead of time in round numbers. "If we do the deal you get $3 million" might be the language that one hears today for a prospective $400 million deal. That works out to 0.75 percent. In such an arrangement, whether the buyer pays $300 million or $500 million, the finder or broker gets a $3 million fee for initiating the transaction.

Bidding wars tend to increase investment banker fees. For example, in

2005, investment banking fees rose 13.5 percent to a total of $63.09 billion.[15] Arbitrageurs can also benefit from bidding wars.

What is an arbitrageur?

An *arbitrageur* buys equity in a company with a plan to sell it in a short period of time, because the arb is betting on the likelihood of some near-term event, such as a bidding war. Ideally, arbitrageurs sit on the sidelines, making bets on a reality they do not control. In the real world, some can succumb to the temptation to obtain and trade on nonpublic inside information. (See Chapter 12 for more on insider trading.)

Do investment banking firms pay fees to finders for bringing them prospective deals?

Yes. Most investment banking firms will pay a finder's fee to someone who brings them a deal. Some successful firms are happy to pay in the area of 10 percent of their fees for a successful lead.

What is a mere volunteer?

Volunteers usually cannot collect finder's or broker's fees. For instance, a so-called telephone book finder, one who sends out thousands of letters suggesting acquisition targets to major corporations and does little or nothing more, is considered a *mere volunteer* and cannot collect a fee when one of the companies is actually acquired, for lack of proof that the volunteer was, in fact, the procuring cause of the transaction. Many legitimately earned fees have been defeated using the mere volunteer defense—especially in the oil business. Some degree or sign of invitation or consent is necessary to establish a compensable finder or broker relationship.

As a buyer, how can you protect yourself against claims for payment of unwarranted finder's or broker's fees?

There are several ways:

- Keep a log of inquiries and correspondence.
- Answer every unsolicited letter by rejecting offers of companies, and keep copies of all such correspondence. But be truthful. Don't

say you're not interested if you are. It can cost you dearly. If you have already been working on an opportunity someone brings to you, say so, and document it.

- Keep your contacts up to date. Finder A refers your company to a business, then you drop the deal for six months, until Finder B revives your interest and you acquire. You may owe fees to both Finder A and Finder B.
- Find out whether your state regulates business opportunity brokers. If the broker is not licensed, you can defeat an illegitimate claim for a fee if the broker negotiates. But you must prove that he or she negotiated, and that is often hard to do.
- Research whether the state you're in has a statute of frauds. If so, the broker or finder may need a written agreement to collect a fee.
- Be aware that you may invite a possible RICO (Racketeer Influenced and Corrupt Organizations Act) claim and triple damages if you try to defraud the broker or finder of a legitimately earned fee. Also, brokers or finders may be able to obtain punitive damages if you conspire to defraud them of a legitimate fee.

As a finder or broker, how can I ensure that I will be paid if I do a deal?

You can take action in a number of ways:

- Get some early writings on the record that you expect to be paid, that you are not a mere volunteer or are doing it out of friendship. A retired president of Joy Manufacturing worked for a year and a half to bring about the sale of his best friend's coal-mining business for $275 million. He had two filing cabinets of correspondence in support of his efforts. But the "best friend" testified that the finder had never told him he expected to be paid and there was nothing in all those filing cabinets that stated he expected to be paid. Always get a written agreement that includes specific language on the fee schedule.
- Keep a log of conversations, especially telephone conversations. If you are out of the office when a client calls, make sure that whoever answers the phone makes a written record of the call and make sure the date, time, and message are recorded and are legible. Transcribe any electronic messages into a file. Such message logs can be powerful evidence in some courts.

- Get the other side to agree that it won't close unless you get paid. A mutually signed written agreement is best, but at least get your expectations in writing by mailing or e-mailing your request.
- Insist on participating in all meetings of the principals. If you are acting as a finder, be sure to clearly state in writing (via e-mail or mail) that you are there as a facilitator and not a negotiator. If possible, get a letter from the other side that you did not negotiate.
- Get some paper on the record. The more the better. Be sure to save your telephone bills, train and plane tickets, hotel receipts, and so on.
- Sue the second you're not paid—and be sure to get a lawyer with some experience in finder's and broker's cases.

If a broker advises a buyer about an opportunity that another broker closes, which broker should be paid?

Such contingencies should be spelled out in the broker or finder agreement. If they are not so defined, however, the fee award depends on the circumstances. If the second deal succeeds because it is restructured, then the second, successful intermediary, not the first, should be paid. If the second one merely presents the same transaction, then the first one is entitled to the fee—or the buyer can arrange for the fee to be split.

ROLE OF INVESTMENT AND COMMERCIAL BANKS IN M&A

What is an investment banker?

An *investment bank* is neither an investor nor a bank.[16] That is, it does not invest its own money and it does not act as a repository for other people's funds. Rather, an investment bank is an intermediary between saving and investing. It is a financial institution that helps operating companies raise debt and equity capital in securities markets.

Investment banks often raise capital on behalf of a company, or issuer, through underwriting—the purchase and resale of a new offering of equity securities. Investment banks also help market the new stock, distributing it to

retail stockbrokers, often through a retail brokerage unit affiliated directly with the bank. These brokerage units in turn may have securities analysts who make, buy, sell, or hold recommendations on particular issues.

Also, some investment bankers get retained to locate entire businesses to buy, and so act as finders or brokers. They may also represent stockholder groups wanting to sell a company or one or more of its divisions, generally by a practice known as an auction. But it is nothing like the usual auction; it usually winds up in an extensive negotiation as to price and terms. As a result they might get a series of fees—finder's, broker's, consulting, origination, and underwriting fees, and, if the securities are exchanged through their offices, a security broker's fee. Finally, investment bankers may render a fairness opinion on a transaction, if they are not the ones getting a commission from it.

Together all these fees are called investment banking fees. In times of heavy merger activity, these fees bring in as much revenue as their retail stock brokerage, and in some years, considerably more.

Investment banking firms typically have research departments that issue reports on equities. Prior to 2002, those firms would often include reports on client companies, including positive reports on companies whose stock the firm was bringing to market. Since passage of the Sarbanes-Oxley Act, such potential conflicts of interest have come under heavy regulation.[17]

What is the difference between the M&A services offered by an investment bank and those offered by a commercial bank?

In today's increasingly competitive market for financial services, the differences in M&A services offered by investment banks, and at least some commercial banks, have narrowed considerably. As commercial banks' lending margins have shrunk in recent years, they have sought other sources of income. Many targeted the M&A advisory business as an extension of their work in financing highly leveraged transactions (HLTs). In the process many banks developed capabilities that rivaled those of the most prestigious investment banking houses.

The commercial banks' capabilities include developing strategies for their clients with respect to acquisitions, recapitalizations, and leveraged buyouts, and acting as dealer-manager in tender offers, as well as rendering fairness opinions (as long as they are not the ones receiving a fee on a transaction).

Investment banks, meanwhile, began to invade some of the commercial

banks' traditional territories by offering to commit their capital in the form of bridge loans to their M&A clients to underwrite at least a portion of the cost of an acquisition, something that commercial banks may not do.

Although they compete against each other, commercial and investment banks often need each other. It is not unusual for them to share clients. For example, a Wall Street investment banker might act as an advisor to a company doing an acquisition. The Wall Street firm might then take its deal to a commercial bank to obtain an acquisition bridge loan plus the long-term senior bank debt needed to refinance existing senior debt, later refinancing some or all of the bank debt with a private placement and/or an underwriting of senior or subordinated public debt. (See Chapter 4.) Because commercial banks have not been that involved with stock market operations, they have been spared the temptations faced by investment bankers to engage in illegal activity. For virtually every big name on Wall Street has been tainted with one scandal or another. Several big-name firms were dragged into the Enron scandal for analyst conflicts of interest.

Is it illegal for a bank to fund one offeror for a company and to advise another, competing offeror?

No, it is not illegal. But many commercial and investment banks avoid such situations for fear of offending one or the other client or creating the impression of a conflict of interest. However, it is more common for commercial banks to offer financing for more than one offeror if an advisory role is involved. In this case a commercial bank will attempt to erect firewalls between the different areas of the bank involved to avoid the possibility of a breach of confidence with respect to confidential information. Tie-in deals, where a client is given a loan only if the client also buys the bank's advisory services, are illegal. However, some clients prefer a bank as an advisor if it is also willing to commit its capital in the form of a loan to facilitate the acquisition.

What is merchant banking?

Merchant banks are essentially the same as investment banks, but the term *merchant* is often associated with first-round financing, particularly in international markets. These banks deal mostly in international finance, long-term loans for companies, and underwriting. They do not provide regular banking services to the general public. (See Chapter 4.)

Are U.S. commercial banks involved in merchant banking?

Yes, but still in only a limited way. Many commercial banks have subsidiary venture capital groups that invest in both the equity and mezzanine securities in promising ventures, including start-up companies and leveraged buyouts. Commercial banks, in their role as investment bankers, are also increasingly becoming partners with their clients by purchasing both the equity and mezzanine securities of companies to whom they also provide senior debt.

GENERAL REGULATORY CONSIDERATIONS FOR BUYERS

What sorts of legal issues can be raised by an acquisition?

Depending on the facts and nature of the transaction, an acquisition may require compliance with federal, state, or local statutes or regulations in a variety of areas. The most common areas triggered by the transaction itself include laws with respect to antitrust, securities, employee benefits, bulk sales, foreign ownership, and the transfer of title to stock or assets. Some of these laws require only routine acts to achieve compliance, which can be attended to relatively late in the acquisition process. Other laws pose potential regulatory barriers that must be considered before proceeding with a given acquisition plan.

Furthermore, in acquiring any company, the acquirer may inherit the acquired company's legal liabilities. This kind of legal exposure is not just legal exposure arising from the transaction, but from the simple fact of doing business in a risky and litigious world. For an overview of the more general kind of liability exposure, see Chapter 6 on due diligence.

How does the purchaser determine what regulatory barriers may exist for a proposed transaction?

Unless the purchaser is a veteran in the relevant field of business it plans to enter, the purchaser must engage legal counsel familiar with the field or skilled in the legal complexities of acquisitions.

Can the failure to identify and satisfy all regulatory requirements in a timely manner delay or kill a deal?

Yes. In some cases, one or both parties must obtain the consent or approval of the responsible agency or agencies before the transaction can be consummated. Failure to do so can result in penalties or even rescission of the contract covering the transaction. This "out" is discussed in Chapter 7, at Section 9.1.

What regulatory hurdles must be surmounted in consummating an acquisition?

Each industry has its own regulatory maze, but some general areas can be identified:

Antitrust. Certain business combinations require filings and clearances with the Federal Trade Commission (FTC) or Department of Justice (DOJ) under the Hart-Scott-Rodino Act.[18]

Disclosure to shareholders. Companies that sell securities to the general public (called public companies) have a myriad of rules to consider, including filings to the SEC. These rules are discussed in Chapter 10.

Environmental concerns. Corporate acquisitions can trigger state law requirements relating to cleanup of sites contaminated by hazardous wastes. A buyer can also be hit under both federal and state law with cleanup costs even if it had no involvement in or knowledge of the pollution. In *United States v. Bestfoods,* the Supreme Court ruled that a parent corporation may be held derivatively liable under the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA) for the polluting activities of its subsidiary, if the corporate veil is misused to accomplish fraud or other wrongful purposes on the shareholders' behalf.[19] Regulators obtained orders requiring responsible parties to spend nearly $230 million to clean up contaminated sites and to reimburse the Superfund more than $300 million for federal cleanup costs.

Commercial banks acting as trustees are also exposed. (See Chapter 6 on due diligence.) Also, certain federal or state laws preclude the transfer by one party to another of environmental operating permits issued in the name of the first party. *Foreign (non-U.S.) ownership of U.S. assets.* Federal law prohibits or requires reporting of ownership of

certain industrial or commercial assets by non-U.S. citizens or entities, including U.S. flag–registered vessels and aircraft, telecommunications facilities, newspapers, nuclear power plants, and certain defense industries. (See Chapter 15 on international transactions.)

U.S. ownership of foreign assets. Many non-U.S. governments closely regulate the ownership by noncitizens of domestic corporations or assets and reserve the right to refuse transfer of any such property to a noncitizen.

European Commission approval of non-EC transactions. Any merger affecting the economy of Europe may be subject to approval by the European Commission (EC) even if it involves non-EC companies.

Industry concerns. The transfer of title to certain types of industrial or commercial assets may be subject to approval by one or more regulating agencies:

- Airlines (the Department of Transportation)
- Banks and other financial services institutions (Office of the Comptroller of the Currency, the Federal Reserve Board, the Federal Deposit Insurance Corporation [FDIC], the Office of Thrift Supervision [OTS], and various state agencies)
- Insurance companies (state regulatory agencies)
- Public utilities (the Federal Energy Regulatory Commission, the Nuclear Regulatory Commission, and state public utilities commissions)
- Shipping (Federal Maritime Commission)
- Telecommunications facilities (Federal Communications Commission [FCC])

Some transactions require approval from multiple authorities. A good example is the merger of Verizon and MCI. The companies announced their intention to merge in February 2005. The DOJ staff then conducted an eight-month study during which Verizon, MCI, and others supplied millions of documents. In October 2005, the DOJ approved the transaction, subject to a consent decree requiring the newly combined company to lease dark (unused) fiber connections to 356 buildings in several states in the Verizon footprint on the East Coast. That same month, shareholders of the two companies approved the transaction, which had been subject to a competing bid for MCI by Quest. The transaction also had to be approved by state regulators, the FCC, and the EC.

Some of those restrictions may apply to only a portion of the transaction. For example, where there are real property assets in several states, and

only one of the states regulates the transfer of contaminated real property, the parties can structure the transaction to close on the unaffected assets in a timely manner, leaving the affected asset for subsequent transfer upon compliance with applicable law, or excluding it from the acquisition. Alternatively, if the principal purchaser cannot obtain regulatory consents for certain assets, the seller may consider selling those assets to another purchaser.

How can the parties assess the significance of regulatory barriers at the planning stage of an acquisition?

Interested parties should determine early on how likely it is that they will obtain the necessary consents, how long this will take, and how difficult and expensive it will be. When the procedures and the criteria for obtaining consents are well defined, this regulatory audit can be performed relatively quickly and reliably. Avoid flexible or discretionary procedures and criteria for approvals, as these can extend the time and increase the uncertainty of obtaining approvals in a timely fashion.

Remain informed about major regulatory and deregulatory developments in your industry and in target industries of interest to you as a potential acquirer. Regulatory and deregulatory developments can change the business climate dramatically.

In general, and especially where third-party financing is involved, it may be not only imprudent but impossible to proceed with the affected part of the transaction prior to obtaining the necessary approval. Therefore, potential buyers and sellers should be sure at the initial planning stages to provide adequate time and resources for the regulatory compliance effort.

ANTITRUST CONSIDERATIONS FOR ACQUISITIONS

What general antitrust considerations should acquisition planners consider when contemplating an acquisition?

Antitrust practitioners divide corporate acquisitions into three types:

- *Vertical acquisitions*—acquisition of suppliers or customers, which may foreclose markets to competitors.
- *Horizontal acquisitions*—between competitors, which may give monopoly power or cause overconcentration.

EXHIBIT 2-3

Premerger Notification and Waiting Period
Under Hart-Scott-Rodino

(a) Filing
Except as exempted pursuant to subsection (c) of this section, no person shall acquire, directly or indirectly, any voting securities or assets of any other person, unless both persons (or in the case of a tender offer, the acquiring person) file notification pursuant to rules under subsection (d)(1) of this section and the waiting period described in subsection (b)(1) of this section has expired, if—**(1)** the acquiring person, or the person whose voting securities or assets are being acquired, is engaged in commerce or in any activity affecting commerce; and **(2)** as a result of such acquisition, the acquiring person would hold an aggregate total amount of the voting securities and assets of the acquired person—
(A) in excess of $226.8 million*
(B)
(i) in excess of $56.7 million* but not in excess of $226.8 million*; and **(ii)(I)** any voting securities or assets of a person engaged in manufacturing which has annual net sales or total assets of $11.3 million* or more are being acquired by any person which has total assets or annual net sales of $113.4 million* or more; **(II)** any voting securities or assets of a person not engaged in manufacturing which has total assets of $11.3 million* or more are being acquired by any person which has total assets or annual net sales of $113.4 million* or more; or **(III)** any voting securities or assets of a person with annual net sales or total assets of $113.4 million* or more are being acquired by any person with total assets or annual net sales of $11.3 million* or more.

In the case of a tender offer, the person whose voting securities are sought to be acquired by a person required to file notification under this subsection shall file notification pursuant to rules under subsection (d) of this section.

*This text is verbatim from U.S. Code Title 15 Section 18a. These amounts are for 2006. Amounts are adjusted annually. Source: www.ftc.gov/os/2006/01/Section_7AThresholdsfrn.pdf.

- *Other acquisitions*—for example, between firms in different industries, which might remove potential competition or discourage competition by others because of the financial or marketing strength of the resulting firm.

Section 7 of the Clayton Act prohibits a corporation from acquiring stock or assets of another corporation if the acquisition might "substantially

lessen competition or tend to create a monopoly" in any line of commerce in any section of the country. A violation of Section 7 may give rise to a court-ordered injunction against the acquisition, an order compelling divestiture of the property or other interests, or other remedies. Section 7 is enforced by the Antitrust Division of the DOJ and FTC. Thresholds are set annually.

Another federal law that can affect mergers today is the Interlocking Directorate Act passed nearly two decades ago (1990). This law amended Section 8 of the Clayton Act to state that "no person shall, at any time, serve as a director or officer in any two corporations (other than banks, banking associations, and trust companies) that are: A) engaged in whole or in part in commerce; and B) by virtue of their business and location of operation competitors." The provision does not apply if both companies are small (with capital and surplus and undivided profits under a threshold amount subject to annual adjustments, currently at $22.761 million) or if the competitive sales involved are low (if either one has competitive sales of less than $2.2761 million).

In conjunction with the federal laws, there are state laws that can restrict mergers. Under federal law—the McCarran-Ferguson Act, 15 U.S.C. 1011(f)—states are given broad authority to regulate mergers involving insurance companies. States have similar authority in other areas in which the states have special regulatory jurisdiction, such as the alcoholic beverages industry.

Mergers of companies with foreign operations or subsidiaries sometimes require review and approval by foreign governments. In addition, some foreign countries (most notably, Canada) have their own premerger notification programs that may have to be complied with.

HART-SCOTT-RODINO

How does the government gather information about proposed mergers and acquisitions?

The Hart-Scott-Rodino Antitrust Improvements Act of 1976 (the HSR Act) requires the parties to a proposed acquisition transaction to furnish certain information about themselves and the deal to the FTC and the DOJ before the merger is allowed to go forward. The information supplied is used by these governmental agencies to determine whether the proposed transaction would have any anticompetitive effects after completion. If so, in general, they must be cured prior to closing. A mandatory waiting period follows the agencies' receipt of the HSR filings.

What mergers or acquisitions require premerger notification under the HSR Act?

Generally, all mergers and acquisitions that meet certain criteria must be reported under the HSR Act and the related premerger notification rules. See Exhibit 2-3. The "persons" involved include not only constituent corporations, but also any other corporation that is under common control. *Control,* for purposes of the HSR Act, is defined as ownership of 50 percent or more of a company's voting securities or having the contractual power to designate a majority of a company's board of directors. Special control rules apply to partnerships and other unincorporated entities.

What information is required in the HSR premerger notification form?

The form requires a description of the parties and the proposed merger or acquisition, certain current financial information about the parties, and a breakdown of revenues of the parties according to industry codes (North American Industry Classification System).[21] This breakdown of revenues is used by the FTC and the DOJ to determine whether the proposed combination of the businesses would result in anticompetitive effects. The information filed is exempt from disclosure under the Freedom of Information Act, and no such information may be made public except pursuant to administrative or judicial proceedings.

After the premerger notification form has been filed, how long must the parties wait before the merger or acquisition can be consummated?

Where the acquisition is being made by a cash tender offer, the parties must wait 15 days before the purchaser may accept shares for payment. In all other cases, the parties must wait 30 days before the transaction can be completed. If the acquisition raises antitrust concerns, the government may extend the waiting period by requesting additional information from the parties. In that case, the waiting period is extended for 30 days (15 days in the case of a cash tender offer) past the time when the additional information is provided.[22]

The parties may request early termination of the waiting period. Where the acquisition raises no antitrust concerns, the government may grant the request at its discretion.

Are certain mergers and acquisitions exempt from the HSR Act?

Yes. Acquisitions made through newly formed corporate acquisition vehicles are frequently exempt from the reporting requirements of the HSR Act because the vehicle does not meet the size-of-person test; that is, it does not have the threshold amount in gross assets or sales. This is true, however, only where no other person having that amount in gross assets or annual sales owns 50 percent or more of the voting stock of the vehicle or has the contractual power to designate a majority of the vehicle's directors. If the vehicle is not controlled by another person, it will be the only company matched against the threshold size-of-person test. If another company or person does control the vehicle, through either a 50 percent stock ownership or a contractual power to appoint a majority of its directors, that controlling person will be matched against this test. Special rules apply in determining control of partnerships and other unincorporated acquisition vehicles.

Special rules are also used to determine the size of a newly formed corporation, and care must be taken to avoid making contractual commitments for additional capital contributions or for guarantees of the new corporation's obligations until after the formation has been completed.

The assets of a newly formed acquisition vehicle that is not controlled by another person do not include the funds contributed to the vehicle or borrowed by the vehicle at the closing to complete the acquisition.

The HSR Act and FTC rules also provide numerous exemptions for special situations.

How can we tell whether a particular horizontal merger is likely to be challenged by the federal government?

Current administration policy is set forth in the revised Horizontal Merger Guidelines. These guidelines, which have stayed the same for the past 10 years, are reprinted in the back of this chapter.[23]

As in previous guidelines, horizontal mergers are assessed according to a sliding scale of permissiveness. Thus, the less concentrated the industry, the larger is the permissible merger. The index used to measure concentration, the Herfindahl-Hirschman Index (referred to as the HHI), sums the squares of the individual companies' market shares to measure both postmerger share and the growth in market share resulting from the transaction. Levels are:

unconcentrated (under 1,000), moderately concentrated (between 1,000 and 1,800), and highly concentrated (over 1,800). A score is only one factor to be considered. It is not enough by itself to make or break a charge of market concentration.

What might be an example of a merger that would create a highly concentrated industry?

If an industry of five firms having market shares of 30 percent, 25 percent, 20 percent, 15 percent, and 10 percent, respectively, has an HHI score of $30^2 + 25^2 + 20^2 + 15^2 + 10^2$, or 2,250. If the third and fifth firms merge, the resulting score is $30^2 + 25^2 + 30^2 + 15^2$, or 2,650, and the increase in the score would be 400.

Is the HHI analysis conducted on the acquirer's industry only?

No. An HHI analysis must be performed for each distinct relevant market in which both of the merging companies operate.

How likely is it that any given merger will be challenged as being in a highly concentrated industry?

Given basic business demographics, chances are relatively low. In unconcentrated industries (with an HHI below 1,000) the largest four firms have 50 percent or less of the market. Historically, this description fits about 60 percent of U.S. industries. In such unconcentrated industries, the DOJ is unlikely to challenge any merger. In moderately concentrated industries (where the HHI falls in the range of 1,000 to 1,800), the four largest firms normally account for between 50 and 70 percent of the market. This is the case with approximately 25 percent of U.S. companies. Within this range the DOJ will review other factors bearing upon the likelihood of predatory practices. Generally, within this range only mergers that increase the HHI by more than 100 points are likely to be challenged. Thus, for example, the over-100 prohibited zone would be reached in such an industry by a merger of two firms each with a 7.1 percent market share, a 10 percent firm with a 5 percent firm, a 25 percent firm with a 2 percent firm, and a 50 percent firm with a 1 percent firm.[24]

In highly concentrated industries (where the HHI exceeds 1,800), the four-firm concentration ratio will exceed 70 percent. This is true of only

about 15 percent of U.S. companies. Even here, only a merger increasing the HHI by more than 50 points is likely to be challenged. If the merger increases the HHI by between 50 and 100 points, the merger may or may not be challenged. If the increase is above the 100-point threshold, a challenge is relatively likely.

Whirlpool's offer to acquire Maytag is one example. After Maytag shareholders voted in December 2005 to approve a sale to Whirlpool, representatives from Maytag's home state expressed concerns about potential job losses at a plant in Newton, Iowa, but focused mainly on antitrust issues. In a letter of January 12, 2006, to the assistant attorney general for antitrust, Senator Tom Harkin (D-IA) and Representative Leonard Boswell (D-IA) wrote, "Whirlpool is already the largest producer in the appliance industry, and the Maytag acquisition would give them almost 50 percent of the market share. If the acquisition is approved, Whirlpool, GE and Electrolux would together control 90 percent of the market." Press reports about the deal claimed that the combination of Maytag and Whirlpool alone would create a market giant producing half of the nation's dishwashers and more than 70 percent of its clothes washers and dryers. On March 29, 2006, Whirlpool and Maytag announced they had received clearance from the DOJ to complete their proposed merger.

What factors would the DOJ and FTC consider beyond the HHI?

The guidelines express an intent to scrutinize mergers that can in some circumstances confer market power on a single firm, even if that firm does not have a sizable market share. If, for example, the two merging firms had previously sold products that were perceived by a substantial number of customers to be close substitutes for one another, the merged firms could raise prices on one product line and risk only some diversion of sales to its other product line.

Whatever the level of concentration, regulators will challenge any merger that is likely to create or enhance one-firm domination of a market. Thus a leading firm that accounts for 35 percent of the market and that is twice the size of its next largest competitor will normally not be allowed to acquire any firm accounting for even 1 percent of that market.

In addition, analysis of horizontal mergers no longer focuses on the market concentration problem usually associated with monopolies. It considers instead other real-market factors, including the following:

- Ease of entry into the market (the easier it is for new firms to enter the market, the less the likelihood of challenge)
- The availability of out-of-market substitutes (the more readily available, the less prospect there is of collusion)
- The degree to which the merging firms confront one another within the relevant market (if they occupy separate sectors of the market, the merger is less a cause of concern than if they are head-to-head in the same corner)
- The level of product homogeneity (the more homogeneous the product, the easier it is to collude)
- The pace of technological change (the slower the rate of change, the more likely is collusion)
- The importance of nonprice terms (the more important they are, the harder it is to collude)
- The degree to which firms have access to information concerning their competitors' transactions (the more information available, the greater is the likelihood of collusion)
- The size and frequency of orders (the smaller and more frequent, the greater is the likelihood of collusion)
- Whether the industry is characterized either by a history of collusion or by patterns of pricing conduct that make collusion more likely (if it is, the likelihood of a challenge increases)
- Historical evidence of noncompetitive performance (challenge is more likely)

What about vertical or conglomerate mergers?

These are not covered in the new guidelines. Vertical and conglomerate mergers have been relatively free from challenge for the past 25 years.

What about foreign competition?

Market shares are assigned for foreign competitors in the same way they are assigned to domestic competitors. These shares may have to be calculated over a longer period of time to account for exchange rate fluctuations. They may also have to be adjusted to account for import quotas. Finally, market shares may have to be combined if foreign firms appear to be acting in a coordinated or collusive way.

If the FTC and the DOJ either do not investigate a reportable transaction or allow it to proceed after investigation, can the transaction still be challenged afterward?

Technically, the government is not prevented from challenging any merger or acquisition at any time, but challenges are almost unheard of where HSR filings have been made and the waiting period has been allowed to expire or has been terminated. On the other hand, transactions may be challenged in state court, or by private litigants.

CONCLUDING COMMENTS

Planning and finding are only the beginning of the merger process—only two of many stages to come. Up ahead are structuring, due diligence, negotiating, closing, and integration—not to mention all the perfecting that must be done in areas like pensions, labor, and compensation. But although planning and finding might take up only 20 percent of the M&A process, they require fully 80 percent of the energy.

In fact, this phase is a perfect example of the 80/20 law coined by economist Vilfredo Pareto. Buyers, it is worth putting 80 percent of your effort in this important phase. So do your strategic planning. Set up your in-house search program. Hire your brokers, finders, and advisors. And last but not least, study the regulatory factors. All this preparation will pay off down the road.

APPENDIX 2A

Types of Organizational Structure

Functional Organization

Widget Company, Inc.
Accounting function
Distribution function
Engineering function
Manufacturing function
Marketing function

Purchasing function
Sales function
    North
    South
    East
    West

Product/Service Organization

Machine Tools Company, Inc.
Product 1
Accounting function
Distribution function
Engineering function
Manufacturing function
Marketing function
Purchasing function
Sales function
    North
    South
    East
    West

Product 2
Accounting function
Distribution function
Engineering function
Manufacturing function
Marketing function
Purchasing function
Sales function
    North
    South
    East
    West

Product 3
Accounting function
Distribution function
Engineering function

Manufacturing function
Marketing function
Purchasing function
Sales function
    North
    South
    East
    West

Divisional Organization

Modern Industries, Inc.
Division 1

Product 1
Accounting function
Distribution function
Engineering function
Manufacturing function
Marketing function
Purchasing function
Sales function
    North
    South
    East
    West

Product 2
Accounting function
Distribution function
Engineering function
Manufacturing function
Marketing function
Purchasing function
Sales function
    North
    South
    East
    West
Division 2

Product 3
Accounting function
Distribution function
Engineering function
Manufacturing function
Marketing function
Purchasing function
Sales function
    North
    South
    East
    West

Product 4
Accounting function
Distribution function
Engineering function
Manufacturing function
Marketing function
Purchasing function
Sales function
    North
    South
    East
    West

Note: These data points can also be organized as block matrixes (two dimensions—products and functions, or products and territories) or cube matrixes (three dimensions—products, functions, and territories).

APPENDIX 2B

Checklist of Assets

Physical Assets*

Equipment (including computer hardware and software)
    Office equipment
    Plant equipment

Inventory
- Finished
- Work-in-process

Land
Materials
Mines
- Production, reserves, locations, development
- Maps

Real estate
- Branch buildings
- Factory buildings
- Construction in progress

Real estate—Other

Financial Assets*

From Balance Sheet

Financial Assets
- Cash
- Investment securities
- Accounts receivable
- Prepaid income taxes
- Other prepaid expenses
- Deferred charges
- Other financial assets
  - Goodwill
  - Long-term receivables
  - Investments in affiliates
  - Goodwill from previous acquisitions

(*For Banks,* Debt Owed to Bank via Outstanding Loans)

Financial Liabilities and Equity
- Financial Liabilities
  - Accounts payable
  - Debt
  - (*For Banks,* Cash Deposits Held by Bank and Owed by Bank to Customer)

Financial Equity
- Common stock outstanding
- Preferred stock outstanding
- Retained earnings

From Income Statement
Gross Revenues
- Growth trend

Net Revenues
- Growth trend

Off Balance-Sheet Financing (MD&A).

Intellectual Assets

Contracts (if favorable—otherwise, a liability)
- Employment agreements
- Franchise agreements
- Noncompete agreements

Culture
- Reporting relationships (real versus formal)
- Policies and procedures
- [Any other cultural factor not covered elsewhere in this taxonomy]

Marketing Intangibles
- Company name recognition
- Brand name recognition
- Service mark (right to use company signage)
- Trademark (right to use company name)

Production Intangibles
- Copyrights
- Favorable supplier contracts
- Patents
- Product design
- Product quality
- Production costs

Production speed
Productions standards
Software
Trade secrets

Human Assets (People)

Knowledge, experience, competencies, and leadership and/or teamwork ability of each individual below:

Directors (including chairman if separate)
CEO/COO/president
Other senior managers
Sales force
Other employees

(See also Human Resources under Organizational Assets)

Organizational Assets (Activities)

Quality of the "infrastructure" described below

Contracts and commitments

Relating to all human capital and also to eternal relations

(If the contract is unfavorable and/or broken, it can turn from an asset into a liability.)

Primary Functions

Management Systems

Processes for design, production, and supply
Channels for distribution

Inbound logistics (for manufacturing; see also Purchasing under Support Functions)

Receiving
Storing
Material handling
Warehousing
Inventory control

- Outbound logistics
  - Distribution

- Manufacturing Function

- R&D Function
  - Laboratory notebooks
  - Invention disclosure forms

- Sales Function
  - Established territories

Support Functions
- Accounting Function
  - Bookkeeping
  - Treasury
  - Internal auditing
- Communications/Marketing Functions
  - Marketing
  - Public Relations
- Corporate Administrative Function
  - Headquarters administration
- Facilities Function
  - Facilities management
- Finance Function
  - Financing (issuing equity, borrowing debt)
  - Management of funds (opening/closing deposits; lockbox)
- HR Function
- Rewarding and "incentivising" performance
  - Base pay
  - Bonus pay
  - Pensions
  - Benefits
  - Special pay arrangements
  - Recognition programs (awards and honors)
- Retention (Retaining key qualities: relevant knowledge, experience, competencies)
- Recruitment (Seeking relevant knowledge, experience, competencies)
- Termination/Retirement (see also Compensation)
- Performance management

- Career development
- Succession planning
- Training

IT Function

- Hardware, software, and systems for internal communications
  - E-mail
  - Telephones (LAN, WAN, routers, switches)
- Legal Function
  - Compliance programs, including internal code of conduct (see also Regulatory relations in External Relations below)

Internal Financial Controls (See COSO)

- Control Environment (cf. pp. 207 ff. of *Integration* by Lajoux for COSO worksheet)*
  - Appropriateness of the entity's organizational structure, and its ability to provide the necessary information to manage its activities
  - Adequacy of definition of key managers' responsibilities, and their understanding of these responsibilities
  - Adequacy of knowledge and experience of key managers in light of responsibilities
  - Appropriateness of reporting relationships
  - Extent to which modifications to the structure are made in light of changed conditions
  - Sufficiency of numbers of employees, particularly in management and supervisory capacity
- Risk Assessment
- Control Activities
- Information/Communication re finances
- Monitoring

Mission, Vision, and Strategy

- Mission statement
- Vision statement
- Strategic plan document

External Relationship Assets

(If any of these has a corresponding function, see Organizational Assets—Functions)

Customer relations
- Reputation of brands
- Reputation of service
- Major customers (required under SAS131)
- Major geographic areas (SAS131)

Shareholder relations
- Reputation for increasing market share/paying dividends
- Stability of holdings by shareholders

Bondholder relations
- Reputation for repaying debt instruments
- Bond rating

Lender Relations
- Rate of interest charged by lenders
- Credit rating

Supplier relations
- Favorable contracts (see also Production Intangibles)

Community relations
- Community programs

Public relations
- Reputation of company name re public issues—see also Company name recognition under Intellectual Property

- Lobbying (if any) See also Legal under Support Functions

History of fulfilling contracts and commitments.

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*Items with an asterisk appear on the balance sheet. Items without an asterisk do not appear on the balance sheet, or any other traditional financial statement. However, they are usually discussed in the Management Discussion and Analysis section of the 10-K report, along with balance sheet items, especially if they are at risk. Note: This entire list can be used as column D of a spreadsheet with these columns:

(Col. A) Phase 1: Strategy

Subphases (These start and end during the strategy phase.)
- Planning
- Search
- Valuation
- Selection

(Col. B) Phase 2: Transaction

Subphases (These start during the strategy phase and extend through the transaction phase.)
- Financing
- Due Diligence
- Negotiation
- Tax Structuring
- Closing

(Col. C) Phase 3: Integration

Subphases (These start during the transaction phase and extend through the integration phase.)
- Integration Planning
- Integration Communication
- Integration Implementation

(Col. D) "Assets" to Track During All Phases

(Insert list of physical, financial, intellectual, human, organizational, and relational assets.)
For more on this subject, see Chapter 1 and Appendix 2A.

APPENDIX 2C

Revision to the Horizontal Merger Guidelines Issued by the U.S. Department of Justice and the Federal Trade Commission

April 8, 1997

4. Efficiencies

Competition usually spurs firms to achieve efficiencies internally. Nevertheless, mergers have the potential to generate significant efficiencies by permitting a better utilization of existing assets, enabling the combined firm to achieve lower costs in producing a given quantity and quality than either firm could have achieved without the proposed transaction. Indeed, the primary benefit of mergers to the economy is their potential to generate such efficiencies.[1]

Efficiencies generated through merger can enhance the merged firm's ability and incentive to compete, which may result in lower prices, improved quality, enhanced service, or new products. For example, merger-generated efficiencies may enhance competition by permitting two ineffective (e.g., high cost) competitors to become one effective (e.g., lower cost) competitor. In a

coordinated interaction context (see Section 2.1), marginal cost reductions may make coordination less likely or effective by enhancing the incentive of a maverick to lower price or by creating a new maverick firm. In a unilateral effects context (see Section 2.2), marginal cost reductions may reduce the merged firm's incentive to elevate price.

Efficiencies also may result in benefits in the form of new or improved products, and efficiencies may result in benefits even when price is not immediately and directly affected. Even when efficiencies generated through merger enhance a firm's ability to compete, however, a merger may have other effects that may lessen competition and ultimately may make the merger anticompetitive.

The Agency will consider only those efficiencies likely to be accomplished with the proposed merger and unlikely to be accomplished in the absence of either the proposed merger or another means having comparable anticompetitive effects. These are termed merger-specific efficiencies. Only alternatives that are practical in the business situation faced by the merging firms will be considered in making this determination; the Agency will not insist upon a less restrictive alternative that is merely theoretical.

Efficiencies are difficult to verify and quantify, in part because much of the information relating to efficiencies is uniquely in the possession of the merging firms. Moreover, efficiencies projected reasonably and in good faith by the merging firms may not be realized.

Therefore, the merging firms must substantiate efficiency claims so that the Agency can verify by reasonable means the likelihood and magnitude of each asserted efficiency, how and when each would be achieved (and any costs of doing so), how each would enhance the merged firm's ability and incentive to compete, and why each would be merger-specific. Efficiency claims will not be considered if they are vague or speculative or otherwise cannot be verified by reasonable means.

Cognizable efficiencies are merger-specific efficiencies that have been verified and do not arise from anticompetitive reductions in output or service. Cognizable efficiencies are assessed net of costs produced by the merger or incurred in achieving those efficiencies. The Agency will not challenge a merger if cognizable efficiencies are of a character and magnitude such that the merger is not likely to be anticompetitive in any relevant market.[2] To make the

requisite determination, the Agency considers whether cognizable efficiencies likely would be sufficient to reverse the merger's potential to harm consumers in the relevant market, e.g., by preventing price increases in that market.

In conducting this analysis,[3] the Agency will not simply compare the magnitude of the cognizable efficiencies with the magnitude of the likely harm to competition absent the efficiencies. The greater the potential adverse competitive effect of a merger—as indicated by the increase in the HHI and post-merger HHI from Section 1, the analysis of potential adverse competitive effects from Section 2, and the timeliness, likelihood, and sufficiency of entry from Section 3—the greater must be cognizable efficiencies in order for the Agency to conclude that the merger will not have an anticompetitive effect in the relevant market. When the potential adverse competitive effect of a merger is likely to be particularly large, extraordinarily great cognizable efficiencies would be necessary to prevent the merger from being anticompetitive.

In the Agency's experience, efficiencies are most likely to make a difference in merger analysis when the likely adverse competitive effects, absent the efficiencies, are not great. Efficiencies almost never justify a merger to monopoly or near-monopoly.

The Agency has found that certain types of efficiencies are more likely to be cognizable and substantial than others. For example, efficiencies resulting from shifting production among facilities formerly owned separately, which enable the merging firms to reduce the marginal cost of production, are more likely to be susceptible to verification, merger-specific, and substantial, and are less likely to result from anticompetitive reductions in output.

Other efficiencies, such as those relating to research and development, are potentially substantial but are generally less susceptible to verification and may be the result of anticompetitive output reductions. Yet others, such as those relating to procurement, management, or capital cost are less likely to be merger-specific or substantial, or may not be cognizable for other reasons.

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[1] The Agency will not deem efficiencies to be merger-specific if they could be preserved by practical alternatives that mitigate competitive concerns, such as divestiture or licensing. If a merger affects not whether but only when an efficiency would be achieved, only the timing advantage is a merger-specific efficiency.

[2] Section 7 of the Clayton Act prohibits mergers that may substantially lessen competition "in any line of commerce . . . in any section of the country." Accordingly, the Agency normally assesses competition in

each relevant market affected by a merger independently and normally will challenge the merger if it is likely to be anticompetitive in any relevant market. In some cases, however, the Agency in its prosecutorial discretion will consider efficiencies not strictly in the relevant market, but so inextricably linked with it that a partial divestiture or other remedy could not feasibly eliminate the anticompetitive effect in the relevant market without sacrificing the efficiencies in the other market(s). Inextricably linked efficiencies rarely are a significant factor in the Agency's determination not to challenge a merger. They are most likely to make a difference when they are great and the likely anticompetitive effect in the relevant market(s) is small.

[3] The result of this analysis over the short term will determine the Agency's enforcement decision in most cases. The Agency also will consider the effects of cognizable efficiencies with no short-term, direct effect on prices in the relevant market. Delayed benefits from efficiencies (due to delay in the achievement of, or the realization of consumer benefits from, the efficiencies) will be given less weight because they are less proximate and more difficult to predict.

(Excerpted from complete guidelines posted at www.usdoj.gov/atr/public/guidelines/horiz_book/hmg1.htm, as accessed February 7, 2006.)

NOTES

1. Michael Porter, *Competitive Strategy,* (New York: Free Press, 1998). This is the most recent edition of this book, which has gone through more than 60 printings.
2. The senior author of this book described such a system two decades ago. See Stanley Foster Reed, "Corporate Growth by Strategic Planning," *Mergers & Acquisitions* 12, nos. 2, 3, and 4, 1977.
3. The answer to this question is summarized from *The Role of the Board in Corporate Strategy,* (Washington, D.C.: National Association of Corporate Directors, 2006). This is the report of a 38-member group of directors, chief executives, investors, and board advisors, led by cochairs Warren L. Batts, retired chairman and CEO of Premark, International, and Robert Stobaugh, Charles E. Wilson Professor of Business Administration, Emeritus, Harvard Business School.
4. Source of this analogy is Lowell F. Christy, Jr., chairman, Cultural Strategies Institute, Seneca, Maryland.
5. Ikon's 2005 annual report states that it had an active acquisition phase in the 1990s but has spent recent years consolidating its acquisitions. In the 1990s, Ikon made well over 100 acquisitions, bringing its sales levels up to over $10 billion.
6. "Acquisitions are a big part of LarsonAllen's expansion, organic growth, to the tune of 8 to 10 percent a year, is crucial to the firm's success. 'As we move forward, we will continue to look for organic growth but we'll support it with acquisition Nicole Garrison-Sprenger. . . . We won't acquire more than 10 percent of our revenue in any one year.' " "LarsonAllen Acquisition Strengthens Hold in Philadelphia," Minneapolis-St. Paul Business Journal, January 6, 2006.

7. As of February 2006, the firm is going through an initial public offering. Acquisitions arguably helped it achieve the necessary size to do this.
8. "Katun Corporation to Acquire the Toner and Developer Product Assets of Nashua Corporation," Katun Corporation, press release, January 17, 2006, Minneapolis, Minnesota.
9. The list of assets shown in Exhibit 2-1 and Appendix 2B were developed by Alexandra Lajoux for publication in *The Art of M&A Integration,* second edition, (New York: McGraw-Hill, 2006). The list of risks were provided by Stanley Foster Reed based on wheel-and-fit sessions with hundreds of companies over a period of 30 years. Significantly, they are almost identical to the categories in the Enhanced Business Reporting Framework from the Enhanced Business Reporting Consortium launched in 2005 by the American Institute of Certified Public Accountants. The main categories are *competition, customers, technological change, shareholder relations, capital availability, legal, political,* and *regulatory.*
10. For the original paper on this, see Norman Crolee Dalke, *The Delphi Method: An Experimental Study of Group Opinion,* a research paper of the RAND Corporation. For a free download of the paper see www.rand.org/pubs/research_memoranda/RM5888/. RAND is a nonprofit organization to "further promote scientific, educational, and charitable purposes, all for the public welfare and security of the United States of America.
11. See for example *Basic v. Levin* in the cases at the back of this book.
12. The Uniform Fraudulent Transfer Act, like the other "uniform" acts, was drafted by the National Conference of Commissions of Uniform State Laws (Uniform Law Commissioners), a group of law professors, former judges, and lawyers who have volunteered to set these standards. The Uniform Law Commissioners propose uniform laws to the states for ratification. To date 41 states have ratified this act. For a list of recent cases, see fraudulenttransfer.com, a Web site operated by the law firm of Riser Adkisson LLP, Atlanta, Georgia.
13. Wendy Fried, "The Secret World of Finders," *Inc. Magazine,* March 2005.
14. Ibid., p. 23.
15. Dealogic, quoted in a Reuters report, "2005 Investment Banking Fees Up 13.5 Percent," dated January 17, 2006.
16. The answer to this question is an updated version of text that appeared in *The Art of M&A Financing: Sources and Instruments for Growth,* (New York: McGraw-Hill, 1999), p. 224.
17. Section 501 of the Sarbanes-Oxley Act requested the National Association of Securities Dealers and the New York Stock Exchange to propose rules for curbing conflicts of interest, and in May 2002, the SEC approved them. See www.sec.gov/rules/final/33-8193.htm.

18. See *Promoting Competition, Protecting Consumers: A Plain English Guide to Antitrust Laws,* (Washington, D.C.: Federal Trade Commission). Undated. Available as of February 2006 at www.ftc.gov/bc/compguide/index.htm.
19. *United States v. Bestfoods,* 542 U.S. 51 (1998).
20. See www.ftc.gov/os/2006/01/Section_8Thresholdsfrn.pdf.
21. For a description of the planned North American Industrial Classification System to be current in 2007, see www.census.gov/epcd/naics07/index.html.
22. See www.law.cornell.edu/uscode/html/uscode15/usc_sec_15_00000018–a000.html.
23. For the full text of the guidelines, see www.usdoj.gov/atr/public/guidelines/horiz_book/hmg1.html.
24. This discussion of the HHI index is based on a Hogan & Hartson (Washington, D.C.) client memo dated April 2, 1992. For a financial point of view on HHI, see J. Fred Weston, "The Payoff in Mergers and Acquisitions," in M.L. Rock, R.H. Rock, and M. Sikora (eds.), *The Mergers and Acquisitions Handbook,* (New York: McGraw-Hill, 1994), pp. 51–76, esp. p. 69.

CHAPTER 3

Valuation and Pricing

INTRODUCTION

No factor counts more than price in closing a transaction, yet very few operating executives know the worth of their own company, much less anyone else's. They may know the prices at which their publicly traded competitors' securities are traded (whether on a stock exchange or through market makers in an over-the-counter market), and they may be able to calculate the premiums paid for those securities. Those prices, however, are only one indicator of value—and not always the best one.

Even assuming that a reported price paid for a security is a proxy for value, the first problem is to decide which quoted price to use—as there are several possibilities. Should one use the current closing price or the average price over the past year, month, week, or day? In the M&A area the 20-day figure—the average of the closing prices of the security over the past 20 trading days—is often used. Why, no one knows.

Furthermore, few people consider the other factors that have affected the price of a company's securities. Are takeover rumors inflating the price? Are there overhanging blocks that have depressed the price? What is the trading supply? Has an investment banker—or worse yet a deal principal—been front-running on the stock? These things not only can happen—they do.[1]

The problems are even more complex in the case of a privately held company, because many transfers of shares in a closely held company are

made for noneconomic purposes. In each case, it is the set of circumstances behind the sale that must be divined and the effect on the price assessed.

The first thing a buyer should do is discover why the target is for sale. Sellers should also have their reasons well thought out.[2] Yet some buyers seem reluctant to begin a negotiation with the question: "Why is the company for sale?"

Although most entrepreneurs know how to start businesses and run them profitably by watching costs, many fail to bring that same circumspection to the acquisition process. As buyers, entrepreneurs often overpay. Further, in selling their businesses, many owners have little idea how to price them. In general, however, buyers are far more skilled at buying than sellers are at selling. Why? Because most buyers buy many times and most sellers sell only once or twice.

Whether a target company is privately owned, with many stockholders, or a so-called close corporation, in which only a handful of individuals or business entities own the stock (as in many family-owned companies); whether it is publicly traded on one or more of the major exchanges or traded in the over-the-counter market; whether it is a division of an operating company or simply a product line, its valuation demands and deserves sophistication.

Many valuations are poorly done and are challenged in court—sometimes years later. Undervaluations can occur when an investment banker leads the buying group of a family-owned or family-controlled company. In other cases, overvaluations by sellers often result from factual distortions and deliberate misstatements, and by failure to reveal significant negative facts. There is even outright fraud from time to time in setting prices for nonpublic companies. The senior author has been an expert witness in many cases where the value was based on distortion of historical numbers. We are not talking about a few percentage points, but rather valuations off by as much as 300 percent.

Professional help in establishing value is not only a smart precaution; in some circumstances, it is required for the proper discharge of fiduciary duties, and that means employing a professional appraiser. Professional appraisals do not include valuations made by investment bankers (usually called *fairness opinions*) who have a stake in the outcome of the transaction.

The appraiser's job is to estimate fair market value. That value is determined by a willing buyer and a willing seller, both being adequately informed of the relevant facts, and neither being under any compulsion to buy or sell.

To facilitate readers' understanding of this key area, this chapter first focuses on various valuation methods, and then develops the details of a typical discounted cash flow (DCF) analysis to discover the net present value (NPV) of the target. This has been the method of choice in valuation for many

decades, beginning with the World Bank's adoption of it in the late 1960s.[3] The second part of the chapter applies DCF in a practical way to explain how LBOs are priced. (Although the term *LBO* evokes images of "Gordon Gekko" 1980s' style M&A, in reality any acquisition that involves debt financing falls into this camp.) Once the price is determined, it must be expressed in the pricing clauses of the acquisition agreements. The final portion of this chapter gives guidance in this area.

VALUATION FUNDAMENTALS

Are valuation and price interchangeable?

To quote the classic words of Arnold Bernhard, founder of Value Line, "Value often differs from price."[4] *Value* is the intrinsic worth of an asset, while *price* is what a buyer has actually paid for it. Value essentially exists only in the minds of people, while price reflects real-world market behavior. Yet, the only criteria we frequently have available to estimate an asset's intrinsic value is past prices. It's circular thinking that can befit many philosophical debates.

But clearly that's not our objective. We only wish to stress that the price paid for an asset, or a company for that matter, does not always reflect its underlying value, but rather the zone of agreement between a buyer and a seller at a given point in time. Mixing valuation and price is an easy trap to fall into—we inadvertently do it ourselves more often than we care to admit. However, it is important to at least keep in mind how the two are differentiated.

Why bother with valuation? Why not turn it over completely to the experts?

Valuation is a highly specialized process. For this reason, it requires the knowledge and experience of specialists. At the same time, however, valuation requires oversight—and good common sense—from the buying and selling management teams. The senior author has spent many days in court as an expert witness testifying as to the value of companies and parts of them. He has been astonished at the range of values that the representatives of top-ranking investment banking, accounting, consulting, and in some cases professional appraisal firms can come up with in valuing the same entity. Under these circumstances, judges and in some cases juries have a tough job making decisions—especially in cases where representatives of two of Wall Street's

top investment banking firms have testified to widely differing values—say, as much as 50 percent on values of $100 million and more.

Most valuations should be operations based. When investment bankers get involved in valuations, the results are often flawed: investment bankers tend to set asset-based values because they understand assets but not operations. Estimates from owners, especially owner-managers, are also frequently seriously flawed because their providers are either overenthusiastic about their prospects or are consciously distorting the numbers. In either case, these insiders' projections are easily attacked in court. That is why values in any major transaction involving the sale of a company should be backed up by the opinions of professional appraisers, whose primary business is appraising the value of operating companies and their subsidiaries.

Specialists abound in the valuation of going concerns. There are consultants and firms that value only printing companies, supermarket chains, knitting and weaving mills, paper mills, mining properties, shipping companies, or railroads. Other firms value only engineering consulting firms, accounting firms, or law practices. Banks, insurance companies, and even investment banking firms and stockbrokers have their valuation specialists with a similarly narrow scope.

Business brokers value and sell smaller businesses or stores—taverns, dry cleaning establishments, restaurants, car washes, and all kinds of franchised operations depending heavily on goodwill value—well into eight figures. And they may be worth it. It's a tricky business; for instance, many stand-alone restaurants with cash-based customers underreport sales and earnings by substantial amounts. When they are put up for sale, the tax returns don't agree with the projected revenues. This same thesis may also apply to stand-alone supermarkets and supermarket chains, or to subsidiary units of larger companies that may not have kept an accurate set of books and may not have been audited by an outside independent auditor for many years.

This gives many buyers the idea that it is okay to pay much more than the going multiple of book for such enterprises. They don't always realize that stand-alone restaurants and chain restaurants that report sales and profits accurately may not be such a steal. Many inexperienced buyers coming from middle management and loaded with large cash settlements from their severance deals—very often a buyout of their postemployment benefits—think they're dealing with one of those stores and often overpay. (A word to the wise: always use legal counsel experienced in M&A. For example, an acquirer purchasing shares of a so-called C corporation of one of these businesses may unknowingly be inheriting a potential back-tax liability that could rival the acquisition price.) Buyers should remember that by law the broker represents the

seller and is out to maximize the price received. While it *is* possible to cut a deal with a broker to represent a buyer rather than a seller and buy at the lowest price, such brokers are hard to find in the business brokerage area.

Tech and biotech industries can see overnight swings in valuation as investors alternately embrace or flee stocks as they learn the results from scientific testing or regulatory approval. In the United States, approval by the Food and Drug Administration can save or savage a pharmaceutical company stock, particularly for a smaller company with a small product range. In the biotechnology arena, companies can attract capital for years without earnings or even revenue. But the same gleam-in-the-eye companies can attract $100 million in an initial public offering (IPO), and substantially more in a secondary offering, can have a poor clinical result, and then lose hundreds of millions of value in a single day. (For example, on November 1, 2005, Nabi Biopharmaceuticals fell 72 percent, wiping out $550 million of equity value, after a late-stage clinical trial of a promising vaccine to prevent dangerous bacterial infections failed to meet its goals.) When the IPO market shies away from these losers, they are forced into other modes of survival, and "What would have been IPOs . . . become M&A transactions."[5]

Even sophisticated investors in conservative industries such as banking can get carried away. That happened when several of the country's largest commercial banks acquired technology-focused investment banking boutiques in the late 1990s. Among the examples include FleetBoston's $800 million buyout of Robertson Stephens in 1998; NationsBank's $1.2 billion acquisition of Montgomery Securities in 1998; and Chase Manhattan's $1.4 billion purchase of Hambrecht & Quist in 1999. In each case, the acquisition was intended to extend the acquirer's investment banking services into new economy sectors such as telecommunications, information technology, and the Internet. However, the targets had cut many of the nontechnology businesses that had fueled their respective rises, leaving them more exposed when the tech crash hit. In the case of Robertson Stephens, for instance, the firm posted a profit of $206 million in 2000, but lost $61 million in 2001. Fleet began cutting jobs at Robertson Stephens and put the subsidiary on the selling block. Few potential acquirers emerged, and Fleet shut down the unit—even as Robertson Stephens' senior management tried to put together a buyout.[6]

What about valuation rules of thumb?

These are tempting, but they can be treacherous. For example, a few years ago, supposedly knowledgeable people said, "Any good tech-based company

is worth at least three times its annual sales," or "Never pay more than 80 percent of net worth." These statements are often wrong because they are based on past numbers and transitory trends of only a few deals on a local or industry basis. As such, they frequently do not reflect the fact that similar companies in different parts of the country or even slightly different end markets can have very different levels of profitability. Consider construction equipment rental companies: a business in the fast-growing Atlanta market, which also benefits from near year-round good construction weather, will likely use its equipment fleet substantially more than a similarly sized business in a slower-growing, more seasonal market such as Detroit.

Even worse, history is plentiful with valuation rules of thumb that really made no business sense. Here are just three examples:

- *Biotech.* In the 1980s, capital rushed into biotech concerns, the valuations of which were often based on a multiple of the number of Ph.D.s who worked there. This rule of thumb eventually proved untrue as biotech values fell and could not get back up.
- *Telecommunications.* The Telecom Act of 1996 drew massive investment into CLECs (competitive local exchange carriers). One often-used valuation measure was the number of equipment switches these companies owned. Meanwhile, the manufacturers of such equipment increasingly were financing the sales of switches to the CLECs. In effect, the CLEC could borrow money from the manufacturer to buy a switch, which in turn increased the CLEC's perceived enterprise value by a multiple of the equipment purchased. It was circular thinking that never got out of the loop.
- *Web sites.* Even early in this decade, many acquirers aggressively bought Internet Web sites at $100 per MUU, or monthly unique user. The logic was that once the buyer crafted a sustainable revenue model each user had an annuity value analogous to a per-subscriber valuation for cable companies. The senior author of this book himself was overconfident in this valuation measure, investing heavily to build a site that later proved to have substantially lower value as a generation of do-it-yourself Web site builders arose.

In all three of these cases, these valuation rules of thumb emerged due to lack of current profitability, and low visibility into future profitability. And in all three cases, reliance on the rule of thumb proved unwise. An old-fashioned, asset-oriented community banker would have done a better job in sizing up the potential for many of these deals.

What about risk?

Risk, like beauty, is in the eye of the beholder. To a firm with very substantial funds either on hand or easily available, money is worth considerably less than it is to a cash-short firm. Financial economists call this the *utility function.* Its proof is found in the assumption that being cash-short makes one risk-averse. Neither rational individuals nor firms run by them will risk their entire net worth on a double-or-nothing flip of a coin. They might risk a third or even half of their net worth, but would most likely require a disproportionate return—one higher than the mathematics of the risk would dictate—and find no takers.

Very wealthy individuals and cash-rich firms give disproportionate odds the other way. They become risk loving. That is one reason why many cash-rich companies constantly overpay for acquisitions. According to one study published in the *Journal of Finance,* acquisitions by cash-rich firms destroy 7 cents in value for every excess dollar of cash reserves held. Cash-rich firms are more likely to make diversifying acquisitions, and their targets are less likely to attract other bidders. The totality of historical results studied shows that mergers in which the bidder is cash-rich are followed by abnormal declines in operating performance.[7]

Risk is an important factor in many valuation methods, particularly in DCF analysis. In some cases, it takes a great deal of sophistication to discover, pre-acquisition, just what is and is not considered truly "cash" in order to perform a DCF analysis and quantify the risk.[8] Where historical cash flow numbers are lacking, buyers in hot areas—such as genetic engineering—seem to look at companies as commodities. What others paid per employee seems to have emerged as a proxy for risk.

Impounded in the utility function is a long string of indeterminates. They outline a buyer's or seller's response to any of hundreds of risk factors that are revealed as part of the due diligence process. Risk factors include the history of similar deals, both in the buying company and in the industry; the future expected inflation rate, including the expected risk-free interest rate; the present and possibly future costs of capital to the buyer; the possibility of noncyclical downturns in the economy; the loss of key people; technical and market obsolescence factors; the possibilities of 9/11-type disasters; and so on. In order to lower risk, more buyers are willing to pay a premium to an owner who agrees to stay and manage the company for a minimum of two years.[9]

For public companies—those trading on an exchange—the capital asset pricing model (CAPM) divides risk into two categories: (1) *systematic risk,*

or risk that cannot be diversified away because it is inherent in the ups and downs of the securities markets; and (2) *specific risk,* or risk inherent in the operation of the company itself. Many investors assume that systematic risk can be estimated by the firm's *beta,* a number that describes its volatility—how closely the stock follows the ups and downs of the public stock markets. A firm's *alpha,* as opposed to its beta, is its specific rather than its systematic risk. It derives from how efficiently the firm is managed compared to others of the same kind.

Most betas use the S&P, a measurement of the average movements of prices of 500 widely held common stocks multiplied by the number of shares issued. The S&P 500 is considered a measurement of average stock market performance because the shares represent over 70 percent of the total value of all the common stocks traded in the public markets (145 industrial and utilities, 128 consumer, 86 information technology and telecom, 84 financial, and 57 health-care companies of the several thousand publicly traded companies in the public market).

A firm with a beta of 1.0 tracks the market exactly. For years, the beta of Motorola was held to be 1.0 by some who tracked stock prices and compiled and sold beta information. They said that the price of Motorola stock followed the market exactly, and thus inferred that the systematic risk for investment in Motorola stock was zero. Motorola holders who believed in betas could then relax and think only of the future of mobile devices and Motorola's positioning and forget about market risk because there was little or nothing they could do about it.

In contrast to Motorola, another stock had a beta of 1.5. It moved faster than the market in both up and down markets and was therefore considered by those who believe that a stock's beta is a proxy for market risk to be half as risky as old 1.0-beta Motorola.

In pricing out nonpublic companies—that is, companies whose stock is not traded publicly—some appraisers, trying to apply CAPM methodologies, seek out comparables, public companies that look like the candidate operationally. They then borrow the betas of those companies in assessing the systematic risk component of total risk.

There are four things wrong with this. First, true operational comparables between traded and nontraded companies are difficult to find, although it is possible to develop averages of betas of operationally similar companies. Second, selecting the particular beta to be used is a very real problem because there are five or six different beta series published, all based on timing differences. Third, if a high beta represents high risk, it should also correlate with

high return. Yet it seldom does, even with manipulation of timing differences. Fourth, some analysts say flatly that both betas and standard deviations penalize funds and firms for variations in upside performance.[10]

Betas should not be used in assessing risk. A beta is simply a descriptor of the volatility of a particular stock over some arbitrary time period in relation to the volatility of the market itself and does not properly describe systematic risk except for very short and usually unusable time periods. As with IBM, betas for many stocks change with time. For example, the electrical utility company American Electric Power (AEP) had been considered a defensive, low beta stock for years. Then it entered the merchant energy business and took on substantial debt. AEP's historic beta no longer reflected the company's new risk profile. Likewise, many technology stocks, such as Google, are so new to the market they have insufficient price history to establish a reliable beta.

Anyone who uses a beta as a proxy or a major component of risk in setting a purchase or selling price is taking a major chance of being wrong.

What is discounting?

In the sixth or seventh grade your teacher probably taught you that a $1 investment, when compounded at 6 percent interest, will have a future value of $2 in 12.4 years, as that original $1 has earned and added $1 in interest. What the teacher did not teach was the reciprocal corollary: that $2 to be paid out 12.4 years from now, when discounted at 6 percent, has a present value of only $1 today. Most M&A investments revolve around projecting how much the investment will yield over some preset time horizon and factoring the uncertainties into the discount rate. The business of estimating M&A investment risk involves including in the discount rate the certainties and uncertainties of receiving a future stream of earnings or cash flows from your M&A investment. The lower the certainty, the higher the discount rate; the higher the certainty, the lower the discount rate.

What are hurdle rates?

A *hurdle rate* is the discount rate, usually set by the board of directors or other major powers in a corporation, that must be applied to a projected earnings stream to determine whether the investment is likely to generate at least a minimally acceptable return. If the expected return does not exceed the hurdle rate, the investment is unlikely to be approved. Most companies set the

hurdle rate as equivalent to their own cost of capital. (See the calculation in Exhibit 3-1.) Special situations then call for documented reasons to add points to the discount rate—for inexperience in the field, for high deviation rates on historical earnings for the target or its industry, or for other risk-related reasons.

For example, in dealing with Scott Paper's planners a few years back, the senior author discovered that Scott had developed different hurdle rates for entries into different industries that coincided with the comfort level of the executive corps' personal feelings about the industry, which, upon investigation, turned out to coincide with their familiarity with the industry. This approach appears rational but is not at all a proper proxy for risk because those assessing the risk were not necessarily the ones who would be managing the acquisition. As a result, Scott Paper at that time was notorious for making bad acquisitions.

Are historical figures useful in assessing risk?

Generally not. However, if the industry is well defined and the target has good numbers compared to its competitors, historical figures can be useful. One measure of risk is the deviation of past comparative reported earnings of the target: low deviation, low risk; high deviation, high risk. However, for some acquirers, unexplained variabilities in sales, cash flows, and executive or customer turnover might be far more important than variability in accounting-based earnings in assessing the risk of entry. In general, though, the higher the standard deviation of historical financial variables, such as pretax earnings, the higher the risk, and the higher the discount rate that an acquirer will apply to the target's projected earnings.

But remember: financial history doesn't just happen; it is created by the people who write about it. The legally permissible variations in accounting methodologies available to corporations in the United States are legion. Moreover, they often depend on the personal proclivities and experience of the corporate comptroller and staff, and may or may not have been consistently applied over the past periods. The quality of any earnings history is only as good as the accounting processes that created the record. *Consistency, uniformity,* and *comparability* are the watchwords of good accounting practices. Only the establishment of a sophisticated audit trail will reveal the effect of accounting changes on the accuracy of historical reporting of accounting-based earnings. Activity-based costing can also help buyers and sellers alike perceive value accurately.

EXHIBIT 3-1

Estimating the Cost of Capital

Any for-profit operation is worth the present value of its future earnings stream taken out to infinity and discounted back to today at a rate that approximates the risk. Most valuators use the company's cost of capital as a proxy for the discount rate or to compute the opportunity cost of an acquisition. The *historical* cost of capital, which may include sunk costs, may be quite different from the *marginal* cost of capital—the rate that would be used to compute the NPV of the earnings stream of a contemplated acquisition. We will deal here only with the marginal rate, weighted for the percentage used to effect the acquisition.

	Weight (%)	Cost (%)	Risk Premium (%)	Weighted Cost (%)
Cost of debt	30	7.5	2.5	3.00
Cost of preferred	20	10.0	—	2.00
Cost of equity	50	20.0	—	10.00
Net pretax cost of capital				15.00

Notes:

- This model uses a risk-free rate of 7.5 percent.
- Most cost-of-capital rates are after-tax models, but this one is pre-tax since the analytical methods described in the text lump and deduct all interest payments whether short or long term.
- The risk premium is derived from market expectations, which are driven by two factors: (1) supply and demand for similar funds in the marketplace, and (2) financial risk, which factors in increased risk associated with post-acquisition increased debt-to-equity ratios.
- The use of retained earnings has been lumped with equity, although its cost is usually 5 to 10 percent less than the cost of new equity, reflecting the saved costs of marketing and underwriting.

PRICING OUT

The Replacement Value Method (RVM)

If a target appears to be profitable but information is lacking as to the components that produce the profit, the only valid method of pricing is replacement cost. Once replacement cost has been established, the buyer's cost of capital is used to discover what kinds of earnings or cash flows must be achieved to justify the investment using the IRR or DCF methods.

The Investment, or Average Rate of Return, Method

Let us assume that you are offered your choice of two different franchised restaurants in a shopping center that is to be torn down in six years. Which should you buy?

EXHIBIT 3-1 (Continued)

Cash Price	Store A—$60,000		Store B—$72,000	
Year	After-Tax Profit	Sales	After-Tax Profit	Sales
1	$10,000	$20,000	$33,000	$45,000
2	10,000	20,000	10,000	22,000
3	10,000	20,000	8,000	20,000
4	10,000	20,000	1,000	13,000
5	10,000	20,000	1,000	13,000
6	10,000	20,000	1,000	13,000
Averages	$10,000	$20,000	$9,000	$21,000

The averaging process assumes that straight-line depreciation is used over the six-year life of each store, and no salvage value is taken at the end. Dividing the initial investment by two gives the *average* investment. For project A that is $30,000; for project B, $36,000. The average rate of return for project A is thus 33.33 percent ($10,000/$30,000), while that for project B is only 25 percent ($9,000/$36,000). Store A is obviously a better investment than Store B.

A variation on the above is to use the original investment rather than the average investment. The average rates of return for Store A and Store B would then be 16.67 and 12.50 percent, respectively; again, the Store A deal looks better.

The Payback Method

In the previous example, the original investment in Store A would be paid back in exactly three years ($20,000 × 3 = $60,000). Store B presents some problems in analysis as it is based on what is known as a *mixed stream* of returns. At the end of the third year, $87,000 will have been paid back. This is more than required if the firm has established a three-year payback hurdle for such acquisitions. The payback period is therefore 2.25 years. For many managers this would be a better buy because the payback period to fully recover the original investment is significantly shorter. For many, this means less risk and is preferred even though the return on investment (ROI) is lower than it is for Store A.

The IRR Method

The ABC Warehousing Company is considering buying out a competing warehousing firm and would like to fully recover its investment in four years when it expects to get $120,000 for it when the firm merges into a larger company.

Their hurdle rate on all investments has been established at 10 percent. They have projected that they will have after-tax profits of $7,000, $8,000, and $8,000 on the acquisition. Will this investment meet their objectives? The answer is yes. The IRR, or internal rate of return, for the investment is 10.29 percent. Here it is graphically.

The Market Value Method

	Price	Earnings per Share	P/E
Comparable A	$40.00	$2.00	20
Comparable B	62.50	2.50	25
Comparable C	45.00	3.00	15
Comparable D	20.00	1.00	20
Comparable E	30.00	1.50	20
Average			20

This kind of analysis has been the standard for investment bankers for many years and is still required in a due diligence inquiry. It is more indicative than determinative as it has been displaced by the discounted cash flow–derived NPV method.

The Comparable Net Worth to Market Value Method

	Adjusted Book	Price	Multiple
Comparable A	$40	$80	2.0 ×
Comparable B	20	30	1.5 ×
Comparable C	30	75	2.5 ×
Comparable D	30	45	1.5 ×
Comparable E	20	50	2.5 ×
Average			2.0 ×

If the adjusted net worth or book value of the target is $15 per share, then the proper value or price will be $30.

The Discounted Cash Flow Method

Following is an example of a relatively sophisticated computerized program to yield NPV for a target company. The program was developed by the Alcar Group and is sold by the Hyperion Solutions Corporation (hyperion.com). Please note that the printout is only for the most likely scenario. The most optimistic and the most pessimistic scenarios, normally an integral part of analysis, do not appear.

EXHIBIT 3-1 (Continued)

Income Statement for Sample Company: Most Likely Scenario

($ in Millions)	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
Sales	$1,934.5	$2,032.0	$2,235.2	$2,414.0	$2,558.9	$2,712.4	$2,875.1
Cost of goods sold	1,435.2	1,529.9	1,698.8	1,834.7	1,842.4	1,844.4	1,955.1
Gross profit	499.3	502.1	536.4	579.4	716.5	868.0	920.0
Salary expense	156.2	169.3	109.5	118.3	125.4	132.9	140.9
Selling expense	54.3	57.8	55.9	60.4	64.0	67.8	71.9
Administrative expenses	87.2	93.5	148.2	125.2	251.0	365.7	377.8
Total SG&A expense	297.7	320.6	313.6	303.8	440.4	566.4	590.6
Other operating income	0.5	1.2	0.9	0.9	0.9	0.9	0.9
Depreciation expense	49.3	55.1	57.5	61.0	64.0	66.1	68.1
Operating profit	$152.8	$127.6	$166.3	$215.4	$213.1	$236.3	$262.3
Interest income	0.0	0.0	8.7	20.5	33.0	47.4	64.2
Interest expense: Sched. debt	N/A	N/A	16.0	16.0	16.0	16.0	16.0
Total interest expense	15.4	17.6	16.0	16.0	16.0	16.0	16.0
Less: Interest capitalized	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Interest expense	12.4	14.6	13.0	13.0	13.0	13.0	13.0
Gain on sale of assets	6.5	7.3	0.0	0.0	0.0	0.0	0.0
Other non-operating income	32.4	36.3	40.2	43.1	45.0	45.0	45.0
Earnings before taxes	$179.3	$156.6	$202.2	$266.1	$278.0	$315.7	358.5
Provision for income taxes	67.1	23.4	70.2	92.9	91.8	102.5	114.4
Extraordinary items	0.0	(2.8)	0.0	0.0	0.0	0.0	0.0
Net income	$112.2	$130.4	$131.9	$173.2	$186.3	$213.3	$244.1
Preferred dividends	4.1	4.3	4.5	4.7	5.1	5.1	5.1
Income available for common	$108.1	$126.1	$127.4	$168.5	$181.2	$208.2	$239.0
Common dividends	$12.5	$13.4	$14.1	$57.2	$61.5	$70.4	$80.6

Balance Sheet for Sample Company: Most Likely Scenario

($ in Millions)	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
Cash	$4.3	$17.8	$24.3	$30.0	$34.7	$39.6	$44.8
Marketable securities	4.1	70.9	166.9	268.2	385.3	522.3	673.1
Accounts receivable	357.9	397.6	420.4	440.4	456.6	473.8	492.0
Raw materials	73.0	75.7	78.3	80.7	82.5	84.5	86.7
Work in progress	182.6	189.2	200.2	209.8	217.7	225.9	234.7
Finished goods	109.5	113.4	120.5	126.7	131.7	137.1	142.7
Total inventories	365.1	378.3	399.0	417.2	431.9	447.6	464.1
Other current assets	43.7	43.7	43.7	43.7	43.7	43.7	43.7
Total current assets	$775.1	$908.3	$1,054.3	$1,199.5	$1,352.2	$1,527.0	$1,717.7
Gross PP&E excl. int. cap.	769.8	798.1	844.2	882.7	910.4	934.9	955.6
Cum. forecast interest cap.	N/A	N/A	3.0	5.8	8.4	10.8	13.0
Less: Accum. depreciation	276.5	269.9	293.7	312.3	329.2	341.2	341.3
Net property, plant, and equip.	493.3	528.2	553.5	576.1	589.5	604.5	627.4
Goodwill	52.9	46.5	46.5	46.5	46.5	46.5	46.5
Other intangibles	4.5	3.3	3.3	3.3	3.3	3.3	3.3
Other assets	22.6	42.3	42.3	42.3	42.3	42.3	42.3
Total assets	$1,348.4	$1,528.6	$1,699.9	$1,867.7	$2,033.9	$2,223.5	$2,437.2
Accounts payable	$145.9	$192.7	$221.1	$246.2	$266.5	$288.0	$310.7
Current portion L-T debt	12.4	11.8	24.9	25.2	25.9	26.6	27.4
Income taxes payable	17.3	17.5	16.4	21.7	21.5	24.0	26.8
Other current liabilities	71.6	71.6	71.6	71.6	71.6	71.6	71.6
Total current liabilities	$247.2	$293.6	$334.0	$364.7	$385.4	$410.2	$436.5
Total L-T debt	323.7	335.9	340.0	350.0	360.0	370.0	380.0
Deferred income taxes	87.3	98.2	108.9	122.7	136.4	151.5	168.4
Other liabilities	22.6	14.2	15.0	15.0	15.0	15.0	15.0
Total liabilities	$680.8	$741.9	$797.9	$852.4	$896.8	$946.7	$999.9
Preferred stock	37.9	39.4	41.4	43.4	45.4	47.4	49.4
Common stock and paid-in cap	612.4	620.3	620.3	620.3	620.3	620.3	620.3
Retained earnings	17.3	127.0	240.3	351.7	471.4	609.1	767.6
Total liabilities and equity	$1,348.4	$1,528.6	$1,699.9	$1,867.7	$2,033.9	$2,223.5	$2,437.2
Unused debt capacity (UDC)	$35.3	$98.6	$153.1	$213.2	$278.3	$355.1	$445.4
UDC plus mkt. securities	$39.4	$169.5	$320.1	$481.4	$663.6	$877.4	$1,118.4

EXHIBIT 3-1 (Continued)

Funds Flow Statement for Sample Company: Most Likely Scenario

($ in Millions)	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Net income	$130.4	$131.9	$173.2	$186.3	$213.3	$244.1
Depr. exp. excl. int. cap.	55.1	57.5	60.8	63.6	65.5	67.3
Depr. exp. on cum. int. cap.	N/A	N/A	0.2	0.4	0.6	0.8
Less: Interest capitalized	3.0	3.0	3.0	3.0	3.0	3.0
Incr. in deferred inc. taxes	10.9	10.7	13.8	13.7	15.2	16.8
Incr. in other liabilities	(8.4)	0.8	0.0	0.0	0.0	0.0
Incr. in debt: Scheduled	12.2	4.1	10.0	10.0	10.0	10.0
Net bk. value of ret. assets	8.1	20.9	18.3	20.0	20.2	14.0
Incr. in accounts payable	46.8	28.4	25.0	20.3	21.5	22.8
Incr. in curr. port. L-T debt	(0.6)	13.1	0.3	0.7	0.7	0.7
Incr. in income tax payable	0.2	(1.1)	5.3	(0.3)	2.5	2.8
Proceeds from sale of common	7.9	0.0	0.0	0.0	0.0	0.0
Proceeds from sale of pf. stk.	1.5	2.0	2.0	2.0	2.0	2.0
Total sources of funds	$261.1	$265.3	$306.0	$313.7	$348.5	$378.4
Fixed capital investment	$98.1	$100.7	$98.9	$94.4	$98.2	$102.0
Additions to goodwill	(6.4)	0.0	0.0	0.0	0.0	0.0
Additions to intangibles	(1.2)	0.0	0.0	0.0	0.0	0.0
Incr. in other assets	19.7	0.0	0.0	0.0	0.0	0.0
Incr. in cash	13.5	6.5	5.7	4.6	4.9	5.2
Incr. in mkt. securities	66.8	96.0	101.3	117.1	137.0	150.7
Incr. in accts. receivable	39.7	22.8	20.0	16.2	17.2	18.2
Incr. in raw materials	2.7	2.6	2.3	1.9	2.0	2.1
Incr. in work in progress	6.6	11.0	9.7	7.8	8.3	8.8
Incr. in finished goods	3.9	7.1	6.2	5.0	5.3	5.7
Total incr. in inventories	13.2	20.7	18.2	14.7	15.6	16.6
Preferred dividends	4.3	4.5	4.7	5.1	5.1	5.1
Common dividends	13.4	14.1	57.2	61.5	70.4	80.6
Total uses of funds	$261.1	$265.3	$306.0	$313.7	$348.5	$378.4

Cash Flow Statement for Sample Company: Most Likely Scenario

($ in Millions)	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Sales	$2,032.0	$2,235.2	$2,414.0	$2,558.9	$2,712.4	$2,875.1
Cost of goods sold	1,529.9	1,698.8	1,834.7	1,842.4	1,844.4	1,955.1
Gross profit	502.1	536.4	579.4	716.5	868.0	920.0
Salary expense	169.3	109.5	118.3	125.4	132.9	140.9
Selling expense	57.8	55.9	60.4	64.0	67.8	71.9
Administrative expenses	93.5	148.2	125.2	251.0	365.7	377.8
Total SG&A expense	320.6	313.6	303.8	440.4	566.4	590.6
Other operating income	1.2	0.9	0.9	0.9	0.9	0.9
Depreciation expense	55.1	57.5	61.0	64.0	66.1	68.1
Operating profit	127.6	166.3	215.4	213.1	236.3	262.3
Depr. exp. excl. int. cap.	55.1	57.5	60.8	63.6	65.5	67.3
Depr. exp. on cum. int. cap.	N/A	N/A	0.2	0.4	0.6	0.8
Funds from opers. before tax	182.7	223.7	276.4	277.0	302.4	330.4
Cash income taxes	19.5	65.8	85.3	84.3	93.5	103.8
Funds from opers. after tax	$163.2	$157.9	$191.2	$192.7	$208.9	$226.6
Increm. working cap. invest.	19.4	22.6	13.6	15.6	13.7	14.4
Fixed capital investment	98.1	100.7	98.9	94.4	98.2	102.0
Additions to goodwill	(6.4)	0.0	0.0	0.0	0.0	0.0
Additions to intangibles	(1.2)	0.0	0.0	0.0	0.0	0.0
Proceeds (af. tax) asset sale	15.4	20.9	18.3	20.0	20.2	14.0
Cash flow from operations	$68.7	$55.5	$97.0	$102.7	$117.1	$124.2
Cash flow from operations	$68.7	$55.5	$97.0	$102.7	$117.1	$124.2
Interest expense: Sched. debt	N/A	16.0	16.0	16.0	16.0	16.0
Total interest expense	17.6	16.0	16.0	16.0	16.0	16.0
Interest expense (after tax)	10.6	9.8	9.8	9.8	9.8	9.8
Non-operating inc. (af. tax)	33.5	48.9	63.6	78.0	92.4	109.2
Non-operating sources	(8.4)	0.8	0.0	0.0	0.0	0.0
Non-operating uses	19.7	0.0	0.0	0.0	0.0	0.0
Proceeds from sale of common	7.9	0.0	0.0	0.0	0.0	0.0
Preferred dividends	4.3	4.5	4.7	5.1	5.1	5.1
Net cash provided	$67.1	$91.0	$146.1	$165.8	$194.7	$218.5
Common dividends	13.4	14.1	57.2	61.5	70.4	80.6
Funding surplus (deficit)	$53.7	$76.9	$89.0	$104.4	$124.3	$138.0
Funding surplus (deficit)	$53.7	$76.9	$89.0	$104.4	$124.3	$138.0
Incr. in curr. port. L-T debt	(0.6)	13.1	0.3	0.7	0.7	0.7
Incr. in debt: Scheduled	12.2	4.1	10.0	10.0	10.0	10.0

EXHIBIT 3-1 (Continued)

Cash Analysis Statement for Sample Company: Most Likely Scenario

($ in Millions)	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Net income	$130.4	$131.9	$173.2	$186.3	$213.3	$244.1
Plus: Depr. exp. excl. int. cap.	55.1	57.5	60.8	63.6	65.5	67.3
Depr. exp. on cum. int. cap.	N/A	N/A	0.2	0.4	0.6	0.8
Extraordinary items	(2.8)	0.0	0.0	0.0	0.0	0.0
Interest expense	14.6	13.0	13.0	13.0	13.0	13.0
Provision for income taxes	23.4	70.2	92.9	91.8	102.5	114.4
Less: Non-operating profit	36.3	48.9	63.6	78.0	92.4	109.2
Gain on sale of assets	7.3	0.0	0.0	0.0	0.0	0.0
Cash income taxes	19.5	64.8	85.3	84.3	93.5	103.8
Funds from opers. after tax	$163.2	$157.9	$191.2	$192.7	$208.9	$226.6
Plus: Incr. in accounts payable	46.8	28.4	25.0	20.3	21.5	22.8
Incr. in income tax payable	0.2	(1.1)	5.3	(0.3)	2.5	2.8
Less: Incr. in cash	13.5	6.5	5.7	4.6	4.9	5.2
Incr. in accts receivable	39.7	22.8	20.0	16.2	17.2	18.2
Incr. in raw materials	2.7	2.6	2.3	1.9	2.0	2.1
Incr. in work in progress	6.6	11.0	9.7	7.8	8.3	8.8
Incr. in finished goods	3.9	7.1	6.2	5.0	5.3	5.7
Total incr. in inventories	13.2	20.7	18.2	14.7	15.6	16.6
Cash from operating cycle	$143.8	$135.4	$177.5	$177.1	$195.2	$212.1
Less: Fixed capital investment	98.1	100.7	98.9	94.4	98.2	102.0
Additions to goodwill	(6.4)	0.0	0.0	0.0	0.0	0.0
Additions to intangibles	(1.2)	0.0	0.0	0.0	0.0	0.0
Plus: Proceeds (af. tax) asset sale	15.4	20.9	18.3	20.0	20.2	14.0
Cash flow from operations	$68.7	$55.5	$97.0	$102.7	$117.1	$124.2
Less: Non-operating uses	19.7	0.0	0.0	0.0	0.0	0.0
Plus: Non-operating sources	(8.4)	0.8	0.0	0.0	0.0	0.0
Non-operating inc. (af. tax)	33.5	48.9	63.6	78.0	92.4	109.2
Cash bef. fin. cost and ext. fin.	$74.1	$105.2	$160.6	$180.7	$209.5	$233.4
Less: Interest expense (after tax)	10.6	9.8	9.8	9.8	9.8	9.8
Preferred dividends	4.3	4.5	4.7	5.1	5.1	5.1
Common dividends	13.4	14.1	57.2	61.5	70.4	80.6
Cash bef. external financing	$45.8	$76.9	$89.0	$104.4	$124.3	$138.0
Plus: Incr. in curr. port. L-T debt	(0.6)	13.1	0.3	0.7	0.7	0.7
Incr. in debt: Scheduled	12.2	4.1	10.0	10.0	10.0	10.0
Proceeds from sale of pf. stk.	1.5	2.0	2.0	2.0	2.0	2.0
Proceeds from sale of common	7.9	0.0	0.0	0.0	0.0	0.0
Incr. in mkt. securities	$66.8	$96.0	$101.3	$117.1	$137.0	$150.7
Proceeds from sale of pf. stk.	1.5	2.0	2.0	2.0	2.0	2.0
Incr. in mkt. securities	$66.8	$96.0	$101.3	$117.1	$137.0	$150.7

Financial Ratios for Sample Company: Most Likely Scenario

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
Profit Performance Ratios							
Gross profit margin (%)	25.810	24.710	24.000	24.000	28.000	32.000	32.000
Change in net income (%)	N/A	16.221	1.153	31.317	7.538	14.497	14.467
Return on sales (%)	5.800	6.417	5.901	7.175	7.279	7.863	8.491
Return on equity (%)	17.818	17.449	15.327	17.821	17.063	17.347	17.589
Return on assets or inv. (%)	9.022	9.407	8.334	9.796	9.638	10.030	10.417
Return on net assets (%)	11.047	11.643	10.372	12.173	11.892	12.299	12.690
Leverage Ratios							
Debt/equity ratio (%)	59.393	51.800	47.206	43.064	39.509	36.117	32.911
Debt/total capital (%)	37.262	34.124	32.068	30.101	28.320	26.534	24.762
Equity ratio (%)	46.700	48.888	50.626	52.040	53.674	55.292	56.948
Times interest earned (×)	12.448	9.727	13.447	17.442	18.190	20.546	23.221
Activity Ratios							
Days in receivables	N/A	67.854	66.785	65.072	63.974	62.602	61.307
Days in payables	N/A	40.391	44.460	46.487	50.781	54.858	55.886
Inventory turnover	N/A	4.116	4.371	4.496	4.339	4.194	4.289
Fixed asset turnover	N/A	3.847	4.038	4.190	4.340	4.487	4.583
Total asset turnover	N/A	1.329	1.315	1.292	1.258	1.220	1.180
Liquidity Ratios							
Quick ratio	1.482	1.656	1.831	2.025	2.274	2.525	2.772
Current ratio	3.136	3.094	3.156	3.289	3.508	3.723	3.935
Per-Share Data							
Earnings per share	$8.07	$9.41	$9.51	$12.58	$13.52	$15.54	$17.84
Change in EPS (%)	N/A	16.65	1.03	32.27	7.51	14.91	14.82
Primary EPS	8.07	9.41	9.51	12.58	13.52	15.54	17.84
Fully diluted EPS	8.07	9.41	9.51	12.58	13.52	15.54	17.84
Dividends per share	0.93	1.00	1.05	4.27	4.59	5.25	6.01
Cash flow per share	N/A	5.13	4.14	7.24	7.66	8.74	9.27
Book value per share	47.70	56.61	65.20	73.63	82.70	93.14	105.14

EXHIBIT 3-1 (Continued)

Financial Ratios for Sample Company: Most Likely Scenario (Continued)

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
Valuation Ratios							
Change in share. val./share	N/A	N/A	7.93	10.12	(0.86)	3.66	3.33
Share. value per share (PV)	N/A	N/A	40.11	50.23	49.37	53.03	56.36
Oper. profit margin (P) (%)	7.899	6.280	7.439	8.924	8.326	8.712	9.123
Threshold margin (%)	N/A	7.664	6.325	7.278	8.695	8.118	8.472
Threshold spread (%)	N/A	(1.384)	1.115	1.646	(0.369)	0.594	0.650
Incremental profit margin (%)	N/A	(25.846)	19.035	27.486	(1.638)	15.139	15.971
Increm. threshold margin (%)	N/A	2.999	6.774	5.270	4.881	4.639	4.482
Increm. threshold spread (%)	N/A	(28.846)	12.261	22.216	(6.519)	10.500	11.490
Value Drivers							
Sales growth rate (G) (%)	N/A	5.04	10.00	8.00	6.00	6.00	6.00
Oper. profit margin (P) (%)	7.90	6.28	7.44	8.92	8.33	8.71	9.12
Inc. fixed cap. inv. (F) (%)	N/A	44.10	21.30	21.30	21.30	21.30	21.30
Inc. work. cap. inv. (W) (%)	N/A	19.90	11.10	7.62	10.76	8.95	8.86
Cash inc. tax rate (Tc) (%)	N/A	15.29	39.58	39.58	39.58	39.58	39.58
Discount Rates							
Average cost of capital (%)	15.30						
Internal rate of return (%)	32.05						

Memo: Avg. cost of capital and IRR based on forecast data
IRR uses pre-strat. resid. value as investment ($433.673 million)

Reconciliation for Sample Company, Year 1: Most Likely Scenario ($ in Millions)

	Earnings	Adjustments	Cash Flows
Sales	$2,414.0		
Less: Incr. in accts receivable		20.0	
Cash receipts			$2,394.0
Cost of goods sold	1,834.7		
Less: Incr. in accounts payable		25.0	
Plus: Total incr. in inventories		18.2	
Cash COGS			1,827.8
Gross profit	$579.4		
Total SG&A expense	303.8		
Plus: Incr. in cash		5.7	
Less: Incr. in income tax payable		5.3	
Cash SG&A expense			304.3
Increm. working cap. invest.		$13.6	
Other operating income	0.9		0.9
Depreciation expense	61.0		
Plus: Depreciation expense, funds		61.0	
Depreciation in other items			0.0
Fixed capital investment		98.9	98.9
Operating profit	$215.4		
Interest income	20.5		
Interest expense	13.0		
Other non-operating income	43.1		
Earnings before taxes	$266.1		
Provision for income taxes	92.9		
Less: Incr. in deferred inc. taxes		13.8	
Cash income taxes			85.3
Proceeds (af. tax) asset sale			18.3
Cash flow from operations			97.0
Net income	$173.2		

EXHIBIT 3-1 (Continued)

Cash Flows and Shareholder Value for Sample Company
Most Likely Scenario
(Average Cost of Capital (%) = 15.3%)
($ in Millions)

Year	Cash Flow	Pres. Value Cash Flow	Cum. PV Cash Flows	Pres. Value Residual Value	Cum PV CF + PV Residual Value	Increase in Value
Year 1	$55.5	$48.2	$48.2	$490.1	$538.3	$104.6
Year 2	97.0	72.9	121.1	550.8	671.8	133.5
Year 3	102.7	67.0	188.1	472.4	660.5	(11.3)
Year 4	117.1	66.3	254.4	454.4	708.8	48.3
Year 5	124.2	60.9	315.3	437.5	752.8	44.0
						$319.1

Marketable securities	70.9
Corporate value	$823.7
Less: Mkt. val. of debt	63.0
Less: Unfunded pension liabs.	16.7
Shareholder value (PV)	$744.0
Share. value per share (PV)	$56.36
Current stock price	$49.50
Prem/disc. over/under mkt. (%)	13.86

Profit Margins for Sample Company:
Most Likely Scenario

Year	Operating Profit Margin	Threshold Margin	Threshold Spread	Incremental Profit Margin	Incremental Threshold Margin	Incremental Threshold Spread
1	7.439%	6.325%	1.115%	19.035%	6.774%	12.261%
2	8.924	7.278	1.646	27.486	5.270	22.216
3	8.326	8.695	(0.369)	(1.638)	4.881	(6.519)
4	8.712	8.118	0.594	15.139	4.639	10.500
5	9.123	8.472	0.650	15.971	4.482	11.490

Valuation Summary for Sample Company: Most Likely Scenario Five-Year Forecast ($ in Millions)

Cumulative PV cash flows	$315.3
Present value of Res. value	437.5
Marketable securities	70.9
Corporate value	$823.7
Less: Mkt. val. of debt	63.0
Less: Unfunded pension liabs.	16.7
Shareholder value (PV)	$744.0
Less: Pre-strat. share. value	424.9
Value contrib. by strategy	$319.1
Share. value per share (PV)	$56.36
Current stock price	$49.50
Prem/disc. over/under mkt. (%)	13.86
Value ROI (%)	180.62
Value ROS (%)	55.79

Relative Impact of Key Variables on Shareholder Value for Sample Company: Most Likely Scenario ($ in Millions)

A 1% Increase In:	Increases Shareholder Value by	% Increase
Sales growth rate (G)	$0.4	0.054
Operating profit margin (P)	8.7	1.163
Increm. fixed capital investment (F)	(1.2)	(0.164)
Increm. working capital investment (W)	(0.5)	(0.074)
Cash income tax rate (Tc)	(2.8)	(0.377)
Residual value income tax rate (Tr)	(4.0)	(0.543)
Cost of capital (K)	(4.2)	(0.560)

What is activity-based costing?

Activity-based costing (ABC) is an accounting technique that allows an organization to determine the actual cost associated with each good or service that it produces without regard to the organizational structure. The technique is one of the audit tools used to uncover hidden values in a target company.

Some of the discoveries are dramatic because much accounting seems designed to cover up rather than uncover the real costs associated with the production of goods and services. For instance, traditional volume-based costing systems can lead to the inappropriate application of overhead. This, in turn, can drive detrimental decision making, with attention and resources focused on unprofitable markets, products lines, and customers. ABC works because normal accounting methodologies have few, if any, negative inputs. They do not quantify and cost out glitches. Factors such as parts reworks, unplanned scrap, and systems that impede the flow of work are not assessed their proper negative costs, as is done in ABC. One company, after implementing ABC, was soon found to be "basking in operating margins that are roughly four times the industry's average."[11] Sophisticated ABC accounting can also uncover large cash windfalls, because it allows companies to reverse arbitrary rulings by the IRS on M&A-generated taxes.[12]

Large manufacturing companies were the first to implement ABC in the late 1980s as a replacement for their older, inefficient, and unreliable volume-based costing systems.[13] ABC is alive and well today, with adoption rates now similar for service firms and manufacturing firms. ABC and even ABM (activity-based management) is particularly common in certain fields such as grocery manufacturing.[14] The technique is even finding new applications in e-commerce.[15]

What is capital rationing?

Few companies have unlimited funds to work with. Therefore, they must ration their capital. This is sometimes accomplished by including funds for M&A in the capital budget. But for "go-go" companies that make acquisitions using their stock and debt rather than budgeted cash flows from earnings and depreciation, capital rationing becomes very complicated. This, in fact, is the reason for the growth in importance of the job of financial vice president in the modern corporation and elevation to board status.

Companies wanting to ration their capital usually perform *differential diagnosis*: which acquisition will best fit the buyer—that is, best complement

its weaknesses and best exploit its strengths. A similar but simpler textbook process known as the *alternate investment decision process* is used to purchase operating assets such as machine tools, but can also be used for making acquisitions—management compares one acquisition target to several others using basic financial criteria, and chooses the best alternative. These kinds of analyses, if institutionalized, force an acquirer to do the analysis that is so often skipped in the rush to close a deal.

In general, never buy a company unless you compare it to at least two other potential acquisitions. Further, always estimate the costs of entering the business de novo, as explained subsequently.

What about time horizons?

Any analysis requires the selection of a time horizon, also known as the *forecast period.* Most companies have standardized at 10 years. However, in industries that depend on shorter-lived styles or fads, such as toys or fashion, five to seven years is much more common. Public utilities traditionally have spun their forecasts out 20 years, but lately turn to much shorter time horizons as patterns of energy production, consumption, and conservation have changed. In parts of Eastern Europe, now approaching conversion to a common currency as the EU expands, and in the Middle East, currently struggling with political uncertainty, traditional planning horizons no longer make sense. Tomorrow is charted on a deal by deal basis. This is where a few financial skills can really help a dealmaker. One of the benefits of sensitivity analysis is to discover the effects of different time horizons on a target company's NPV.

Unfortunately, there is a trend toward shortening the time horizon or forecast period under conditions of uncertainty that are not random. This shortening is a poor substitute for factoring in quantifiable risk. In many cases, with a little work, the uncertainties can be converted to probabilities that can be quantified without creating a jumble of forecast periods. One needn't be a financial economist to get this work done. Any accredited business school is likely to have a team of them ready, willing, and able to help—at an affordable price, or even pro bono.

What is M&A leverage?

M&A leverage is the ability to borrow money to finance an acquisition. It adds to the risk of the transaction because the target must earn interest payments before it can pay dividends. In bad times, M&A leverage reduces or

even eliminates the cash available for dividends. In good times, it generates excess cash. All told, M&A leverage amplifies cash returns and tends to produce a yo-yo track record that can discourage investors and depress the value of the company. This is especially true of companies whose stock is publicly traded.

What is the commodity theory of M&A pricing?

At any one time, in commodities markets, there are oversupplies and undersupplies of corn, wheat, pork bellies, frozen orange juice, and so on. Generally, commodities are *fungible,* alike in character—one kernel of wheat or one soybean or one dollar bill is pretty much like another. But there is a futures market in ships' bottoms—the ability to move goods over water at a locked-in price at some future shipper's contract date. Certainly, they are not as fungible as pork bellies or fuel oil but there's still a futures market for them. Supply and demand affect the present and future prices of all commodities.

The same economics laws that apply to commodities that are traded on commodity exchanges *may* apply to businesses for sale. This has been made possible through the concept of the strategic business unit (SBU). Many of them are remarkably alike, especially in franchised businesses, which are often sold over and over. A McDonald's franchise is really a commodity.

Right now, there is a shortage of SBUs in such areas as renewable energy. For example, a wave of investment has been overtaking ethanol, a fuel produced from crops such as corn, grain sorghum, wheat, sugar, and other agricultural feedstocks. Interest in the fuel soared after President Bush signed an energy act in August 2005 requiring the oil industry for the first time to use some renewable fuels to make motor fuel. The annual mandate grows to 7.5 billion gallons in 2012 from 4 billion gallons in 2005. In addition to reducing U.S. dependence on imported oil, the fuel generates fewer greenhouse gases and particulate matter than gasoline. Over the last 25 years, 81 new ethanol plants have been built, and 33 additional plants are under construction today. However, U.S. ethanol makers are either small parts of sprawling companies, start-ups, or private concerns.

Demand is so great that there is a kind of futures market developing for ethanol-related companies as capital is raised with IPOs based on the promise to investors that the principal object of starting the business is to build it up and then sell it off at some later date to a larger concern for a huge profit—just like planting a crop of corn or soybeans that may or may not survive drought and flood. And it's not escaping the focus of the investing public. The stock of

The Andersons, a Maumee, Ohio, company with interests in grain, fertilizer, and railcars, increased by $145 million, or 28 percent, in March 2006 in the two weeks following company disclosure that it had acquired stakes in three ethanol plants that were then under construction. This, despite the fact that The Andersons had invested just $36.1 million in its ethanol holdings.[16]

Techniques for the founding and the building of businesses, generally incorporated in the term *entrepreneurship,* are being taught at more and more academic institutions. Just as the soybean futures market sells soybeans before they are even planted, much less harvested, demand is so great for companies in the renewable energy area that it is possible to sell shares or even the whole company before it has made its first dollar of sales, much less a profit. It is almost certain that there will be a market glut of such companies sometime in the future, just as there always is in corn and pork bellies and soybeans. One day, company prices in the ethanol industry will plummet.

This growing trading market for SBUs is not confined to the United States; it is happening worldwide. Right now, the hunger for SBUs seems insatiable. The recent mass restructuring of much of business in the United States and the resultant reduction in the white-collar workforce of middle management executives has prompted many of them to start up tens of thousands of new businesses, many of them surprisingly successful. High prices are being paid for some of these start-ups—especially those that are, in reality, spin-offs from larger companies as part of their downsizing programs. Some are even financed by a seller that has induced a group of its own executives to buy out one of their own in-house suppliers.

In the international markets, privatization continues to be a source of companies for sale. A World Bank study found that despite years of privatization involving 7,860 transactions worth $410 billion from 1990 to 2003, "government ownership is still prevalent in some regions and countries, and in certain sectors in virtually all regions."[17] Although 120 countries engaged in privatization during this period, nearly half of the transactions were concentrated in just five countries: Brazil, China, India, Poland, and Russia. During this period, the average transaction price had risen from $30 million to $97 million. But smaller transactions continue to be possible everywhere, particularly in countries where the privatization agenda is only now beginning to take hold.

A final word: particular subindustries are subject to booms and busts. In hot industries, particularly those that can get started with a low investment, too many new companies get founded, especially in popular fields, and there are minicrashes. Vulnerable industries in recent times include ethanol, biodiesel,

genetic engineering, water filtration, nanotechnology, and so on. The reader is advised to be careful in paying premiums for entry into such popular fields.

What are some of the specific methods used for pricing a company, an operating division, or a product line?

There is no limit to the number of pricing methods that can be created and used. The following list includes only the seven most common methods at this time. (Sample calculations for each of these methods are shown in Exhibit 3-1.)

- *The replacement value method.* The replacement value method is the simplest but the most tedious of the valuation processes. Given a target operation, the buyer sets out to discover the cash costs to create from scratch an exact duplicate of the target in all of its perspectives. It includes both hard and soft assets. Hard assets include land, buildings and machinery, inventories, work-in-process, and so forth. Soft assets include the costs of recruitment and training of people, the creation of markets and protective devices such as copyrights and trademarks, the development of a customer base, and so on. In an acquisition, the buyer will not have to compete with the seller. With a replacement value calculation for de novo entry, continued competition must be factored in. The potential acquirer compares this estimate to the asking price for the target, or uses it as the basis for an offer and the subsequent negotiation. Properly done, it is the best of the valuation methods because it asks and answers the simple question, "What will it cost the buyer to duplicate the target right now?" without the complications of factoring in past or future accounting-based earnings that may or may not represent reality.

  The buying company can use such a formal estimate of replacement value in internal negotiations because it can be used to support the argument that it is often "cheaper to buy than to build."

  One major advantage in the replacement value approach is that professional appraisal firms are highly skilled in generating the basic numbers. These estimates will usually stand up in court should there be a challenge. Its disadvantage is in getting enough accurate information about the target and its industry needed to generate the costs to create a valid duplicate.

The replacement value method also seems to give a potential buyer a negotiating edge over a seller. Computing replacement value can also be a factor in fulfilling due diligence requirements.

- *The investment, or average rate of return, method.* The investment, or average rate of return, method has been the most common method used to value acquisitions. It is an accounting-based method that compares the projected average return to the projected average investment in the project. The projected average required return is sometimes called a *hurdle rate,* which is most often the buyer's cost of capital. This, as mentioned previously, is modified at will to reflect entry risk, as the rate will be lowered for businesses with which the buyer is more familiar.

  In practice, in the M&A field, this valuation analysis begins with the up-front sum to be paid for the target or, in an installment purchase, for the down payment. The acquirer modifies this figure through the years as the buyer either withdraws or invests additional capital. It is especially useful if an installment purchase is to be made, or when major assets are to be sold off or acquired. Its advantage is in its simplicity; its usual disadvantage is in its failure to properly discount the time value of money.
- *The payback method. Payback* is one of the time-honored methods used to evaluate an acquisition. Borrowed from the capital budgeting area, it has been and is still used for the purchase of major machine tools and other capital items. In the payback method, the corporate powers that be arbitrarily decide that their capital investments should be recovered or paid back in some set period of time. Typically, the purchase of a large computer-controlled machine tool or a bank of such machines must return its purchase price (including the costs of freight, installation, operator training, and so on) in three to five years or the company will not make the investment. Risk factors of technological obsolescence, downturns in sales, labor strikes, and other catastrophes are all taken into account by shortening the payback period while projected positive events will lengthen it.

  Payback is a simple method that can be understood by people who are not trained in finance, and it is easy to incorporate in simple budgeting and marketing programs. For many years, it was used (and still is) for the purchase of competitors in service industries. Like the investment method, its advantage is in its

simplicity; its disadvantage is that it does not properly take into account the time value of money. It is recommended for use only in the simplest of transactions where the operating parameters are well known and are easily budgeted and controlled.

- *The IRR Method.* In this method, the object is to discover what discount rate is needed to make the present value of the future cash flows of an investment equal the cost of the investment. When the net present values of cash outflows and cash inflows equal zero, the rate of discount being used is the IRR. To be acceptable, it must equal or exceed the hurdle rate.

  The IRR method, unless fully understood by the analyst, is flawed. First, mathematically, there are always at least two solutions to an IRR calculation and sometimes many more when there are several income reversals projected. Second, highly complex calculations can take time even on the fastest computers since they are done by a long series of successive approximations. Third, varying the inputs in performing sensitivity analyses to produce the NPV, compared with the DCF method, is tiresome; computational errors are frequent, and results can be misleading and are not easily defended in court. The IRR method of valuation is not recommended.
- *The market value method.* The market value method, used primarily for the acquisition of publicly traded companies, requires a search for comparables in the publicly traded markets. It assumes that the public markets are efficient—that is, all the information about the comparables is available to buyers and sellers and is being used to set the prices for their securities.[18] Still employed today, and generally required by the due diligence process in the case of the purchase of controlling interests in publicly traded companies, the market value method uses the P/E multiples of publicly traded comparable companies to establish a price or a range of prices. In many cases, the problem of comparability is difficult to solve. There may simply be no truly comparable companies anywhere, and the valuator then must average the figures for a group of close comparables. For some sellers, it is a dangerous method because an experienced buyer can cherry-pick the comparables. There are also other flaws. In past markets, many stocks were undervalued by the public, and it was not unusual for a buyer to pay a 50 percent

premium over the publicly traded stock price *after* a DCF or other analytical method indicated that a premium price was in order. In those cases, it was assumed that the market was truly inefficient.

Accounting variables are also important here. For instance, one can average the prices and the P/E ratios of several dozen property and casualty (P&C) insurance companies and use the resulting number to negotiate a purchase price. But insurance accounting is not uniform from company to company, and historically accurate numbers are difficult to come by since they were never kept product by product. Allocating the surpluses to the product lines that produced them is a near impossibility, and figuring the marginal incremental costs of fixed and working capital to add $1 of premium inflow on a product-by-product valuation is nearly impossible. The only way to properly price the purchase of a P/C company is by direct examination of the product-by-product risks to which the particular insurer has exposed itself. When this is run against projected revenues and totaled, it will generally yield an entirely different number from the average of the P/E multiple–derived prices of a group of comparable insurances.

Although the differences are dramatic in the insurance industry, lack of accounting standards and their consistent application make historical earnings figures difficult to rely on in many industries. But many, many investors still rely on the efficient market theory that says the investing public sees through the accounting facade and properly values most securities, even those where there are attempts at price manipulation in anticipation of a sale. The market value method has been for many years the method of choice in the M&A area until the advent of the DCF method, which has largely displaced it in generating NPVs. (For due diligence purposes, an acquirer should still compare and reconcile market values of comparables based on P/Es versus DCF/NPV values.)

- *The comparable net worth to market value method.* Net worth is not a good measure of the present value of anything unless it's all in cash and can be immediately withdrawn, which is never the case. In most cases, only lip service has been paid to the requirements for consistency, uniformity, and comparability in generating operating figures that have produced earned surpluses. Thus, a

net worth progression is difficult to use as a proxy for predicting future profits. Knowing where and when the surpluses arose can elucidate past performance and help to predict future performance.

A method of valuation developed by the senior author, which is now one of the approved methods of valuation in the state of Pennsylvania after a long litigative history, is the *comparable net worth to market value method.* It is usually employed in unfriendly situations such as "squeeze outs" where a majority control group is squeezing out the minority holders; information on future sales and profits is not made available to the challenging minority stockholders, and the courts usually sustain the majority stockholders' contention that to release such information would aid competitors. (Such information would also be needed to do a proper DCF/NPV valuation.)

In this method of valuation, 5 to 10 comparable publicly traded companies are identified. Their accounting practices are carefully analyzed and various adjustments, especially to accounting treatments of inventories, cash, and receivables, are made to increase the comparability, and any excesses (or shortages) of cash, cash equivalents, and other nonworking assets are computed. The resulting adjusted net worths are then compared to the price at which their stocks are being traded. In the Pennsylvania case, it was discovered that the average price of a share of common stock of the 10 comparables was selling for exactly twice the average adjusted net worth at the time of the squeeze out with a very low standard deviation in the sample group. This method, approved by the court, yielded a figure more than double the valuation made by a major Wall Street investment banking house using the market value method and resulted in a multimillion-dollar recovery for the minority stockholders.

The method's major advantage is that it uses only publicly available information in computing values. Its disadvantage is that it requires a great deal of sophistication to remake the balance sheets, and in some cases the operating statements, of the sample group of public companies to make them comparable to the company being valued.

- *The discounted cash flow method.* The DCF method is the only proper way to value an operating company. Any company is worth the going value or NPV of its future earnings stream taken out to

infinity and discounted at some rate that approximates the risk. All desktop spreadsheet programs known to the authors have a DCF program built in.

Before explaining how to calculate DCF, it may be important to explain why DCF should be calculated—and heeded. In the long run, a company is worth what someone is willing to pay for it in cash or cash equivalents. History provides indisputable evidence of what people have been willing to pay. However, accounting rules are so variable—industry by industry, company by company, and country by country—that accounting numbers based on past earnings can rarely be used as a basis for negotiating a price. Thus, numbers must be converted to a future value. Aside from those who might pay twice what a company is worth because "the stars are right" (and that happens), the final price should depend on what the buyer believes the net cash flows will be in the future.

The seller can maximize the price received by having a plan for the future with rational reasons for predicting future cash flows and explaining anomalies in past cash flows. Those plans are usually proprietary and not disclosed to the public, including stockholders. As a result, the NPV might well be different from what the public has valued it in the stock market. When this happens, it is difficult to close a deal. If the NPV is at a substantial premium over the market cap (i.e., the total value of the shares of the company), due diligence requires that the acquirer justify the price. This requires a methodology for factoring in the future.

Fortunately, buyers and sellers alike can choose from a plethora of software packages containing DCF programs to produce a number that is the net present value of a projected cash stream. A buyer can easily negotiate with a seller by varying the financial elements that go into the computation of the NPV.

It is thus that many if not most negotiations on price today are held in front of a computer screen, or should be. For all these reasons, the *discounted future earnings,* or *discounted cash flow,* method has displaced all other methods in yielding NPVs that serve at least as the takeoff point for bargaining the price of a company or a subsidiary operation for sale. In its simplest form, the DCF process proceeds as follows:

Step 1. Set aside the value of all assets—current and fixed—not used in the business to produce the estimated future earnings stream that is to be discounted.

Step 2. Estimate future sales year by year over a preselected time horizon.

Step 3. Estimate the gross margins year by year including depreciation expenses.

Step 4. Estimate earnings before interest and taxes (EBIT) year by year.

Step 5. Subtract interest and estimated cash taxes year by year.

Step 6. Compute and subtract the average marginal incremental working capital costs required to put on each additional dollar of sales year by year (reverse for any downsizing).

Step 7. Compute and subtract the average marginal incremental fixed capital costs of putting on each additional dollar of sales year by year (reverse for any major asset sales).

Step 8. Add back depreciation and amortization (reverse for recaptures).

Step 9. Compute the residual value of the company after the end of the horizon period by capitalizing the last year's projected earnings at the reciprocal of the selected discount rate.

Step 10. Discount all values, including residual value to present value, using a risk-adjusted cost of capital for the discount rate.

Step 11. Add back all set-aside values (step 1) for current and fixed assets not used to produce revenues. The total will be the NPV value of the business.

Do managers always know the NPV values of their companies?

Often, but not always. Why? To compute NPV by the DCF method requires long-term time horizons and some long-term educated guesses about the future, which managers are often reluctant to make for fear of being wrong. Outsiders, however, are not so reluctant, which is one reason why premiums are often paid over market values for going companies. Acquirers are far more willing to make the analyses with a minimum of information than the managers are with a maximum! This is how prospective buyers uncover values that long-term managers have never considered. This valuation blind spot is particularly acute in conglomerates.

What special valuation principles apply to conglomerates?

In the typical conglomerate, parts are often worth more separately than they are together. There is all too often no economic rationale for a conglomerate. Notwithstanding the prefix *con,* connoting some commonality of market or production or distribution methods, most are *ag*glomerates, an assortment of disparate operations, each paying a fee for what often proves to be headquarters hindrance rather than headquarters help. The benefits of association, synergies such as the smoothing of cash flows effected by joining countercyclical operations, are often more than offset by headquarters stultification of the entrepreneurial process so necessary to successful growth. The agglomerators are discovering that their disparate operations will generally do better as stand-alones if they cannot be integrated with similar operations.

The media industry today offers many examples. In early 2006, Viacom spun off CBS (including the CBS network, 39 local TV stations, the Infinity radio and billboard businesses, Showtime, the Simon & Schuster book publisher, and some theme parks), but retained most of its cable networks, such as MTV, Nickelodeon, Comedy Central, and the Paramount movie studio. The split up came less than six years after the two businesses were put together, the combined entity hailed as a great synergistic match that would result in the cross-selling of advertising across the various media properties, as well as a host of other benefits. For the most part, these didn't materialize.[19] The AOL Time Warner merger, closed in 2000 like Viacom/CBS, met similar criticisms.[20]

PRICING ISSUES

The previous discussion was about value; we now move to price, the practical manifestation of value for a buyer and a seller. As explained in Chapter 2, there are two basic types of buyer: *strategic* versus *financial.* Each may offer very different prices for the same business.

What are the characteristics of a strategic buyer?

Typically, the strategic buyer has accumulated cash for the acquisition program and is considering where to spend it. If it has been profitable and is publicly traded, its stock is often as good as cash—even better, because it can be

used to effect a tax-free exchange, which has a great appeal to many sellers and selling groups.

The typical strategic buyer is well aware of synergies in combined operations. The time horizon of the operating buyer is probably relatively long term, 5 to 10 years (although an important exception will arise if the acquisition is being considered as a defensive maneuver against a hostile takeover). Perhaps most important, the strategic buyer is probably operating in an institutional, corporate framework in which full strategic planning is part of the corporate culture.

What are the characteristics of a typical LBO buyer?

The typical LBO buyer is usually a group (though it can be a single individual), perhaps organized in corporate or partnership form, that intends to finance the purchase price primarily through maximizing borrowing against the assets and future cash flows of the target and minimizing its provision of equity. The LBO buyer typically plans to pay down the debt through operating cash flows (sometimes accelerated by sharply reducing expenses), and by selling off surplus or underutilized assets.

Once the debt is substantially reduced or eliminated, LBO buyers will reap the benefits of their investment through dividends, through taking the company public with an IPO, or by sale of the company to another buyer—typically a strategic buyer—or to the company's ESOP. LBO buyers usually rely on the existing management of the target company to operate it without major changes in structure or personnel and may include key managers in the ownership group. They may be simultaneously investing in other companies, but they do not look for synergies between these other investments and the target; rather, their philosophy is "each tub on its own bottom." They prefer to keep their companies independent so that each can be operated and disposed of without affecting the others.

How does the LBO buyer price a potential acquisition?

Most experienced LBO buyers try to determine how much they must pay for a company and then analyze whether the deal will work on this basis. In so doing, they look at a number of standard ratios that focus principally on the relationship of the gross unleveraged price to operating cash flow, operating

income, or unleveraged book value. The ratios really perform only a support function. However, the business of finding, pursuing, negotiating, consummating, and overseeing LBOs is a practical business and, more than anything else, a people business. There is little reliance on theoretical financial models.

That seems to be a backward approach. Why is it done this way?

A key element of success in structuring and completing LBOs is creativity. If LBO buyers try to value a company in a vacuum, using the standard valuation techniques—earnings, cash flow, book value multiples, and DCF analyses—they will probably overlook the unusual elements that separate the truly successful LBOs from all others. If, however, the buyer has a target price that must be reached, the buyer will tend to push hard and be more creative in order to reach that target. It is basic human nature: people will perform better when they have a specific target. One of the great things about LBOs is that, if the deal works, it does not matter what conventions have been broken.

How do you decide if a deal works at a certain price?

That depends on the answer to two fundamental questions:

- Can the deal be financed, given that only limited amounts of senior debt, subordinated debt, and equity are available for any company?
- Can the company service the debt and still provide an attractive return to the equity holders?

Do you mean maximizing the return to the equity holders?

That is a part of it, but there is a lot more to it than that. Typically, the equity holders in an LBO will include two or three different types of investors, often with differing goals and objectives. They have differing risk-return objectives and thus differing investment decision-making criteria.

The management team of the company not only is an equity investor but is also devoting its full time to running the business. Its equity stake, and the appreciation of the value of that stake, is an integral part of management's compensation. The potential value of that stake, when added to management's

current compensation, must be competitive with other opportunities available to the individuals who form the management team.

The management team tends to have another important objective—to diversify the personal assets of its members. Typically, members of management do not have millions of dollars to invest. With their careers already tied to the company's future, individuals in senior management are often willing to give up some upside in dollars in order to retain personal assets outside of their investment in the company. In other words, not all investing managers are willing to "bet the farm," nor should they be expected to. (In many cases, management involved in an LBO might each be expected to invest one year's pretax compensation into the deal, although this is clearly not a hard and fast rule.)

The LBO buyer who leads the deal also has several objectives. This sponsor must analyze an acquisition in terms of the opportunity cost of the time expended in pursuing, negotiating, closing, and subsequently overseeing the company. Regardless of the return on hard dollars invested, the sponsor must see a potential total dollar return that justifies the time investment. An LBO investment firm must also carefully consider risk. A successful LBO firm must look at every deal knowing that there is a lot more at risk than just its time and equity dollars. If the target eventually fails and a lender suffers a loss, it will adversely affect the firm's reputation and ability to attract and finance acquisitions in the future.

Finally, there are the institutional equity investors—investors in LBO funds or who are given the right to buy equity as part of an agreement to lend senior or subordinated debt to the company. Investors in LBO funds, which many of the major LBO firms utilize to finance deals, are looking for a pure financial return on their high-risk dollars. During the 1980s' heyday, their target was 40 percent or more, and many LBO firms delivered returns significantly higher than that. Lenders also frequently sought equity participation in order to boost their blended returns to the middle to high teens in the case of senior lenders (typically banks) or the high teens or twenties in the case of subordinated lenders (usually insurance companies or junk bond buyers). Since then, the LBO industry has become more competitive and it's not uncommon for returns today to be half those earned in the 1980s.

How do you decide whether a deal can be financed?

Financing LBOs is certainly more art than science, but there are some useful guidelines. The first step is to gather some basic information about the

company in order to begin formulating a financing plan. The key issues, on a broad level, include the following:

- What is the total financing required to close the acquisition and to finance future operations?
- What cash flow will the company generate that will be available to pay interest and principal?

The financing requirement is based, first, on the purchase price and the need to refinance any existing debt and, second, on the company's ability to repay the loan out of its projected cash flow. The topics of financing and refinancing will be covered in greater depth in Chapter 4.

How do you project cash flow?

Projecting cash flow is the most difficult and usually the most subjective part of doing a deal. It requires addressing a myriad of questions, including the following:

- What are the company's projections?
- Are they reasonable?
- Has the company been able to meet its projections in the past?
- What are the industry's prospects?
- How secure is the company's competitive position?
- Is it a cyclical business? If so, do the projections properly take this into account?
- What are the company's growth or expansion plans?
- What are the working capital and fixed asset requirements attendant to these plans?
- Is the business seasonal? If so, what are the seasonal working capital needs?
- What events (such as strikes, currency fluctuations, foreign competition, loss of suppliers, and so on) could affect the projected results?
- Does the company have any excess assets or divisions that can or should be sold?
- How long would it take to make these sales, and how much money would they generate?
- Are there any other potential sources of cash?

- What can go wrong in all this, and does the company have any contingency plans?

This list is far from exhaustive, and it can take anywhere from a few hours to several weeks or months of due diligence to get a good feel for the cash flow. Once this has been done, the LBO buyer will be able to estimate reasonably the total financing needed at the closing date and prospectively for a 5- to 10-year period thereafter.

What do you do with all this information?

Armed with these data, the buyer can begin to map out a financing plan. A large variety of debt instruments and financing sources is available, although generally all LBO debt can be classified as either senior debt or subordinated debt. (See Chapter 4 for a fuller discussion of the different kinds of debt used in LBOs.)

Most senior debt in LBOs has traditionally come from banks and is either secured, meaning that specific assets or stock are legally pledged to secure the loan, or unsecured. Because senior debt is the cheapest source of financing, an acquirer should try to obtain the greatest amount of senior debt possible.

How does a senior lender decide how much to lend in an acquisition?

That depends on a number of factors, including the type of loan being obtained. Senior loans to LBOs generally defy strict classification, but they can usually be divided into three groups: asset-based loans, cash flow loans, and bridge or interim loans.

In an asset-based loan, the bank is lending against specific assets or pools of assets and will decide how much to lend against each type of asset (the advance rate). For example, a bank may lend 80 percent against the book value of current accounts receivable, 60 percent against the book value of inventory in a warehouse, 30 percent against the book value of inventory in a retail store, and 50 to 75 percent against the fair market value of property, plant, and equipment.

In a cash flow loan, the bank is lending based on the company's ability to consistently generate cash flow from operations. On a cash flow loan, a bank will typically look for interest coverage (operating income divided by total interest expense) in the first year of at least 1.3 to 1.5 times and total repayment of the bank loan within 5 to 7 years. An important factor in determining an acceptable coverage ratio is the degree of certainty of the

projections. A lender may prefer 1:1 coverage with a 95 percent probability to 1:5 coverage with a 50 percent probability of achieving the projections.

A bridge or interim loan often contains elements of both asset-based and cash flow loans. Typically, it is used to finance the purchase of assets or discrete businesses targeted for sale in the acquisition and usually amounts to a percentage, between 50 and 100, of the estimated net proceeds. The advance rate depends on the timing and certainty of the disposition and on the bank's degree of comfort with the value and marketability of the subsidiaries or assets to be divested. The loans are generally secured by the stock of subsidiaries or the assets of the operations targeted for sale. Loans that bridge to future subordinated debt financing—so-called junk bond bridge loans—are a different matter and are described in Chapter 4.

How do you decide which type of senior loan to borrow?

It depends on several factors, including the acquirer's plans for the company, the nature of its key businesses, and the composition of its assets. The primary goal, again, is to maximize the dollar amount of senior loans. A secondary goal is to obtain the lowest cost of funds. Certain types of companies, such as basic manufacturing companies and retailers, are rich in fixed assets, inventory, and receivables. If these assets are not already pledged to existing debt, an asset-based loan may yield the larger amount.

On the other hand, many businesses tend not to have large amounts of hard or tangible assets. This group usually includes companies in the communications, high-tech, and service industries. For acquisitions of these types of companies, a cash flow loan will tend to yield the greater amount.

In LBOs where the acquirer anticipates realizing significant proceeds from the sale of assets or entire businesses within a relatively short period (up to two years) after the acquisition date, the acquirer should attempt to obtain a portion of the senior bank debt in the form of an interim or bridge loan tied to the realization of those proceeds.

What is the typical payment term of an LBO loan?

Bridge or interim facilities, which will be repaid upon the occurrence of specified events, can have a maturity in the range of six months to two years, depending on the expected timing of those events.

Revolver and term loans usually have terms of three to seven years. Revolver loans are often evergreen facilities, with no repayment schedule until final maturity, or sometimes one or two mandatory reductions over the life of the loan. Term loans generally mandate repayment schedules beginning immediately or certainly within one year of the acquisition closing date and specify a repayment schedule tied to the company's projections. Often, term loan repayment schedules are prorated over the life of the loan. Term loans may require both scheduled repayments and additional payments out of excess cash flow.

What is the role of junk bonds in an LBO?

Junk bonds, which are subordinated debt usually sold to institutional investors, have played an integral role in LBO financing. Subordinated debt bridges the gap between what banks are willing to pay for companies and the equity that investors can and will contribute (see Chapter 4).

The junk bond, or high-yield, debt market is a relatively new market. More than any other factor, its tremendous growth in the 1980s fueled much of the LBO boom by allowing companies to be acquired for relatively small amounts of equity.

Compared to the market for senior debt, the junk bond market is less developed and much more volatile—proving to be highly cyclical (as well as seasonal).[21] In fact, after the stock market crash on October 19, 1987, the market for new junk bonds virtually dried up for two to three months and led to a temporary, but dramatic, slowdown in large LBO activity. The crash of October 13, 1989, also had a depressing effect on junk bond financing of LBOs. However, junk bonds have survived and seem to have become a permanent fixture in acquisition financing.[22]

How do issuers of junk bonds decide how much to lend?

Junk bond lenders generally bear a significant portion of the risk in an LBO and are looking for a return to compensate them for their risk. Generally, the amount and terms of a subordinated loan or debt offering will reflect the risk-return relationship. Depending on the perceived risk of an acquisition, a junk bond lender will seek a return anywhere from a straight interest yield of 11 to 12 percent to a combined IRR, factoring in equity participation, in the range of 25 to 30 percent. If risk is excessive, the lender will be unwilling to lend at any return.

In evaluating risk, junk bond buyers look to see (1) whether the breakup value of the company exceeds the aggregate amount of senior and subordinated

debt, and (2) whether cash flow from operations and asset sales is sufficient to meet senior and subordinated debt payment requirements.

How much equity should be invested in an LBO?

The amount of equity in an LBO is really a plug number. There should be enough equity to get the deal done and provide assurance for the company's success. Equity must fill the gap between the total debt financing obtained and the total funds required to consummate the acquisition. A minimum amount of equity contribution is necessary to ensure solvency of the company (see Chapter 4); how much a lender will require depends on the lender's confidence in the company and the general business cycle.

Typically, there is a complex interplay between the senior lenders, subordinated lenders, and equity investors in the financing of an LBO. The senior lenders seek to maximize the amounts of subordinated debt and equity; the subordinated lenders aim to maximize the amount of equity; and the equity investors try to minimize the amount of equity, maximize the senior debt, and bridge the gap with subordinated debt.

At the end of the day, the cyclicality of the lending market will generally dictate how much equity must go into an LBO. In the 1980s, many financial buyers got away with as little as 3 to 5 percent equity, particularly when average debt multiples (i.e., bank and nonbank debt to EBITDA or earnings before interest, taxes, depreciation, and amortization) hit an all-time peak of nearly 9.0x. By 2001, when liquidity was tighter, 35 percent equity and roughly 3.8x debt-to-EBITDA was the norm. At the midpoint of the current decade, after roughly a three-year bull market, those figures are closer to 20 percent and 7.3x.[23]

Every deal eventually comes down to the moment when the equity principal sets down all the facts (or a best estimate of the facts)—the terms and amounts of senior and subordinated debt and the required amount of equity—and decides whether the potential returns to the equity justify the investment in time and dollars, and the risk.

In other words, you do your financial plan for an LBO before you price?

Exactly. Pricing is a function of financeability. The price will be equal to what the LBO buyer is able to borrow against the assets and cash flow of the target, plus a marginal amount of equity. The process is interactive. Buyers

try to ascertain how much they must pay and then design a financial structure based on that price. As a result of these activities, buyers discover whether they can meet the seller's price, or at what level they can bid for the company.

How is this method of pricing consistent with the DCF analysis discussed earlier in this chapter?

It is entirely consistent; in fact, it directly applies DCF concepts. The LBO buyer simply sets out to accomplish in fact what the DCF analyst does in theory: to extract in cash, through borrowings or equity investments, the present value of the target on a DCF basis, and then to use the proceeds to buy the target. The returns required by senior lenders, subordinated lenders, and equity investors, when blended, represent the required discount rate. The LBO buyer looks at the price and the amounts and costs of available financing. This determines what return remains for the equity investment. If it is sufficient to justify the risk, the deal works.

What is the role of the various financial ratios in valuing companies?

The financial ratios are important tools used to address the fundamental issues of financeability and return to the equity investors. The ratios provide quick ways to value businesses and to quantify prices and values in terms of easily understood figures. The ratios also facilitate easy comparisons of different divisions within a company, different companies within an industry, and different industries.

What is the most commonly used ratio?

The most common measurement of price or value relates the price paid, free of debt, to the free cash flow available to service debt. The exact calculation can vary depending on the nature of the company or industry. The numerator is the gross unleveraged purchase price, which is the price paid for the equity, plus any debt assumed, plus the fees and expenses of the acquisition. The denominator is the company's free cash flow—that is, operating cash flow (operating income before deducting taxes, interest, and depreciation) less the amount of capital expenditures required to maintain the company's current level of operations (the maintenance level).

For many manufacturing or industrial companies, the maintenance level of capital expenditures over time is approximately equal to depreciation, and operating income is therefore a good proxy for free cash flow. On the other hand, many service businesses—broadcasting, publishing, cable television, and others—require minimal amounts of maintenance-level capital expenditures. For these companies, operating cash flow is a good proxy for free cash flow. Obviously, 1:1 is a floor for this ratio, with 1.4:1 a more normal benchmark.

Which year's financial statements should be used to calculate the free cash flow multiple?

Theoretically, you should be looking at free cash flow for the 12-month period beginning on the acquisition closing date. This number will obviously be a forecast and should be viewed in light of historical results. Investors (particularly equity), being relatively aggressive and optimistic people, will for purely psychological reasons generally tend to look at last year's numbers during difficult or depressed economic times and at next year's numbers during buoyant times.

The picture gets cloudy when a company is going through a major transition at the time the acquisition is closed, or will go through a major transition as a result of the acquisition. For example, suppose that a company is undergoing a major restructuring involving dramatic overhead reductions, the sale of an unprofitable business, and the absorption of a recently completed acquisition. Once the restructuring is completed, operating profit is expected to jump dramatically, giving rise to what is called a hockey stick projection: the line of the graph goes down a little, then turns and goes way up. Assume that actual and projected profits are as follows (in millions):

Year 1	$15
Year 2	$10
Year 3	$5
Year 4	$10
Year 5	$20

If the acquisition closes in the middle of year 1, the acquirer would look at year 2 earnings to calculate the free cash flow multiple—but the acquirer had better know the lender well enough to be sure it will agree.

How do you apply the free cash flow ratio to acquisitions where several divestitures are envisioned?

In situations where an acquirer plans to divest one or more businesses, both the numerator and the denominator of the ratio must be adjusted. The gross purchase price should be reduced by the sum of the estimated net after-tax proceeds of the divestiture, plus any debt to be assumed by buyers of divested operations. Operating income should be adjusted to reflect the pro forma operating income of the remaining operations.

What are the limitations of the free cash flow ratio?

The ratio fails to take into account a number of factors, including cyclicality and growth.

Cyclical companies tend not to make attractive LBO candidates because of the unpredictability of cash flow. When analyzing a cyclical business, it is important to determine the company's current stage in the economic cycle and factor the likelihood of a recession in the company's projections. Because of the volatility of earnings over the cycle, a free cash flow ratio based on just one year can be misleading, whereas a projection encompassing the entire business cycle will adjust cash flows properly. For further discussion of the kinds of companies suitable for LBOs, see Chapter 4.

The free cash flow multiple does not adjust in any way for the growth of a company. Obviously, a company with $50 million of operating income growing at 20 percent per year is worth more than a company with the same earnings growing at 5 percent per year. A pure multiple—whether of free cash flow, earnings, or any other financial statistic—does not indicate growth or the ultimate value of the company.

Growth prospects may, however, be reflected in the price to be paid for the company expressed as a multiple of free cash flow.

What rules of thumb does a lender use in considering how long the loan will be outstanding?

Lenders, particularly banks, like to see their loans retired and coverage improve reasonably rapidly. One common test is to see how much of the loan is projected to be paid off in five years. If substantially all the loan can be paid

off in this time, the company has a good chance of getting through the early high-debt danger period successfully.

Another test is to see how soon the target 1.5:1 coverage ratio can be reached between annual earnings and interest payments. Lenders can feel substantial confidence if this 50 percent cushion is projected to be achieved in two to three years (a period of time short enough to be somewhat reliably predictable by management). If projections don't indicate this point will be reached until the fifth year or beyond, lenders may be much more dubious.

At what prices have LBOs been done historically, expressed as a multiple of free cash flow?

Prices have generally been increasing for freestanding investments since LBOs were popularized in the 1980s. In the early part of that decade, companies could be bought at three to four times free cash flow. By the mid-1980s, most transactions were in the range of four to five times free cash flow. By the early 1990s, as competition increased, transactions were being priced at up to six or seven times free cash flow. The rollup wave of the late 1990s drove free cash flow multiples even higher for some popular industries. Since about 2003, liquidity has been eased to the point that an 8 to 10 times multiple for a target with solid free cash flow characteristics is not uncommon. (Taking a step back, it's probably no surprise that private equity IRRs have halved over the past 20 years as acquisition multiples have doubled.)

As described earlier, such higher prices were made possible, in part, by expanding leveraged-lending multiples, as well as higher prices the public was willing to pay for equity in IPOs of LBO companies.

The LBO going-public movement has also sparked an increase in so-called reverse mergers or shell transactions, where an LBO goes public not by merging into a public company or by launching an IPO, but by backing into an inactive public corporation with an exchange of shares, and a deal with an investment banking firm or firms to immediately make a market in the shares. It's quick, it's inexpensive, and it no longer has the stigma it once had.

What effect do these price/cash flow multiples have on debt payout?

At three to four times free cash flow, a company can withstand a decline in operating cash flow and retire its debt within seven years. At four to five

times free cash flow, a company can go a number of years with flat earnings and the equity will still appreciate in value. But at six to seven times free cash flow and higher, the company must have solid prospects of earnings increases for the deal to make sense.

What is the utility of a debt-equity ratio?

Many people focus too much on capitalization ratios, the ratio of debt to equity. LBOs sometimes exhibit dramatic ratios of 100:1 or more, and these are taken as demonstrations that the company is overleveraged and will be in trouble after the closing. However, the ratio of debt to purchase price is not the real test. Much more important are the ratios of (1) debt to market value, which indicates the public's perception of the degree of solvency of the company, and (2) operating income to interest and principal payments, which measures the company's ability to service its debt.

For example, suppose you contract to purchase a broadcast company for $100 million—10 times cash flow—and then, before closing, negotiate a deal to pre-sell half of its stations for $65 million—13 times cash flow—thereby effectively obtaining the remaining stations for 7 times cash flow, substantially below the prevailing market price. Your purchase price for the remaining stations was, in effect, $35 million, on which you borrowed $34 million and put up $1 million in equity. The stations are worth $50 million on closing day. It is more accurate to say that your debt-equity ratio is 34:16 ($50 million – $34 million = $16 million) rather than 34:1.

Similarly, if the buyer is overpaying, a good debt-equity ratio won't make the deal successful. Suppose the target's cash flow will support $40 million of debt, and it has been purchased for $60 million, of which $45 million is debt and $15 million is equity from a too-eager buyout fund. The capitalization ratio is a reasonable 3:1, but trouble is sure to come. Capitalization ratios work when the total value can be clearly determined by a smoothly functioning market, which is reflected in the purchase price of the target rather than from go-go bankers. The valuation of companies in go-go markets is too complex and the market too imperfect to apply rule-of-thumb capitalization ratios as go–no-go criteria.

How useful are company projections in evaluating future cash flow prospects?

They are extremely important. Where the LBO buyer is doing a management buyout and pre-acquisition management will remain in place after the buyout,

managers stand to gain either as stockholders or with increased salaries if the company prospers. After all, they know the business better than the buyer does—at least in the early stages—and it is to their advantage to make accurate projections.

It is generally advisable for the buyer to begin by asking managers to share their business plan projections of future economic performance, then ask for their past projections and compare them with how they actually did. Any major differences must be explained.

Generally speaking, the management team that can present a solid business plan and can give a crisp, precise, well-thought-out set of projections will be a winner. Losers are found in the team that fumbles around and says, "Gee, we don't do projections," or "We only do them once a year," or "We did them six months ago; we have to bring them up to date."

How do you avoid undue optimism in projections?

Two sets of projections should be made: the *base case* and a *reasonably worst case.* The base case tends to have some optimistic thinking in it, and the reasonably worst case is one where management believes it has a 90 percent chance of meeting its targets. The buyer's decision to pursue a deal and the money targeted to borrow is dependent on that 90 percent case. If the buyer relies on the reasonably worst case projection, everything need not fall exactly into place for the target to meet its debt obligations.

If base case projections are far more optimistic than the reasonably worst case, be cautious. The company may have too high a level of volatility in its earnings to be a good LBO candidate.

When studying projections, the buyer should be sure to ask selling management why the company or division is for sale. Is there something in the future that will cause this business not to earn as much money as it has been earning?

Buyers should also focus on what effect the post-LBO company's leverage ratio will have on its operations—for example, in obtaining trade credit.

SPECIAL CONSIDERATIONS FOR PRIVATE COMPANIES

What's unique about private company M&A?

Acquisitions of public companies tend to capture the most headlines, but in practice the real action is in the market for private company M&A, where

more than 10,000 businesses can trade hands every year. The sale of a privately held company frequently involves dynamics that are different from the merger of two large, publicly traded enterprises.

Most (but clearly not all) private companies are smaller and of narrower scope than public companies. They might be built around a single product area and its natural extensions, rather than a portfolio of diversified offerings. As such, they often have higher customer concentration, and perhaps have less bench strength in terms of management expertise beyond the entrepreneur and some key personnel. This may result in a discounted M&A valuation.

Sometimes, the company is family owned or controlled, which can draw in personal emotions and other nonbusiness considerations. But perhaps most important, the sale of a private company often involves a one-time opportunity for an entrepreneur or small group of shareholders, inexperienced in the M&A process, to maximize the financial rewards for a lifetime's work. Though public company M&A is sexier, the fact is there are typically more opportunities for advisors to add value in private company M&A.

Are there preparations for sale that an owner can make to maximize value during the M&A process?

Absolutely. Many private companies do not have audited financial statements unless their lenders require them to do so. However, depending on how far in advance the seller is planning, having an audit by a reputable accounting firm can be of enormous benefit. For starters, an audit can discount the perceived risk to an acquirer of the financial results presented as part of the process. Lower risk frequently means higher valuations. In the event the buyer is a public company and the target represents 10 percent or more of the assets of the combined company, the audit may be necessary anyway.

Are there other financial reporting considerations for a private company?

Yes. While we clearly can't condone the practice, shareholders of many private companies either run personal expenses through the business in order to obtain a tax deduction, or (in the case of a C corporation that's owner managed) pay themselves unusually high compensation in order to avoid double taxation of dividend income. It is quite normal for a seller to have pro forma financial statements that add back expenses that would not occur if the business was owned

by someone else. This does not mean that 100 percent of the entrepreneur's or CEO's compensation should be added back (unless that person was entirely absentee); after all, someone must manage the business at a market level of compensation. However, to the extent that the entrepreneur/CEO is compensated above market terms, this might be an appropriate add-back. It can have a meaningful impact to the bottom line. For example, $100,000 of excess CEO compensation, at a buyout multiple of eight times free cash flow, translates into $800,000 of incremental transaction value (at a capital gains tax rate, no less).

Other add-backs that the authors have seen from time to time include insurance premiums, automotive allowances, sports tickets, and other fringe benefits. However, whatever add-backs sellers proffer should be items that they are prepared to not receive post-transaction. More important, all add-backs should be limited in scope, logical, and easily identifiable.

What advice would you offer a potential buyer of a privately held company?

In the authors' experience, the seller of a private company is concerned about three things: (1) maximum value, (2) form of transaction consideration, and (3) certainty of close. The first item is readily understandable; it's human nature, after all.

The second item, form of transaction consideration, might differ on a case-by-case basis. In some situations, the seller is harvesting substantial cash dividends each year from the business. In the authors' experience, it is a losing battle to try to convince such a seller to take stock in another private company as transaction consideration; it overlooks a common key driver of the sale process—liquidity. As the old saying goes, cash is king. Some sellers in these circumstances will take stock in a public company, but occasionally only if the shares are registered and freely tradable (subject to the SEC's affiliate sales rules).

On the other hand, some sellers don't want a cash deal because it will trigger a substantial tax liability. Such sellers might be more inclined to want stock in a public company as transaction consideration, particularly the older the owner is (and for estate planning purposes would benefit from a stepped-up tax basis). Our advice: ask sellers what their objectives are, and craft the transaction around them.

The third item, certainty of close, is particularly important for sellers who have not been down the M&A road previously. Many become concerned about operational disruptions from employees, customers, or competitors

after a deal is announced, and fear that their life's work is at risk if the transaction does not close. The buyer who can present the best case for why it will close on time will often have the upper hand in a competitive sale process.

EXPRESSING THE PURCHASE PRICE IN THE ACQUISITION AGREEMENT

Once the parties agree on the price, they must express it properly and concern themselves with the effect on the price, if any, of any significant change in profits and losses between the signing and closing.

Once the buyer and seller arrive at the purchase price, how is it set forth in the acquisition agreement?

The buyer and seller can agree that the price is a fixed amount or an amount determined by a formula. A fixed amount is specified as a total dollar amount, which may be payable in cash or a combination of cash and securities. The noncash portion of the price will normally be in the form of subordinated promissory notes, preferred stock, or, if the buyer is a publicly held company, common stock of the buyer. It is less common for the seller to retain a common stock interest in the acquired company.

Where the price is determined by a formula, it is commonly based on book value, or stockholders' equity from a balance sheet prepared as of the closing date, plus or minus a dollar amount.

Under another variation, a fixed price is established, and the buyer receives a credit against the price for any excess earnings or is required to pay an increased amount equal to any losses realized by the business after a specified date. This can be expressed as an adjustment for changes in working capital—that is, the difference between cash and other current assets versus current liabilities of the company on the closing date.

How is a book value formula price implemented?

Typically, the acquisition agreement provides that the buyer will purchase the company by paying the estimated book value at closing, plus or minus *x,* and that an adjustment will be made after the closing when a precise book value figure has been determined.

How do these provisions work?

The seller typically delivers an estimated closing balance sheet five business days prior to the closing, together with supporting documentation. The parties agree on, and close on the basis of, the estimated balance sheet. After the closing, the seller prepares the balance sheet as of the closing date, which is usually the end of an accounting period. The actual closing balance sheet (ABS) is compared to the estimated closing balance sheet (EBS). If the ABS shows a higher book value than the EBS, the buyer pays the seller the difference. If such value is lower, the seller pays the buyer.

Are accountants used in this process?

Absolutely. The seller's accounting firm will often audit the closing balance sheet. The buyer's accountants then review the audit. If the parties and the accountants differ on the correct presentation of the balance sheet, buyer and seller (or their accountants) may turn to a third accounting firm to resolve any differences.

Such review procedures vary from the simple to the exceedingly complex. The agreement often provides that if the final balance sheet varies by more than a specified percentage (often 10 percent), then the challenging parties' fees are paid. If they do not vary materially, the challenger may be required to pay the fees of the prevailing party.

Because of the different results that can be obtained while complying with generally accepted accounting principles (GAAP), some agreements provide that the net effect of any challenge to the seller's balance sheet presentation must be more than a specified dollar amount to require an adjustment.

What other issues arise in such provisions?

In addition to specifying that balance sheets must be prepared in accordance with GAAP, the parties should specify which method of inventory valuation should be used. Taxes may also be important in determining book value. It is also wise to state that the balance sheet should not reflect any liability that arises solely from the sale of the business.

What other arrangements are used in pricing?

Some deals provide that the acquisition be effective on a specific date. After that date, the profits and losses of the business are for the buyer's account. This

period is sometimes called the *interim* or *stub period.* Typically, gains decrease and losses increase a fixed purchase price. As with adjustments to book value, rather than waiting for the final results, closings are often made on the basis of an estimate and adjusted when the actual results are determined.

Many things can happen between agreement and closing. A buyer's best protection is to put someone on-site to monitor operations. Even so, the usual provisions that the business shall be operated in the ordinary course of events should be incorporated in the agreement. Some buyers have been surprised at the amount of time consumed in getting from agreement to closing.

To measure profit and loss, the parties must define precisely what they intend. For example, net income may be calculated without deduction for administrative charges and interest expense. Net income should not be reduced by nonrecurring expenses incurred in connection with the transaction, such as legal and accounting fees, separation payments, or special entertainments.

Sophisticated sellers may credit the buyer with the stub period earnings but may try to build up offsets against them such as interest at a fixed rate (for instance, 10 percent) on the purchase price during the interim period.

When is it appropriate to use a formula rather than a fixed-price provision in the acquisition agreement?

If a substantial period of time is to pass between signing the acquisition agreement and the closing, the buyer will want protection against changes in the value of the target during the interim. While most of the value is impounded in the earnings stream, changes in operations may not show up in operating losses for many years and are difficult to guard against. However, one kind of protection is to set forth a book value formula. Generally, this will detect any sales of assets or other major changes in operations from the ordinary course of business.

Files on intangibles, such as patents and trademarks, should be sequestered so as not to be encumbered either by intent or error.

The variant method of setting a fixed price and then providing a working capital or earnings adjustment to the closing price may have the advantage for both buyer and seller of reducing the amount of variation possible between estimated and final price, and focusing more sharply on those aspects of company performance that the adjustment is intended to cover.

The variant method thus reduces the difficulty of that critical moment in the process that arises when the seller presents the buyer, on the eve of the

closing, with the estimated balance sheet book value number. Significant differences between estimates and actuals serve as an opening for further negotiations, not only on price but also on other issues that both parties have been identifying as loose ends since the acquisition agreement was signed. A selling party nervous about closing would prefer that any closing price differences be as large as possible so that there is an excuse to walk, while the buyer who is eager to get into operations wants it as small as possible so the seller can't walk.

What issues arise where the price is determined by reference to the seller's or buyer's stock price?

The parties could agree that the value of a share is equal to the market price on the day the deal is struck no matter what happens to the stock after the news gets out. However, because the market price can be higher or lower on the closing date, sometimes substantially so, the parties may instead agree to use the market price on the closing date. Another alternative is to use the average price at closing for the 20 days prior to the closing. Another method is to look at the price of the stock over the past year and, while using the price on the day of closing, place a maximum and minimum (a *collar*) on the stock price independent of the trading price on closing day. The parties will have set limits on the total consideration. For example, if a stock's average price is $30 prior to signing, the parties may agree that, regardless of the actual average before closing, the price per share will be no lower than $25 or higher than $32. The collar can also regulate the maximum and minimum number of the buyer's shares that the buyer must deliver to selling stockholders.

Is there any other approach that should be considered?

An underwriting agreement is, in effect, a sale and purchase agreement. Typically, the underwriter only agrees to make "best efforts" to consummate a deal. Less common today is a firm commitment to buy the company's stock at a set price regardless of whether or not the underwriter can resell it. The firmness of the agreement is set by the number and the terms of the market outs negotiated by the parties. Since the October 1987 market crash, for instance, one typical market out states that the underwriter does not have to go through with the contract if there is a 25 percent drop in the S&P 500, or if

the United States declares war, or if other adverse market conditions exist. Sellers could also request market outs if something negative happens to them or their industry, but they rarely do so because they don't want the underwriter to trade them off for a new set of market outs.

With what form of consideration should one pay—stock, cash, notes, or a combination?

The form of the consideration to be paid can be almost as important to the buyer and seller as the amount that will be paid because of the tax treatment accorded the deal. This is discussed in depth in Chapter 5.

In transactions involving public companies, how can buyers use a combination of cash and securities?

Some transactions are structured, usually for tax reasons, to provide for fixed percentages of cash and stock. For example, the buyer might offer $20 million in cash and 2 million shares of buyer's stock to holders of the 2 million shares of the target company. The agreement can allocate such cash and securities proportionally—$10 in cash and one share for each share of the target. Alternatively, stockholders of the target may be given the option to elect between all cash and all securities or any combination. If too many stockholders elect cash, they may be forced to take some stock as well. Such provisions are often referred to as a *cramdown* because of their coercive nature. As an alternative, to avoid a cramdown, certain large insider stockholders may agree separately to take a combination of cash and securities so that other, smaller holders can elect to be paid all cash. (See Chapter 10 on public company acquisitions.)

What is an earnout?

An *earnout* is a method of compensating a seller based on the future earnings of a company. It is the contingent portion of the purchase price. A common type of earnout provides for additional payments to a seller if the earnings exceed agreed-upon levels. Another type of earnout may provide that certain debt given to the seller as part of the acquisition price is anticipated and paid early out of earnings exceeding agreed-upon levels.

Earnouts require consideration of various factors: the type of contingent payment (cash or stock), the measurement of performance (operating

income, cash flow, net income, or other), the measurement period, maximum limits (if any), and the timing of payments.

Why would the parties use an earnout?

The parties may disagree on the value of the business because they have different opinions about the projected profit stream. Often, the buyer is relying on the seller's projections of future cash flow in setting the price. The buyer and seller may disagree on the seller's ability to realize the projected results. A buyer will be willing to pay a higher price for greater cash flow if, and only if, the projected cash flow is realized. An earnout permits the buyer to pay a reasonable price plus a premium when and if the cash flow is realized. It also allows the seller to realize the full value of the business if it is as profitable as represented.

Why are earnouts difficult to administer?

A typical earnout might provide that the seller will receive an additional payment in each of the first three years after the sale, provided that in each of those years the acquired company realizes operating income of, say, $1 million or more.

Although simple in concept, earnouts raise a number of problems. The buyer and seller must agree on the definition of operating income. The buyer will want to be sure that such income comes from continuing operations and not extraordinary or nonrecurring events. Furthermore, the earnout may require that the acquired company be operated separately and consistently with past practice. If the buyer wants to combine certain of its operations or modify them, such changes will be difficult to factor into the levels of earnings to be achieved, particularly if they are not decided upon until after the sale.

What concerns will the seller have in an earnout?

The seller is interested in ensuring that changes in the operation of the company after the sale do not affect the company's ability to attain the targeted earnings. The seller may thus seek agreements that goodwill will be ignored in making the calculations and that the company will continue to be operated in a fashion consistent with past practice and will not be charged with new administrative overhead expenses. The seller may also focus on depreciation, interest charges, and intercompany transactions with the buyer's company.

The seller will want to receive credit for the target's post-acquisition results, even if the $1 million level in the example is not achieved. If in the first three years the company earns, respectively, $800,000, $1 million, and $1.2 million, the seller will feel entitled to receive the total contingent payment, even though operating income did not exceed $1 million in the first year. The parties may agree on a sliding scale or averaging approach and a maximum payment.

The seller will also focus on when it receives a contingent payment—after each year or at the end of the period, say, three years. The buyer must now consider whether this will trigger any obligation to refund a payment for year 1 if the results in years 2 and 3 are substandard.

Ultimately, no legal agreement can provide complete protection for both parties in earnout agreements; there are far too many variables. Buyer and seller must rely on either the provisions expressed in terms of the intent or good faith of the parties or their reasonable business judgments. By the time buyer and seller have gone through a turbulent acquisition closing with each other, they may find little comfort in such arrangements. Many painfully negotiated earnout agreements are bought out as the closing approaches.

Are there tax and accounting considerations with earnouts?

Earnouts can spread out income in taxable transactions for sellers with resulting tax benefits. To have a tax-free reorganization, contingent shares must be issued within five years of the closing. The buyer may also obtain a tax deduction where the earnout is paid as compensation under an employment agreement. However, the payments may be ordinary income to the recipient.

Why are earnouts not more common?

The senior author has negotiated many earnouts but has always been surprised at the number that are bought out at or very near closing. It comes from the difficulty of policing costs with the buyer now in command. The buyer could overspend on R&D, advertising, and so on, and reap the benefits many years in the future but reduce the price paid today by reducing reported earnings. If the seller is still running the business, the reverse is true: the seller reduces essential expense and hockey-sticks the earnings.

In other cases, especially in a conglomerate or a chain (which might have 60 or 70 profit centers), where a strategic business unit or a product line has not been the subject of regular audits, and where direct and indirect

transfer costs have not been properly charged, no one knows, from the record, whether it is currently profitable or not, and audits won't help because the records are missing or miskept. So it must be sold with an earnout contingency (sometimes to insiders who know where all the bodies are buried and who may have themselves depressed the earnings) to discover whether or not it is profitable, and if so, how profitable.

In other cases, where an earnout might look feasible, the buyer may need to own all the upside potential to interest investors or lenders and doesn't want to share the upside potential with the seller. Very often, the buyer may be lucky: all the seller wants is to get out and go on to something else. The last thing the seller wants is to ride herd on decisions as to what are and are not direct expenses, the essence of the proper administration of an earnout.

For all of these reasons, earnouts are often negotiated but seldom signed.

Are there alternatives to the earnout concept?

Certainly, but, unfortunately for the seller, they are mostly in the control of the buyer. The first one has to do with the price of the stock where stock has been used as the purchase medium. The problem with this is dramatized by one Detroit seller that got a guarantee as to stock price, with makeup shares as the compensating vehicle. The seller wound up in control of a major acquirer when its stock fell out of bed. Other types of contingent consideration are preferred stock, warrants, and other contingent instruments.

What are solvency opinions and who generally requests them?

Solvency opinions are designed to meet the needs of lenders and investment bankers, particularly in highly leveraged transactions. The purpose of the solvency opinion is to help the lender or banker document solvency and enable it to rebut potential fraudulent conveyance claims in case the borrower encounters financial difficulties.

Can outside accountants issue solvency opinions?

No. An outside accountant cannot provide any form of assurance, whether through an examination, review, or application of agreed-upon procedures, that an entity (1) is not insolvent at the time debt is incurred or will not be

rendered insolvent thereby; (2) does not have unreasonably small capital; or (3) has the ability to pay its debts as they mature.

Providing such assurance is precluded because these matters are legal concepts subject to legal definition and varying legal interpretations that are not clearly defined for financial reporting purposes.[24]

What services may an outside accountant provide to assist in solvency determinations?

Although outside accountants cannot give any direct assurance as to solvency, they can provide services that may be useful to a company seeking financing. Such services include examination and review of historical information, examination and review of pro forma financial information, and examination and compilation of prospective financial information. Restricted use reports (that is, agreed-upon procedure reports pursuant to auditing attestation, or prospective financial information standards) may be provided in connection with a financing, but may not speak to matters of solvency.

What are comfort letters and who typically requests them?

Under federal securities laws, an underwriter is responsible for carrying out a reasonable investigation of financial and nonfinancial data included in registration statements filed with the SEC under the Securities Act of 1933. As part of this reasonable investigation, letters of assurance regarding financial data (comfort letters) are typically requested by underwriters and issued by outside accountants in connection with an underwritten offering of securities under the Securities Act. Comfort letters may also be requested by underwriters in conjunction with securities offerings not subject to the Securities Act.

In issuing comfort letters, accountants generally apply selected procedures to financial data not otherwise reported on by the accountant, such as (1) unaudited financial statements, condensed interim financial statements, capsule information, and pro forma financial information; (2) changes in selected financial statement items (such as capital stock, long-term debt, net current assets or net assets, net sales, and the total or per-share amounts of net income) during a period subsequent to the date and period of the latest financial statements included in the registration statement; and (3) tables, statistics, and other financial information.

What comfort does such a letter provide underwriters?

The assurance outside accountants provide underwriters by way of comfort letters is subject to limitations. First, any procedures performed short of an audit, such as the agreed-upon procedures contemplated in a comfort letter, provide outside accountants with a basis for expressing, at most, negative assurance (that is, that nothing came to their attention that indicated something was wrong). Second, outside accountants can properly comment in their professional capacity only on matters to which their professional expertise is relevant (for example, outside accountants' ability to measure does not make it appropriate for them to give comfort on the square feet in a plant).

In addition, what constitutes a reasonable investigation sufficient for an underwriter's purposes has never been authoritatively established. As a result, the underwriter, not the outside accountant, is responsible for the sufficiency of the comfort letter procedures for the underwriter's purposes.

CONCLUDING COMMENTS

To be effective as a buyer or seller, you don't need to be a valuation expert—in fact, thinking you have enough knowledge can be (to quote Alexander Pope) a "dangerous thing." Valuation is such a complex art, and there are so many good specialists to consult, that this is one area where produce can be counterproductive. At the same time, to avoid overpaying for a company (or getting underpaid as a seller) you do need to know valuation fundamentals, and how to express them in an acquisition agreement. In closing, then, let us reflect on the words of the Chinese philosopher Confucius, writing some 2,500 years ago: "When you know a thing, to hold that you know it; and when you do not know a thing, to allow that you do not know it—this is knowledge." The valuation stage is a good time to develop and strengthen these twin virtues of confidence and humility.

NOTES

1. As for takeover rumors, they can add up to 31 percent to the price of a stock—according to the *Wall Street Journal* columnist John R. Dorfman (writing in "Heard on the Street," May 28, 1991). This compares to a "typical" M&A premium of 20 to 30 percent, although premiums exceeded 50 percent in 1999–2000. "The Problem with Premiums," *The Deal,* July 26, 2004, p. 24.

One M&A executive attributed the recurring 30 percent takeover premium to the "country club" factor: "The CEOs don't want to go to the country club on the weekend and have their friends say, 'You overpaid for that company. . . .' " "Boon Time: A Conversation with CSFB's Americas M&A Chief Boon Sim," *The Deal,* August 8, 2004, p. 32.

2. M&A legend, Bruce Wasserstein, suggests a few reasons in his book, *Big Deal:* "Why the seller wants to dispose of the business is the first question asked. Lack of strategic fit is sometimes persuasive. Modesty is also effective. Selling the notion that somebody with a different skill set is needed to take advantage of latent opportunities works." Bruce Wasserstein, *Big Deal* (Warner Books, 1998), p. 648.
3. George B. Baldwin, "Discounted Cash Flow," *Finance & Development,* September 1969.
4. Arnold Bernhard, "The Valuation of Listed Stocks," *The Book of Investing Wisdom* (John Wiley & Sons, Inc. 1999).
5. The eloquence of Mark N. Schwarz, in an investment banker roundtable called "On the Threshold of an Upbeat in M&A Dealmaking," *Mergers & Acquisitions,* September/October 1993, p. 20. With the increased requirements of public companies following Sarbanes-Oxley, some private companies seeking liquidity have chosen the M&A route rather than going public. Raymond Hennessey, "IPO Market Ended Year Better Than It Started," *Wall Street Journal,* January 2, 2004, p. R15.
6. Chris Gaither, "FleetBoston Financial to Close Its Robertson Stephens Investment Banking Unit," *Boston Globe,* July 15, 2002.
7. "Corporate Cash Reserves and Acquisitions," *Journal of Finance,* December 1999.
8. James McNeill Stancill, "When Is There Cash in Cash Flow?" *Harvard Business Review,* March–April 1987.
9. "Sellers Find That It Pays to Stick around after a Deal: Buyers of Businesses Reward Former Owners Who Help Reduce the Risks," *Wall Street Journal,* November 9, 1993.
10. "Grasping the Slippery Idea of Risk," *New York Times,* December 12, 1993.
11. "A Bean-Counter's Best Friend," *Business Week,* Special Issue, "Managing for Quality," 1991.
12. "When Tax Audits Might Mean Windfalls to Companies," *New York Times,* April 16, 1991.
13. By the early 1990s, a survey by the Cost Management Group of the Institute of Management Accounting found that nearly half of all companies were using ABC. Among those cited included Tektronix, Hewlett-Packard, IBM, Weyerhaeuser, and Dell Computer. "Corporate Controller Survey Reveals

Progress on Ethics Codes, Performance Measurement," *Director's Monthly,* May 1994, p. 8.

14. N. Roztocki, "Adoption and Implementation of Activity-Based Costing: A Web-Based Survey," with Sally M. Schultz. Proceedings of the 12th Annual Industrial Engineering Research Conference (IERC 2003), Portland, OR, May 18–20, 2003. In May 2006, the Web site of the Grocery Manufacturer's Association, an association of food, beverage, and consumer products companies, declared that its benchmarking surveys "show that activity based costing, activity based management and other unique customer approaches and bundling of services continue to be competitive strategies used by industry leaders." Source: www.gmabrands.com/industryaffairs/docs/whitepaper.cfm?DocID=353&

15. N. Roztocki, "Activity-Based Management for E-Commerce," *WeB 2003 Proceedings,* Seattle, WA, December 13–14, 2003, pp. 121–129.

16. Scott Kilman, "Ethanol Shifts Share Prices Into Overdrive," *Wall Street Journal,* April 13, 2006, p. C1.

17. Sunita Kikeri and Aishetu Kolo, Privatization Trends and Recent Developments (Washington, D.C.: The World Bank, 2006). http://rru.worldbank.org/Documents/Privatization/Privatization_paper.pdf.

18. "Luck or Logic? Debate Rages On over 'Efficient-Market' Theory," *Wall Street Journal,* November 4, 1993.

19. "The Allure of the New CBS," *Barron's,* December 12, 2005.

20. "For Time Warner, Case Floats Idea of Four-Way Split," *Wall Street Journal,* December 12, 2005, p. B4.

21. All else equal, high-yield investors' appetite for risk is frequently higher as the calendar year-end approaches—ahead of the seasonal uplift in the financial markets that December often delivers. "Hefty Junk-Bond Calendar Awaits," *Wall Street Journal,* December 9, 2005, p. C4.

22. "Junk Bonds for Leveraged Buyouts Make a Comeback," *Financial Times,* September 28, 2004, p. 46.

23. "Sudden Jolts Take the Heat Out of Markets," *Financial Times,* June 22, 2005, p. 4; "Leveraged-Lending Market Update—A Prosperous Outlook," *The Deal,* September 13, 2004, p. 52.

24. Note, however, that this distinction has not prevented the Big Four accounting firms from facing some billions of dollars worth of lawsuits alleging blame in the auditing of savings and loans that failed after receiving unqualified audit reports.

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CHAPTER 4

The Art of Financing and Refinancing

INTRODUCTION

Of all aspects of the merger/acquisition/buyout process, perhaps none is as critical as financing. There is no such thing as a free merger: it takes money to buy a company, and the money must come from somewhere. At the simplest level, all transactions are paid for in the form of cash, stock, and/or notes, but behind these three basic modes of payment lies a complex universe of funding sources and issues.

If the deal is funded by stock, will the stock come from existing shares, a public offering, or a private placement? Will a private equity firm be involved in the deal and, if so, how much control will it want over the company's operations going forward? If the deal is funded from cash, will the cash be generated internally from profits, or will it be borrowed? If it is borrowed, will it come from a traditional commercial bank or from a less traditional source, such as a commercial finance company, a leasing company, or a life insurance company? How many lenders will be involved under what terms? Will the seller accept promissory notes as part of the payment? Can part of the price be paid out as a contingency payment, based on company performance? Will the terms of any loan agreements or notes unduly restrict plans the acquirer has to pay the lender or seller back?

In the dynamic terrain of financial dealmaking, what matters most is how the money will be structured, not where it will come from. In this

highly creative field, much depends on written agreements between buyers, seller, and various third parties (including, but not limited to, commercial bankers) all of whom are betting on the future. Creativity, negotiating skills, and a keen eye for detail can make the difference between success and failure here.

This chapter begins with an overview of financing sources, followed by a brief discussion of equity sales as a source of capital. The remainder of this chapter will focus on debt. We will focus on highly leveraged transactions (HLTs) with an emphasis on LBOs—that is, taking publicly held companies or units private using borrowed cash.[1] Some of the principles described here are also applicable to the less-leveraged acquisitions, but we will not take pains to point out such broad applications.

Leveraged deals fall in and out of fashion, but in any environment, company executives and their advisors need to ask, "How much debt financing is enough? How little is too little?" The main objective of the leverage maestro is to finance as large a part of the cost of an acquisition as possible by borrowing against the assets and the future cash flows of the acquired company. Through aggressive structuring of financing, leveraged buyers have been able in some cases to reduce their equity investment to as little as 5 percent or less of the acquisition price. This chapter will provide a variety of strategies dealmakers can use to achieve such results.

FINANCING OVERVIEW

How can a buyer find money to make acquisitions?

The art of M&A (merger-and-acquisition) financing is a subject worthy of an entire book. See, for example, Alexandra R. Lajoux and J. Fred Weston, *The Art of M&A Financing and Refinancing: Sources and Instruments for Growth* (New York: McGraw-Hill, 1999). This is because there are literally hundreds of specific sources of capital ranging from an accounts receivable credit line to a wraparound mortgage.[2] The simplest source, of course, is the cash the company already has in its bank accounts. Beyond this, financing sources vary greatly by size of business, as described later in the chapter.

All these different modes of financing, and hundreds more, can be divided into *equity, debt,* and *hybrids* of the two.[3]

FINANCING INSTRUMENTS: EQUITY VS. DEBT VS. HYBRIDS

What exactly is equity and how does it work as an M&A financing source?

Equity is the value of a company, shown in a balance sheet as net worth after liabilities have been subtracted from assets. It is expressed in units called shares or, collectively, stock. Shares of stock can be sold as a security—a financial instrument "secured" by the value of an operating company or a government.

Under normal circumstances, the value of equity can be realized either as dividends the company pays its stockholders, or as gains stockholders can make by selling shares. When a company is insolvent (bankrupt), equity represents claims on assets after all other claims have been paid.

There are two types of equity-financed M&A deals. A company can sell its equity and use the money to buy another company. Or it can simply offer its own shares to the buyer as a mode of payment for a company.

If a company wishes to remain private, it can do a *private offering* of equity or debt securities with a private placement firm. The placement must be limited to 35 investors of any description, plus any number of "accredited investors."[4] If so, the offering will be exempt from the extensive regulations covering public offerings as defined by securities regulators (in the United States, the SEC). In a private placement, a brief notice of sale of federal Form D must be filed with the SEC for informational purposes. However, there is no federal review of comment process for such a placement as there is with a public company.

A *public offering* of securities, including any securities issued in connection with a merger or acquisition, must be registered with the SEC. Public offerings—both IPOs and secondary offerings after that—are managed by an underwriter, usually an investment banking firm (described later in the chapter). Once the public owns stock in a company (and thus establishes a market value) it is generally easier for the issuer to use its shares as an acquisition currency. Alternatively, the company can have a secondary public offering or a debt offering and use that cash for acquisitions. (For more about registration of equity and debt securities, see the discussion about registration rights.)

What exactly is debt and how does it work as an M&A financing source?

Debt is a promise to repay a certain sum by a definite time. The promise is made in the form of an agreement, also called (in multilender deals) a facility. To raise capital via debt, a company can do two basic things:

- It can take out a loan from a creditor such as a commercial bank.
- It can sell a bond, note, or commercial paper to an investor such as a pension fund.

Whether debt capital is obtained by borrowing from a lender or by selling a debt security to an investor, interest is charged either in fixed or variable rates. The interest rate(s) for the typical loan—for example, a standard term loan—can be determined by the lender's cost of funds as well as the following rates, listed highest to lowest: the bank prime rate, the federal funds rate, and/or the London Interbank Offered Rate (LIBOR).[5] Under normal circumstances, the value of debt can be realized through the rate of interest charged.

What are some examples of financial instruments that have both equity and debt (hybrid) characteristics?

Securities may be issued as equity securities (shares of company stock) or as debt (company or government bonds, notes, or paper). *Common stock* typically grants its owners the right to vote and (if authorized by the company's board of directors) receive dividends. *Preferred stock* is a hybrid security with characteristics of both debt and equity. Payments to preferred stockholders are called preferred dividends. Being based on a contract promising payments of fixed size, preferred dividends are similar to interest payments on debt (albeit taxed differently).

Why does it matter whether an instrument is characterized as debt versus equity?

The characterization of an instrument as debt vs. equity can change how the company accounts for a transaction, as well as how taxes are paid. For more details, see Chapter 5 on Structuring.

FINANCING SOURCES

What are some common sources of equity and debt financing?

As mentioned, there are literally hundreds of sources of financing. Here are some of the most common ones:

- Asset-based lenders, which make loans based on a company's hard collateral, such as real estate.
- Commercial and community banks, which make term loans. Larger commercial banks provide other services through subsidiaries, such as stock brokerage firms that retail company stock or offer credit cards, a source of funding for very small companies.
- Commercial finance companies, which make term loans (but unlike banks cannot take deposits).
- Employees, who can buy a company's stock through an employee stock ownership plan, a special type of private stock offering.[6]
- Insurance companies (which are permitted to make loans collateralized by insurance policies).
- Investment banks, which serve as underwriters by working with brokerage firms as buyers and resellers of issues of equity and debt. They, in turn, sell to institutional investors such as pension funds, which buy stocks and bonds for their beneficiaries, and investment companies (see following).
- Merchant banks, which are like investment banks, but which invest their own money as principals in a transaction.
- Investment companies, also called mutual funds, which buy stock in publicly traded companies to create portfolios for customers.
- Private investment firms, also called venture capital firms, which buy debt or equity securities of privately held companies as an investment.

There is a thin line between an investment company (subject to the Investment Company Act of 1940) and a private investment firm, which may or may not be subject to that law. A list of private investment firms (some of which may also qualify as investment companies, depending on circumstances) includes:

- *Crossover funds.* Funds that invest in both public and private equity.
- *Hedge funds.* Funds of investors (usually institutional) and wealthy individuals exempt from many investment company rules and able to use regulations, and can thus use aggressive investment strategies that are unavailable to mutual funds, including selling short, leverage, program trading, swaps, arbitrage (investing in companies that have made and/or received acquisition tender offers), and derivatives—all ways of hedging investments.
- *Fund of funds.* Funds that invest in other funds. Types include master-feeder and multiple-class funds.
- *Leasing funds.* Funds that invest in leases.[7]
- *Pledge funds.* Funds created through multiple pledges from individual investors.[8]
- *Private equity (LBO/MBO) funds.* Funds that buy all the stock in a public company, or buy a unit of a public company, and thus take the company or unit private. See further discussion later in this chapter.
- *Mezzanine funds.* Funds that invest in relatively large loans that are generally unsecured (not backed by a pledging of assets) or have a deeply subordinated security structure (e.g., third lien).
- *Real estate funds.* Funds that invest in real estate, often structured as real estate investment trusts (REITs).
- *SBIC funds.* Funds that qualify as Small Business Investment Companies (SBICs) under a Small Business Administration (SBA) program to encourage small business investing. See further discussion later in this chapter.
- *Venture capital funds.*[9] Funds that manage money from investors who want to buy stock in smaller companies with potential for growth.

Note that the use of these sources varies by company size.

- The primary sources of financing for small businesses currently are personal savings (36 percent), commercial bank loans (20 percent), community bank loans (14 percent), and credit cards (11 percent). Remaining sources were loans backed by the SBA (6 percent), credit union loans (1 percent), and others (12 percent), according to a 2006 survey of 402 business owners by the National Small

Business Association.[10] If a small company decides to buy another one, it is likely to use one of these sources to expand. (Bear in mind that the great majority of M&A transactions are valued at under $50 million.)

- At the other extreme, the large multinational company will raise capital through a variety of debt and structured finance transactions, including syndicated loans, leveraged loans, high yield bond offerings, mezzanine financing, project finance, equipment financings, restructurings, and securitizations. These sources, too, can be used to fund mergers—generally through use of commercial and/or investment bankers.[11]

What is the difference between a commercial bank and an investment bank?

Today the word "bank" is used broadly to cover a great range of financial institutions, including commercial banks and investment banks, merchant banks, so-called nonbank banks, and, of course, savings banks. What most ordinary citizens think of as a bank, however, remains the *commercial bank*—the bank which makes loans and lets customers make deposits that can be withdrawn on demand (demand deposits).

An *investment bank* is neither an investor nor a bank. As stated in Chapter 3, it does not invest its own money, and it does not take deposited funds. Rather, an investment bank is an intermediary between saving and investing. An investment bank, in its broadest definition, is a financial institution that helps companies find the money they need to operate and/or grow. Although investment banks do not make loans directly, they can be a bridge to lending. Investment bankers may also serve as finders or brokers in locating and approaching company buyers or sellers, as discussed in Chapter 3.

Following the repeal of the banking law known as Glass-Steagall, the distinction between commercial banks and investment banks has been blurred for two reasons:

- Companies other than commercial banks (including industrial companies with no past financial experience) have made inroads into the services traditionally offered by commercial banks, such as loans. There are even nonbank banks, which may provide depositary services or make loans (but not both).

- Conversely, many commercial and investment banks have formed holding companies that own other kinds of financial institutions, broadening their scope of services.

How can a company decide which kind of source to use for financing?

Every company has a unique capital structure and network of relationships that will determine the kind of financing that would be most advantageous for it, and the sources that would be the most likely to provide funding.

Start by deciding the appropriate kind of financing you want, based on the company's current financial condition, and then begin approaching sources. Any company officer, director, or advisor with financing expertise can be the point of contact. The important thing is to avoid preconceived notions about what these sources can and cannot do. For example, don't think that because you are a small private firm, you cannot sell equity in your business.

There are four main types of underwriting:

- *Firm commitment.* An arrangement in which an underwriter assumes all the risks of bringing new securities issues to market by buying the issue from the issuer and guaranteeing the sale of a certain minimum number of shares to investors.
- *Dutch auction.* Offers come in and determine highest beginning price. The bank buys a set amount for a specific value. Clearing price is determined by investor demand, as revealed through the bidding process, rather than set in advance as in the firm commitment.
- *Best efforts.* An underwriting in which an investment bank, acting as an agent for an issuer, agrees to do its best to sell an offering to the public, but does not buy the securities outright or guarantee any particular financial result from the issuance. Over the past 20 years, this has become the standard, rather than the firm offering.
- *Bought deal.* One investment bank buys entire offering and resells it.

Sometimes, bankers keep their initial purchase conservative and add a *green shoe* provision in the underwriting agreement of an IPO. The green shoe option, which is also often referred to as an over-allotment provision, allows the underwriting syndicate to buy up to an additional 15 percent of the shares at the offering price if public demand for the shares exceeds expectations and the stock trades above its offering price.

Suppose a small private company—say a $10 million company—wants to get funding for an acquisition without doing a public offering. What would be a possible source?

One possible source can be SBICs, which as mentioned earlier are used by some small businesses (about 6 percent in 2005, according to one study cited earlier). SBICs are like investment companies but have special privileges under the tax code (and so are thought of as "government venture capital" although they are owned and controlled privately. SBICs make loans and charge interest, take equity positions, or may insist on holding options or warrants that allow the holder to them to buy stock at predetermined prices for a predetermined period of time.

Companies that meet the SBA's definition of small are eligible for SBIC financing. Generally, the SBIC program defines a company as small when its net worth is $18 million or less and its average after tax net income for the prior two years does not exceed $6 million.[12] There are over 400 licensed SBICs currently licensed to operate. They invest about $3 billion per year in small businesses. Most SBICs concentrate on a particular stage of investment (i.e., start-up, expansion, or turnaround) and identify a geographic area in which to focus:

- *Securities SBICs* typically focus on making pure equity investments but can make debt investments as well.
- *Debenture SBICs* focus primarily on providing debt or debt with equity features. Debenture SBICs will typically focus on companies that are mature enough to make current interest payments on the investment.[13]

The best use of this kind of financing is "activities that generate cash flow in a relatively short period of time, such as product rollout, or for *additional manufacturing or service capacity for which there is a demand.*"[14] The acquisition of a successful going concern would certainly fit this second criterion.

HIGHLY LEVERAGED TRANSACTIONS

How can a buyer finance the acquisition with the acquired company's assets and revenues?

As this question implies, LBOs seem to defy conventional buy-sell wisdom. How, one may ask, can the buyer borrow against the assets of the

acquired company when it is a different entity and needs the money as a precondition to the acquisition? Really it is no more mysterious than a mortgage loan. Lenders don't mind lending against a house as long as they own the house until the loan is repaid. The key concept here is assets—the left side of the balance sheet. The typical leveraged acquisition is based on collateral a lender would consider desirable. So a key structuring objective is to cause the assets and revenues (cash flow) of the acquired company to be located in the buyer-borrower. This can be achieved in three different ways:

- The buyer can acquire the assets and business of the company.
- The buyer can acquire the stock of the company and immediately thereafter merge with it (the question of which entity survives the merger is important for tax, and occasionally other, reasons; see Chapter 5).
- Skipping the stock acquisition stage, the buyer and the company can simply merge directly.

If the buyer and company merge, a problem of timing arises at the closing: payment for the stock purchased by the buyer must be made *before* the merger places the assets of the acquired company in the buyer's possession, but the loan to the buyer cannot be funded until *after* the merger is consummated. To resolve this problem, the parties to the closing agree that all transactions will be treated as occurring *simultaneously* or, for the sticklers, that the seller of the stock will get a promissory note, which is repaid minutes later when the merger documents are filed. Sometimes lenders prefer to have both the buyer and the company named as borrowers on the acquisition loan. Tax or contract compliance questions may be raised by these timing issues (see Chapter 5), and they should be thought through carefully.

What exactly is a highly leveraged transaction? What is the reasonable threshold of leverage?

Highly leveraged loans are debt-financed transactions in which the borrower would end with a debt-to-equity ratio of 75 percent or higher. These HLTs must be identified as such in bank disclosure documents. Regulators also encourage banks and bank regulators to discourage other HLTs, and they have published complete guidelines for this purpose.[15] Note also that some situations—such as default—may trigger a lower ratio.[16]

Why would a buyer want to do a highly leveraged transaction? Doesn't this leave the acquired business in a financially exposed position?

Certainly it does—this was the great lesson of the 1980s, the era of overleverage, which drove a number of companies into bankruptcy. Prudently undertaken, however, a high level of debt need not harm postmerger performance. Indeed, there is some evidence that debt-driven mergers do as well or better than stock-driven mergers.[17] Furthermore, as a mode of payment, debt is an equalizer. Few have the cash or stock already in hand to buy a company, but many can borrow; debt financing enables a buyer with limited resources—in particular, a management group—to own a company. It also gives an investor a chance to reap an enormous return on equity. The Gibson Greeting Cards LBO, which returned several thousand percent to its equity suppliers, is a classic example. Other LBO successes range from the many successful small and mid-sized investments by Forstmann Little[18] to the blockbuster $25 billion RJR Nabisco deal that enriched its promoter, Kohlberg Kravis & Roberts (KKR). Other successful KKR deals include Duracell Inc., Owens-Illinois Inc., and Safeway Stores Inc.

But for every example of easy success there is one of precarious struggle. Forstmann Little made telecommunications investments that tanked, causing a major shareholder (the state of Connecticut) to sue the firm recently, claiming negligence. The verdict was mixed.[19]

What is the verdict, then, on heavy leverage in general? Good or bad?

The jury is still out. Pro-leverage forces point to the successes and say that having a large amount of debt on the balance sheet provides survival incentive for managers to perform efficiently. Management, say these LBO boosters, will focus on making the core business profitable, minimizing the use of capital and maximizing cash flow, rather than on building personal empires. Research on postmerger returns does appear to support this theory.[20]

The antileverage philosophers disagree. Heavy debt servicing competes against operating excellence as dollars once marked for needed research and development or plant and equipment go to interest payments, often with dire consequences for the acquired company and eventually its community.

Both sides agree, however, on one point: if the buyer plans to impose heavy financial leverage on a company, the buyer must be sure that the

company can bear the interest and paydown burdens and must minimize operating risks. LBOs are *not* recommended for managers who are not prepared to operate with substantial amounts of financial exposure for their companies. (We are not even contemplating here the personal financial exposure to individual buyers through guarantees, which present an even higher level of risk.)

What kinds of businesses lend themselves to financial leverage?

Look for mature businesses that generate cash flow on a steady basis. High growth potential is not necessarily a prerequisite; more probably, suitable candidates will show only moderate growth and will be easier to buy. LBO candidates should be on the far end of the spectrum opposite from venture capital operations, which tend to be early-stage, growth companies. Such companies, unless they are too small to attract any outside financing beyond the personal sphere, are financed predominantly through equity.

Producers of basic products or services in stable markets are the best LBO candidates. Start-ups and highly cyclical companies should be avoided. So should companies whose success is highly dependent on forces beyond the control of management. Oil and gas deals that depend on fuel prices are thus not suitable for highly leveraged deals, in contrast to oil pipeline or trucking companies, which receive a steady, stable payment for transportation charges and do not speculate on oil prices. (Trucking companies, by the way, can be good candidates for the "rollups" discussed in Chapter 1, or the "leveraged buildups," discussed in Chapter 16.)

In any industry, stable management offers an important element of reassurance. When evaluating the likelihood of repayment, lenders want to see a team of managers who work well together and who have weathered several business cycles.

MINIMIZING BORROWING

How can a buyer minimize borrowing?

A buyer's first thought in financial planning should be a very simple one: the less I have to lay out at closing, the less I have to borrow.

The financing needs to be met at the closing can be calculated as follows:

- The purchase price of the stock or assets of the acquired company.
- Plus any existing debt that must be refinanced at closing.
- Plus any working capital needs of the acquired company (these amounts need not actually be borrowed, but the credit line must be large enough to cover them).
- Plus administrative costs to effect the acquisition.
- Plus post-acquisition payments that may be necessary because of settlement of litigation.
- Less cash or cash equivalents of the acquired company.
- Less any proceeds from partial divestitures of the acquired business.

(Seller takeback financing also reduces the closing payment, but is analyzed here as part of the borrowing program because of the many interconnections between it and other financing layers.)

The next step in our analysis is to explore how to minimize each of the cost elements and minimize the closing payment.

How can the buyer minimize the purchase price?

Most sellers have multiple objectives, including price, speed, and certainty of closing. Thus a buyer need not necessarily offer the highest price in order to gain the contract. It should also offer the seller noncash incentives for the deal, such as the following:

- "We can close faster."
- "We have a good track record in obtaining financing and closing similar transactions."
- "We can offer a substantial deposit on signing the acquisition agreement."
- "We can work well with you and your management."

Other incentives that can make a deal attractive include good terms for management such as shares in the company, favorable employment contracts, profit-sharing plans, and the like. When the transaction involves the sale of a privately owned company, there is no limit to the value and utility of such social considerations. In the sale or merger of a public company, however, it is good to exercise caution. There may be the appearance of

self-dealing at the expense of shareholders. Even companies that have maintained a strong reputation for ethics can be tainted by this brush.[21]

One of the most delicate questions of buying (or buying out) a company is whether to obtain a lower price by assuming substantially greater risks or to accept significant defects in the candidate. Such risks or defects can loom very large in the eyes of the acquisition lenders, and the timing of negotiations does not always permit them to be checked out with a lender before signing the contract. Here is a cardinal rule: Negotiate and sign *fast* when the price is right. The willingness to close expeditiously can bring a lower price. (Some of the most spectacularly successful deals have been achieved when a buyer saw that management and a lender could live with a minor flaw the seller thought was major.)

Another way to lower the purchase price is to buy only some of the assets or divisions of a company, or to buy all of them with a firm plan for post-merger sell-offs in mind.

When planning post-deal sell-offs, how easy is it for an acquirer to pick and choose among acquired assets?

It is desirable—but often difficult—for a buyer to be selective about what it acquires. The seller may be packaging some "dogs" together with some "stars" (to use some old terms from Boston Consulting Group). Therefore, the buyer should consider gaming the offer out from the seller's point of view and making a counterproposal. Crucial for such selection is knowing the seller's business better than the seller does—not impossible if the seller is a large conglomerate of which the target is a small part, and management is the buyer or is already on the buyer's side. The offer of sale may include several businesses, some of which are easier to finance than others, or assets used in part by each of several business operations. The buyer may have a choice, for example, between buying and building a computer system or merely leasing it.

Sometimes a deal can be changed to the buyer's advantage after the main price and other negotiating points have been determined. The seller may then be receptive to either including or excluding what appear to be minor ancillary facilities as a last step to signing. To encourage the seller, the buyer may guarantee the resale price of unwanted assets or share any losses realized on their disposal. Taking or not taking these minor assets may become the key to cash flow in the critical first two years after the buyout.

Can a buyer always finance all or part of a transaction through partial divestments or spin-offs?

Not necessarily. This is possible only when the business acquired consists of separate components or has excess real estate or other assets. The buyer must balance financial and operational considerations; there should always be a good business reason for the divestment. Consider selling off those portions of the business that are separable from the part that is most desirable.

As indicated earlier, not all businesses generate the cash flow or have the stability necessary for highly leveraged transactions, yet many cash-rich buyers are available for such businesses. A solid domestic smokestack (industrial) business with valuable assets, itself highly suitable for leveraged financing, may have a subsidiary with foreign manufacturing and distribution operations, a separate retail division, and a large timberland holding—all candidates for divestiture. The foreign operations are accessible to a whole new set of possible buyers; the retail division could function better as part of another company's nationwide chain; and the timberland does not generate cash flow.

Many buyout transactions are undertaken in order to divest assets at a profit. These transactions are better called restructurings or breakups. For example, the acquisition of Beatrice Foods by KKR in the height of the LBO boom of the 1980s resulted in the disbanding of its senior management and the sale of most of its assets. This is an entirely different kind of transaction from an MBO, where the core business is preserved, and management takes an ownership interest and stays on as a team.[22] Interestingly, the Canadian division of Beatrice, which was not a part of the KKR buyout, remained intact, growing through acquisition until getting acquired by Paramalat, S.A. in the late 1990s.[23] The divergent paths of the two Beatrices (in the United States and in Canada) illustrates the range of strategic and financing options available to acquirers—much as studies of twins can help us understand heredity versus environment.

There is a question of timing here; it is not advisable to start beating the bushes for a purchaser of a company's division or subsidiary without a signed contract for the purchase of the company as a whole. On signing an agreement, however, looking for division buyers is perfectly appropriate. Indeed, it is not uncommon to have an escrow closing of the divestiture in advance of the closing to minimize the risk of last-minute holdups. Even if the deal does not close simultaneously with the main acquisition, the presence of the divestiture agreement of such pre-sold assets may make possible a bridge loan to be taken out at the closing.

What cash can a buyer find in the company?

Cash can be found on the balance sheet, as well as in more unusual places. Does the acquired company have a lawsuit pending against a third party that can be settled quickly and profitably? Does it have excess funded reserves? Is its employee benefit plan overfunded, and if so, can it be terminated or restructured? Can its pension plan acquire any of the company assets? Typically, pension plans can invest a portion of their assets in real estate of a diversified nature, including real estate acquired from the company. Has the company been acquiring marketable stock or debt of unrelated companies? Does it have a valuable art collection that can be cashed in at the next Sotheby's auction?

Keep track of changes in the company's cash position between signing the acquisition agreement and closing. The terms of the acquisition agreement can ensure either that the buyer retains cash at the closing or that all cash goes to the seller. (See Chapters 3 and 9.)

Before selling a division, is it advisable to take the cash out of it?

It depends on how the sale is structured. In most sales, there's no obligation to include cash among the assets. It is perfectly ethical to move the cash to a corporate account and sell the assets without the cash. This would be the exact equivalent of selling the cash as an asset at face value. However, in most stock sales, the seller must acknowledge that the value of the stock includes the value of the cash and make appropriate adjustments when pricing the transaction if the cash is removed.

DETERMINING STRUCTURE IN DEBT FINANCING

After the need to borrow is minimized, the next step is to organize and orchestrate the borrowing program. The art of structuring a financing is to allocate the revenues and assets of the acquired company to lenders in a manner that does the following:

- Maximizes the amount loaned by the most senior and highly secured and thus lowest interest rate lenders.
- Leaves sufficient cash flow to support, if needed, a layer of subordinated, higher-interest-rate mezzanine debt, as well as any seller takeback financing.

- Provides for adequate working capital and is consistent with seasonal variations and foreseeable one-time bulges or dips in cash flow.
- Permits the separate leveraging of distinct assets that can be more advantageously set aside for specialized lenders, such as sale-leasebacks of office buildings or manufacturing facilities.
- Accommodates both good news and bad—that is, permits debt prepayment without penalty if revenues are sufficient and permits nonpayment and nonenforcement of subordinated debt if revenues are insufficient.
- Avoids and, where necessary, resolves conflicts between lenders.

Customarily, these results are achieved through layering of debt.

What types of debt are typically used in an LBO?

Although sometimes only one secured lender is needed (or in the case of a very simple business with strong cash flow, only a single unsecured lender), multiple tiers of lenders are normally necessary for large transactions. The multilender LBO may include several or all of the following layers of debt, in rough order of seniority:

- *Senior revolving debt,* secured by a first lien on current assets (inventory and accounts receivable), a first or second lien on fixed assets (property, plant, and equipment, or PPE), liens on intangibles, and perhaps a pledge of stock of the acquired company or its subsidiaries. This debt typically provides a part of the acquisition financing and working capital, including letter of credit financing, and is generally provided by commercial banks or similar institutional lenders. It is often referred to as "commercial paper."[24]
- *Senior term debt,* secured by a first lien on fixed assets, a first or second lien on current assets, and liens on intangibles and stock of the company and subsidiaries, to provide acquisition financing. Sometimes—but not very frequently—this debt is subordinated to the senior revolving debt. It is normally provided by commercial banks in conjunction with senior revolving debt, or by similar commercial lenders or insurance companies.
- *Senior subordinated debt,* or mezzanine debt unsecured or secured by junior liens on the assets securing the senior debt, used for

acquisition financing. These instruments, known as high-yield debt by promoters and junk bonds by detractors, are mainly placed by investment bankers, the principal purchasers being insurance companies, pension and investment funds, and financial institutions.

- *Sale leasebacks or other special financing arrangements* for specific facilities or equipment. These arrangements may range from installment purchases of office copiers or long-term computer lease-purchases to sales of the target's real estate to an independent investment partnership, which then net leases such real estate back to the target.
- *Seller's subordinated note or warrant,* secured or unsecured, perhaps convertible to stock.

Beneath all of these in seniority are various forms of equity.[25] These types of financing instruments have a relatively low priority on the financing totem pole and will not be discussed in the remainder of this chapter, which focuses largely on debt financing.

We will discuss senior debt from both banking and insurance companies, high-yield/junk bonds, LBO investment funds, and seller takeback financing in greater detail later in this chapter. First, however, we should consider how much debt can be obtained at each of these layers.

How are the amounts of the different layers of debt determined?

The initial decision is, of course, the lender's. As discussed below and in Chapter 3, the lender for each layer of the financing will indicate to the buyer a range or approximation of the amount it is prepared to lend. The lender's decision (or, if there are several lenders, each lender's decision) will be based largely on amount, interest rate, and payback period, but also on ability to perform. A basic objective is to maximize senior debt, which bears the lowest interest rate. At the same time, senior debt also requires relatively favorable coverage ratios; therefore, there will be excess cash flow left over after servicing senior debt to support high-yield/junk bonds or other mezzanine debt. After mezzanine debt is covered, something should still remain to persuade the seller that its takeback financing has a reasonable chance of payment.

The process is not exact. Each lender evaluates the cash flow and assets of the target differently, and uses a different formula for setting the loan amount. The term lender may be willing to lend $10 more if the revolving lender lends $8 less, but the buyer may be reluctant to explore that possibility

for fear that the term lender had not previously focused on the exact amount being loaned by the revolving lender, and a second review by the term lender's credit committee could result in a decision not to make the loan at all.

When resources and time permit, the best course of action for a buyer will probably be to obtain bids from several lenders on each layer, and then to select, at the moment when the lenders' commitment letters are about to be signed, the optimum combination and present it to each approved lender as a *fait accompli,* burning no bridges to the unsuccessful lenders until the package has been accepted by all the intended players. In this way, commitments can be entered into with the optimum combination of lenders. The competitive nature of the process will discourage objections by the lender fortunate enough to be selected. In addition, lenders tend to leave to the later stages of the closing a full investigation of the other lenders' terms, by which time they may be less likely to rethink the terms of their loan.

How does a senior lender decide how much to lend in an acquisition?

A number of considerations are key to a bank's lending decision:

- Liquidation value of the collateral
- Credibility of the borrower's financial projections
- Whether the borrower's projections show enough cash flow to service the debt (including junior debt)
- Whether proposed asset liquidations are likely to take place in time and in sufficient amount to amortize the term debt (or reduce the revolver commitment)
- Potential company profitability and industry prospects
- The amount of junior debt (and capacity of the junior creditor to assist the borrower with additional funds in a workout scenario)
- The amount of equity

SENIOR DEBT

When should the senior lender in a transaction enter the picture?

Ideally, the senior lender should be brought into the transaction as early as possible, and thus one of the first steps a buyer takes is to prepare his presentation

of the deal to lenders. Many lenders are reluctant to review a proposed acquisition unless they already have a formal or informal agreement to go through with the transaction, or at least to cover their costs and, perhaps, a fee. Thus, the presentation is quickly followed by a commitment letter.

The senior lender's loan will usually represent the single largest portion of the cash to be raised for the transaction. If the senior lender is not willing to finance, the deal cannot be done. For that reason, the buyer must be sure to make a correct judgment about the financeability of the transaction before he or she incurs the considerable expense of negotiating an acquisition agreement.

What form does senior debt take?

Typically, senior debt is part term loan and part revolving loan, with the term loan used to finance the purchase price, and the revolving loan used to provide working capital (although a portion of the revolving loan is often used to finance the purchase price as well). Usually, senior debt is provided by banks or their affiliates, and thus we often use the term "bank" to refer to a senior lender.

What is demand lending?

It is becoming more and more common for senior debt to be provided by banks in a demand format quite different from traditional local bank financing, which relied primarily on the personal guarantees of the business owner, had a fixed term and limited covenants, and kept its nose out of the borrower's business. By contrast, demand lending gives the initial impression to a borrower of being intrusive and one-sided: the bank may have the right to call the loan at any time, make revolving loan advances only at its discretion, require all business receipts to be applied immediately to repayment, and have a bristling array of protective covenants that require bank consent for almost any action not in the ordinary course of business. The appropriate trade-offs for these provisions are absence of personal guarantees and a willingness to lend relatively large amounts.

Because this style of lending is unfamiliar to many borrowers and lenders, the logic of the trade-offs may not be observed: the bank may require a demand loan and guarantees as well, or the borrower may seek a high loan limit but refuse to consider demand repayment. Borrower and bank need to clearly understand their relationship from the start. Success depends on both players recognizing that the relationship will be a close one involving cooperation and mutual dependency.

Can lenders be arbitrary?

No. A borrower can take considerable comfort in the principle of "commercial reasonableness" that binds lenders and should thus understand that many of the rights the bank obtains on paper it cannot exercise in practice. A number of cases have held that if a bank makes a loan on terms that give it extensive power over a company's financial affairs, it cannot use that power arbitrarily and may in fact be liable for consequential damages if the company is put out of business or otherwise damaged because of an unreasonable refusal to lend. (See the summary of the *Irving Trust* case cited in the landmark legal case summaries in the back of the book.)

What guidelines do banks use to judge the quality of a loan made in a leveraged transaction?

Banks follow guidelines issued by bank regulators, adding, of course, their own experience. By regulatory definition in the United States, with certain exceptions, highly leveraged loans are finance transactions in which the borrower would end with a debt-to-equity ratio of 75 percent or higher. As mentioned earlier, these HLTs must be identified in bank disclosure documents. Regulators also encourage banks and bank regulators to discourage other HLTs, and they have published complete guidelines for this purpose.[26]

Global banks in 10 countries (referred to as the G10) are now implementing the recommendations of Basel II: International Convergence of Capital Measurement and Capital Standards—A Revised Framework. Basel I standards were published in 1988; Basel II standards, in the making since 1999, were published in November 2005 and will be implemented by the end of 2007. The standard retains the general requirement for banks to hold total capital equivalent to at least 8% of their risk-weighted assets. The new standard expands the definition of risk. It says that a bank's capital, divided by its risk (defined as credit, market, and operations risk) should not exceed 8 percent.

Even for global banks, when it comes to the HLT, the new standard applies. The Basel II document states that "where a jurisdiction employs a supplementary capital measure (such as a leverage ratio or a large exposure limit) . . . the capital required under the supplementary measure may be more binding."[27]

SALE-LEASEBACKS

What are sale-leasebacks and what are the pros and cons of using them?

A sale-leaseback involves the sale of the seller's real estate or equipment to a third party, which then net leases the real estate or equipment back to the company. In essence, a company takes out a mortgage on a property in the form of a sale-leaseback. The ownership remains with the original entity, yet the lender is taking a lien on the assets of the surviving company as collateral on the loan. This type of financing is ideal for leveraged buyouts, where companies are often looking for ways to replace expensive unsecured debt or equity debt with less expensive secured debt as a means of raising cash or controlling capital debt structure.

A sale-leaseback may be structured as an installment contract, an operating lease, or as a finance lease. These distinctions have important tax and accounting ramifications and should always be kept in mind.[28] When a leaseback is structured as a finance lease, which is considered a type of capital lease under U.S. accounting rules, the acquirer as lessee can make a case as owners of the asset for tax and accounting purposes. The lending source (lessor) generally retains title and takes a perfected first security interest in the equipment. The lessee raises cash from the sale-leaseback.

Acquirers should note several points:

- Price can be negotiable. If the value of the leaseback is expressed as a percent of the equipment price, beware. The lessor will most likely want to only value the equipment at its liquidation value, which may be significantly different from any remaining depreciation or book value of the equipment.
- In a true sale-leaseback, if title is in the lessee's name, it must pass to the leasing company so applicable sales taxes can be accounted for.
- A finance lease acts the same as a loan against the asset. Thus, the obligation and the yield or rate of the transaction might be greater than the borrowers' incremental borrowing rate at its primary bank. The acquiring entity must weigh the benefits of leasing (conservation of capital and credit lines for unsecured lending, etc.) as a way to manage their cost of funds or available capital instead of pledging the same assets in other forms of borrowing.

- In any leaseback scenario, there are tax and accounting implications. These must be reviewed and weighed toward the benefits of the transaction.

Some sale-leasebacks offer an option to buy. How does this type of transaction affect an acquirer?

In this type of leaseback, the leasing company is purchasing the equipment at a fixed amount, then leasing back to the entity. In this type of deal, the stream of payments may or may not equal the value of the equipment and interest charged over the term. In this instance there is a residual position in the equipment on behalf of the leasing company (the lease is not a full-payout lease). Thus at the end of the term of the lease, the leasing company is looking for one of two things to happen:

- For the original entity to make them whole on their residual position.
- For the original entity to return the equipment so the leasing company can remarket the equipment to another user, thus recapturing its residual position.

Why would an acquirer want to do a leaseback?

Let's say an acquirer has bought a company that has assets suitable for a sale-leaseback, and has found a leasing company that is willing to take a residual position on the equipment. Let's also assume that the acquirer is able to sell the equipment for 100% of its value to the leasing company and promises a stream of payments, not including the end purchase option that equals only 90% of the transaction. At the end of the lease, the lessee must either exercise its purchase option or return the equipment. If the lessee elects to return the equipment (then, in effect, use the leasing company as a remarketing agent as well as a funding source), it has raised relatively inexpensive capital by only paying the stream rate versus the full yield of the transaction (stream plus residual). Here is the math for a three-year sale-leaseback with a 10% purchase option (written as a finance lease):

Asset value at time of sale-leaseback:	$100,000
Residual position at 3 years taken by leasing company	$10,000
All-in yield required by leasing company including residual	12%
Payment terms	
36 payments @	$3,089
Purchase option	$10,000
Total payments made if lessee does not exercise purchase option*	$111,214
Thus effective interest rate paid by lessee would be	7.9%
Total payments if lessee exercises purchase option	$121,214
Thus effective interest rate paid by lessee would be	12.00%

*Leasing company remarkets the equipment looking for at least its residual position plus remarketing expenses.

What paperwork is involved in a sale-leaseback?

To prepare for a sale-leaseback, a detailed appraisal, an as-built survey, and title insurance of the real estate must be ordered, preferably at least six weeks in advance of closing. The other loan documents must be drafted to permit the sale-leaseback. The sale-leaseback may be financed by a mortgage loan. The lease and the mortgage loan documents must clarify that the borrower/tenant continues to own, and the senior lender continues to enjoy a first and prior lien upon, all equipment and fixtures used in the borrower's/tenant's business.

PROS AND CONS OF PRESERVING DEBT AND LEASE OBLIGATIONS

What are the pros and cons of keeping existing debt in place?

Review carefully the existing debt of the target and determine whether prepayment may be necessary or advisable. In some cases, the acquisition may entitle the lender to prepayment, perhaps at a premium. In other cases, even where prepayment is not required, it might be a good idea to repay existing debt because of high interest rates or burdensome covenants in leases, loan agreements, or indentures.

What should a buyer look for in a new debt agreement?

Restrictive covenants in leases or loan agreements may prohibit a sale of assets without the lessor's or lender's consent, a condition that could hamper post-merger restructuring or spin-offs. Restrictions on sale of assets provide important protection to a lessor or lender who otherwise cannot prevent major changes in the structure or operations of its lessee or debtor, and courts have interpreted such restrictions liberally in favor of lessors and lenders. Although many covenants use the language "all or substantially all" in describing this restriction, even modest asset sales may be challenged. Any sale of more than 25 percent of the assets raises questions, particularly if the assets being sold constitute the major revenue-producing operations of the historical core business.

Indentures for unsecured borrowings also typically contain covenants prohibiting the imposition of liens on assets of the lessor or debtor and may prohibit more than one class of debt or interlayering (for example, both senior and subordinated debt). Such financing must be done on an unsecured basis and without recourse to some of the techniques for layering of debt discussed later in this chapter.

Debt agreements of this unsecured kind are deceptively simple. It may first appear that the lack of elaborate and specific covenants, such as those contained in the typical secured loan, offers many opportunities to substantially restructure the company without lenders' consents. But the canny buyer, when analyzing such loan agreements, will realize that the broad prohibitions on making dividend payments or selling assets can defeat most financing plans. Whereas technically tight, detailed loan agreements can encourage and even legitimize the use of loopholes based on technicalities, so the broadly written loan agreement makes lawyers and other technicians cautious about arrangements that may violate the spirit of the existing debt agreement.

In addition to restrictions on sales of assets or liens on assets, the selling company may also be subject to preexisting covenants prohibiting a change of control of the lessee or debtor. In such cases, preservation of existing debt may require changing the structure of the acquisition. A common legal issue that arises in such cases is whether the merger of the lessee or debtor into another corporation constitutes a transfer of ownership requiring the lessor or lender's consent. In most cases, it is possible to conclude that the merger is not a transfer to another entity, because the original lessee or debtor continues as part of the surviving entity, although the conclusion varies according to state law.

How common is it for an acquired company to have a lot of leases, and how important are they?

In recent decades, leasing has increased as a source of financing, as companies (particularly smaller ones) lease their equipment, vehicles, and other valuable property, in order to leverage their cash and equity. Although such lease obligations are not material to the overall balance sheet position of large companies, they can greatly affect the value of small and mid-sized firms.

Suppose an acquirer wants to buy a company that has a lot of valuable leases, but the leases contain a lot of fine print about cancellation in the event of a change of control. How serious is such fine print?

The seriousness of the fine print, as with everything in M&A life, depends first and foremost on the size and nature of the entities involved and the past relationship between them. Beyond this general rule, the situation will vary according to whether the company being acquired is a heavy lessee, a lessor, or both.

What advice do you have for the acquirer of a heavy lessee?

If the company being acquired has signed one or more important lease agreements as a lessee, the first decision to be made will be whether or not the acquirer will be assuming the lessee's obligations. This is usually what happens. Note, though, that the original lessee will almost always need to get approval from the lessor before it can assign its lease obligations or sublease to a new owner.

Therefore, the first order of business for any acquirer will be to contact the lessor and inform it of the pending transaction. The lessee should also contact the lessor. Almost every lease requires that the funding source must be notified if there is a change in ownership. (This is to enable the lessor to look at the credit history and worthiness of any new owners before allowing the previous ownership to assign their obligations over to it.) On almost any lease, *non-notification of change in ownership or location of the equipment is generally considered a technical default of the terms of the lease.* If the new

and old owners are in technical default, the funding sources may call the remaining payments due.

Of course, if the company that is leasing survives, and is as strong as it was or stronger before the merger, there won't be any issues. At the end of the day, it isn't as much the change in ownership but the change in credit risk that is of concern. Ordinarily the credit of the acquiring company is better than the existing entity, so the acquirer can make its own decision as to whether or not to assume the lease, renegotiate it, or pay it off.

But in cases where the lease that must be assigned and the credit of the acquiring company is not sufficient, then there is a chance that the original lessee, especially in small privately held companies, will be required to remain as a guarantor of the lease or find some structure to ensure the funding source that they will continue to receive timely and complete payments.

In LBOs, the financial ratios of the selling company might change dramatically, making the credit worthiness of the new entity insufficient for the original funding source. In this case, the lessor may have to repay the funding source through a prepayment of the lease with monies raised in the leveraged buyout or may need to pledge additional collateral in order to give the funding source sufficient comfort from a credit perspective in what they may see as a new transaction.

Differing funding/lending sources have different policies for lease rewrites, buyouts, and refinancing. Lessors responsible for any significant lease need to understand these policies and learn about options for early lease termination.

What advice do you have for the acquirer of a heavy lessor with major lease receivables?

Buying a company with major lease receivables raises a different set of issues. Many companies have contracts with customers whereby those customers agree to pay for their equipment in a lease or lease-type transaction. Some companies that have a consumable component to their sales may rent equipment with their consumables in order to tie their customers up over time. In this type of company, an acquirer will find accounts receivable from bundled lease papers or installment contracts. Also, companies that manufacture capital equipment may offer a lease alternative to customers that can't afford to pay up-front cash. In such companies, acquirers will also find significant lease receivables carried on the balance sheet.

In either case, prospective acquirers should perform a due diligence on the portfolio of leases. Before starting, it is important not to reinvent the wheel when dealing with a public company. The advisors doing the acquirer's due diligence in this area or any other area of risk can simply ask for management's most current report on internal financial controls. Under Section 404 of the Sarbanes-Oxley Act, companies have to include in their annual reports a report of management on the company's "internal control over financial reporting." For this reason, internal controls are already getting extra scrutiny these days. (Indeed, some experts have complained that the controls are becoming excessive, and are getting applied to areas that are not even a financial risk.[29]) Nonetheless, it is safe to say that in the aftermath of Sarbanes-Oxley, the quality of lease portfolios, like any other object of due diligence, is more likely to stand up to scrutiny due to stronger internal controls in many public companies.

On the upside, there may be options to discount the leases to third parties, generating a possible premium—or at least a vehicle to reevaluate the asset values of the receivables given by the company being acquired. On the down side, leases might not be included in the lessor's accounts for delinquency, days sales outstanding, or bad debt, thus giving a higher level of performance of the overall company than they should. For example, some capital equipment leases are really sales that the lessor would not take for credit or documentation reasons—so, as a liquid asset, they are suspect.

Sometimes the accounting for the leases varies and how the company books them may not give a true picture of the company's balance sheet or revenue stream. For instance, say the company being acquired is a subsidiary of a large entity with a low cost of capital, and that this subsidiary historically wrote contracts with its customers as leases at current market rates, but booked the deals by discounting the stream at its (much lower) cost of funds. Since the company books these transactions by discounting the paper, the booked sales amount or present value amount might in fact be higher than the actual sales price.

One company that looked great as an acquisition candidate delivered disappointing financial results after the deal because of such a practice. This company leased internally about 15% of its capital sales, and then discounted the stream up front at the corporate cost of funds. This elevated the apparent sales amount by 110%! The company's good-looking revenues, which indicated a great deal, didn't take into account a differing cost of funds. Revenues after the acquisition were lower since the new entity couldn't borrow at the same rates and/or discount the deals below market.

SELLER TAKEBACK FINANCING

Many leveraged acquisitions involve contingency payments structured with a takeback by the seller of debt or stock. This is particularly likely to occur if the seller is a major corporation divesting a minor operation. In such deals, the seller takes only part of the money, with the understanding that it will be paid more if certain conditions (contingencies) are met. In return, the seller gets a note from the buyer. If the note is subordinated to other debt, it is called a seller's subordinated note.

If debt is taken back, it may be structured as a simple installment sale, or it may involve accompanying warrants. In either case, the claims of the seller are generally junior to those of other creditors, such as the senior lenders to the buyer. A seller takeback is not always possible. In particular, it may be necessary to pay stockholders of publicly held companies the acquisition price entirely in cash because of the delays and disclosures involved in offering them debt or other securities that require a prospectus registered under federal security laws.

Why do sellers consider takeback financing, including junior class financing?

Sellers are generally reluctant to take back stock or debt that is junior to all other debt. Still, a seller benefits from such subordinated financing by receiving an increased purchase price, at least nominally, and obtaining an equity kicker or its equivalent. The seller may well be aware, and should be prepared to face the fact, that the note or stock will realize full value only if the acquired company prospers, and that there is a real risk that this part of the purchase price will never be paid.

By the same token, however, the upside potential that the seller can realize if the transaction is successful can be much greater than it could receive if no part of its purchase price were contingent or exposed. There may also be cosmetic advantages to both buyer and seller in achieving a higher nominal price for the target company, even though a portion of that price is paid in a note or preferred stock with a market value and a book value below face. Thus, for example, if a seller has announced that it will not let its company go for less than $100 million, but has overestimated its value, the seller may eventually be pleased to settle for $60 million cash and a $40 million 10-year subordinated note at 4 percent interest. The note will go onto the seller's books at a substantial discount. (The amount of the discount will be useful for

the buyer to discover if he or she later wishes to negotiate prepayment of the note in connection with a restructuring or a workout.)

What are the relative advantages of subordinated debt and preferred stock?

Preferred stock has the advantage of increasing the equity line on the balance sheet and thus helps protect the highly leveraged company from insolvency and makes it more attractive to senior and junk bond lenders. Remember that an insolvent corporation cannot transfer its property to anyone else without receiving full consideration. To do otherwise would be to defraud its creditors—that is, to deprive them of access to its assets. Thus, if solvency is an issue, the seller and lenders may feel more comfortable in including some preferred stock on the balance sheet.

Subordinated debt offers considerable advantages to the seller, however. Payments are due whether or not there are corporate earnings, unless otherwise restricted by subordination provisions. Negotiators may have been told to sever completely the seller's connection with the company. Taking back a note bespeaks a greater degree of separation and greater apparent certainty that the amounts due will be paid. The seller may intend to sell the paper it takes back and can get more for a note than it could get for preferred stock. The seller may be able to obtain security interests in the acquired company's assets, junior of course to the liens of the acquisition lenders, but no such security interest accompanies preferred stock.

From the buyer's point of view, a note has the major advantage of generating deductible interest payments rather than nondeductible dividends. Preferred stock has the important disadvantage of preventing a buyer from electing pass-through tax status as an S corporation. For both reasons, be sure that if a note does emerge, it is not subject to reclassification as equity by the IRS. Seller preferred stock can also have other adverse tax consequences (see Chapter 5).

Absent unusual circumstances, if the buyer can persuade the senior and junk bond lenders to accept a seller's subordinated note rather than preferred stock, the seller should have no objections. If not, the lenders and seller may accept preferred stock convertible into a note at buyer's option once the company achieves a certain net worth or cash flow level. As a last resort, the buyer may persuade the seller, six months or a year after closing when debt has been somewhat reduced, to convert the preferred stock into a note.

How can a seller obtain an equity kicker in the company it is selling?

Sometimes, as mentioned before, a takeback note has the same effect as an equity kicker because it serves to inflate the sales price beyond the company's real present worth, and it can only be paid if the company has good future earnings. It is also quite possible for the seller simply to retain common stock in the acquired company. In the alternative, the seller can obtain participating preferred stock, in which dividend payments are determined as a percentage of earnings or as a percentage of dividend payments made to common stockholders, and in which the redemption price of the preferred rises with the value of the company. Some of these choices have tax consequences (see Chapter 5).

WARRANTS

How exactly do warrants work?

One increasingly popular alternative to preferred or common stock is a warrant to acquire common stock at some time in the future. This has the double advantage for the buyer of not making the seller a common stockholder entitled to receive information and participate in stockholders' meetings during the immediate post-acquisition period, and of not adversely affecting the target's eligibility for S corporation status. S corporations may not have more than 35 stockholders, and, with minor exceptions, all stockholders must be individuals. A corporate seller cannot remain as a stockholder of an S corporation, but it can remain as a warrant holder. It is important, however, that the warrants not be immediately exercisable, since their exercise will cause a loss of S corporation status. Thus, certain triggers are established as preconditions to their exercise. These are basically events that entitle the stockholder investors to extract value from their stock: a public sale of stock, a sale of substantially all the stock or assets, or a change of control of the target. Once one of these events occurs, S corporation status is likely to be lost anyway, and it is logical to let the warrant holder cash in and get the benefit of equity ownership.

What are the key terms generally found in warrants?

Key provisions will address how many shares can be acquired upon exercise of the warrant: the amount of the "exercise price" (the amount to be paid to

acquire the shares); the period of time during which exercise may occur (which, to prevent interference with any future sale of the company, should not extend beyond the date of any such sale); any restrictions on transfer of the warrant; and any rights, discussed more extensively later, when the warrant holder may have to register shares or participate in registrations by the company for a public stock offering under the securities laws. There are also lengthy and technical provisions providing for adjustment in the number of shares for which the warrant can be exercised to prevent dilution if there are stock splits or dividends or if shares are sold to others at less than full value.

Does the seller ever receive security interests as a subordinated lender?

Occasionally, but not typically. The seller may take a subordinated note either on an unsecured basis or with security. Security interests strengthen a seller's bargaining power with senior lenders in the event of bankruptcy or refinancing. The collateral gives the seller a right to foreclose as well as a seat at the bankruptcy table, even if under the subordination provisions the seller has no immediate right to payment. Possession of a security interest also gives the subordinated lender leverage to initiate and influence a refinancing.

Suppose that an acquisition candidate is leasing a facility under terms that guarantee purchase for a nominal price at the end of the lease (say under a tax-exempt bond deal). How easy is it for an acquirer to assume the lease and get the same purchase rights?

This is very hard to answer as a general rule. Most leases issued under tax-exempt funding involve very large sums of money, and as with all large transactions, each lease tends to have some unique terms and conditions. A few points of advice may be in order here nonetheless.

First, it should be noted that the nominal end-of-term price generally does not matter as much as the original structure and reason for issuing the tax-exempt funds. Changes in ownership more often than not signal changes in the conditions of the lessee and, thus, the primary reason tax exempt funding was available. Remember, just because an entity is tax-exempt does not always mean that it is qualified to receive tax-exempt leasing or funding. For these reasons, under the terms of most agreements, the issuing authority must be notified of any changes in the status of the lessor.

In general, both the lessor and the lessee will hope for continuation of a lease of this type. Although tax exemption was given originally to the lessee, it winds up (through the economics of leasing) being enjoyed by the lessor. Tax-exempt leases enable the lessor to offer a lower cost of funds to the lessee, since the lessor does not have to pay tax on the profit from the interest charges within the lease.

What issues arise in leases extended to tax-exempt organizations?

When a company leases a piece of equipment, it must pay taxes including personal property tax, sales tax, and/or use tax. Many different tax authorities may require that the tax be paid up front and some require the tax to be paid on the payments over the term of the lease. In tax-exempt situations where an entity is *exempt from items such as sales and use taxes,* this may also be in effect on its current leases. (But check with a tax attorney: even tax-exempt organizations may have to pay unrelated business income (UBIT) tax under some circumstances.) If a company is acquired by an entity that does not qualify from a tax standpoint, or if a change of control changes the tax exempt status, the leasing company can't always be relied upon to recognize this during the transfer of the lease from one entity to another. Though leases specify that the leasing entity is liable to collect and submit any taxes owed, some leases state that the lessee is also liable. Thus the acquiring entity needs to raise the issue of possible changes in its tax-exempt status and tax payment obligations to the leasing company. Such concerns should be incorporated into the assignment of obligations in the acquisition agreement—and possibly in the deal's payment structure as well.

WORKING CAPITAL DEBT OF THE SELLER

What is working capital debt? Should an acquirer leave it in place or refinance it?

Working capital debt of the target before the acquisition is likely to appear in any of at least four forms:

- A secured revolving credit loan from an outside lender.
- A parent's intercompany transfers, either with or without interest.
- Bank letters of credit or guarantees to secure purchases from suppliers, principally for foreign sourcing.
- More or less generous payment terms from suppliers.

The first two kinds of debt will almost certainly have to be refinanced at the acquisition closing. A secured revolver, or even an unsecured one, will inevitably tie up assets and stand in the way of any plans for secured acquisition financing, and the parent/seller will not want to retain what are probably short-term, rather informal financial arrangements of an in-house nature. There may, however, be some room for a buyer to argue for at least some short-term financing through a seller takeback of existing intercompany loans.

Refinancing the third type of debt is also common, but risky for all parties. A senior revolving credit acquisition lender often provides letter of credit financing after the acquisition and will probably insist upon doing this financing as part of the deal. Sometimes this can be trouble, because while the new acquisition lender is learning the ropes, there can be awkward slipups in a sensitive area. One possible solution is to explore including the existing letter of credit lender in the lending group where its expertise will be accessible.

As for the fourth type of debt, it usually should not be a problem to retain existing relationships and favorable terms with suppliers. They will probably be relieved to find that the buyer doesn't plan to close the business or move it elsewhere. In some cases, suppliers have relied on the presence of a deep-pocket parent company as added security and may be looking for special assurances difficult for the post-acquisition company to provide. In other cases, it is possible to structure the acquisition so that a subsidiary that purchases on trade credit has a better debt-to-equity ratio than its parent and can retain favorable trade terms.

What should be done if existing debt includes tax-exempt industrial development bonds?

Tax-exempt industrial development bonds give the borrower the advantage of low interest rates but also carry disadvantages: they encumber assets better used to support new borrowings, and they may carry with them old parent company guarantees that must be lifted as a condition of the acquisition. Often these bonds can be "defeased" under the terms of their trust indentures; that is, high-quality obligations (usually issued or guaranteed by the U.S. government) can be deposited with the trustee bank for the bond issue in an amount high enough to retire the bonds over their term through scheduled payments on the obligations. If the interest rate on the bonds is low enough, the amount of obligations required to defease them may be less than their face amount, and once the bonds are defeased, their covenants and liens cease to have any effect. Note, however, that the defeasance of high-interest rate

bonds is expensive, and the defeasance of variable-rate bonds is impossible because they lack a predictable interest rate for which a sufficient sum for certain can be set aside. In addition, tax problems can arise: Are the earnings on the defeasance fund taxable, and does the defeasance give rise to discharge of indebtedness income for the borrower?

Tax-exempt bond issues are likely to be complex, and any transactions involving them may require special attention from the bank serving as bond trustee and the issuer's original bond counsel. Such issues involve a two-step process: the funds are borrowed by a governmental body and are then reloaned to the company to build a facility or are used to construct a facility that is leased to the company, normally but not necessarily on terms that permit a purchase for a nominal price at the end of the lease term. Check with a tax or leasing expert for hidden problems.

THE BANK BOOK AND COMMITMENT LETTER

How is an LBO transaction presented to prospective lenders?

The normal medium of the LBO transaction is the so-called bank book, a brief narrative description of the proposed transaction and the target company. The bank book indicates what financing structure is contemplated and includes projections of earnings sufficient to cover working capital needs and to amortize debt, along with a balance sheet setting forth the pledgeable assets. (Since the balance sheet will typically value assets based on GAAP, an appraisal of actual market and/or liquidation value, if available, may be attached or referenced.)

What happens after the Bank Book is presented to a lender?

If the loan officer believes that the bank may be willing to make a loan that meets the dollar amount and general terms requested by the buyer, he or she will seek to obtain as much information as possible about the company from the buyer. This information will include proxy statements, 10-Ks, and 10-Qs if the target is a public company, and audited financials or tax returns if it is not. The loan officer will also send out a team of reviewers to visit the company's facilities and interview its management and will obtain an internal or outside appraisal of the

assets. This review can take from half a week to a month or more. Banks are aware that they are in a competitive business and generally move quickly, particularly if the loan is being simultaneously considered by several of them.

The loan officer will then prepare a write-up recommending the proposed loan and will present it to the bank's credit committee. The committee may endorse the recommendation as made, approve it with changes (presumably acceptable to the buyer), or turn it down. If the proposal is approved, the bank will prepare a commitment letter (sometimes with the assistance of its counsel, but often not) setting forth the bank's binding commitment to make the loan. This letter thereafter becomes the bank officer's governing document in future negotiations.

What does the commitment letter contain?

Apart from the bare essentials (the amount of the loan, how much will be term and how much revolver, the maturity of the term loan and amortization provisions, and interest rates), the commitment letter will also set forth the bank's proposals on the following:

- Fees to be paid to the bank
- Voluntary prepayment rights and penalties under the term loan
- What collateral is required; whether any other lender may take a junior lien on any collateral on which the bank has a senior lien, and whether the bank is to receive a junior lien on any other collateral subject to another lender's senior lien
- How the funds are to be used
- The amount of subordinated debt and equity that may be required as a condition to the making of the senior loan
- Payment of the bank's expenses

The commitment may also set forth in some detail lists of covenants, default triggers, reporting requirements, and conditions to closing, including legal opinions to be furnished by counsel to the borrowers; it also usually contemplates additional closing conditions and covenants that may be imposed by the bank as the closing process evolves. The commitment letter will also contain an expiration date, typically a very early one. For example, it may provide that the offer to make the loan will expire in 24 hours if not accepted in writing by the borrower, or it may allow as much as two weeks.

The commitment letter, if it provides for a revolving line of credit (usually called a revolver), will generally state both the maximum amount that

may be borrowed under the line (the cap) and a potentially lower amount that the bank would actually lend, sometimes expressed as a percentage of the value of the collateral pledged to secure the revolver. This lower amount is called the borrowing base. The difference between the amount actually borrowed on the revolver at any time and the amount that could be borrowed (i.e., the lower of the cap or the borrowing base) is called availability.

How is the borrowing base determined?

If receivables are pledged, the commitment letter may distinguish between "eligible receivables" and other "receivables." Both are subject to the bank's lien, but only the former may be used to enhance the amount of availability; that is, they may constitute assets against which borrowings may be made.

In a typical situation, eligible receivables will be those that are not more than 90 days old or past due, have been created in the normal course of business, arise from bona fide sales of goods or services to financially sound parties unrelated to the borrower or its affiliates, and are not subject to offset, counterclaim, or other dispute. The bank will lend up to a specified percentage (typically 70 to 90 percent) of eligible receivables. This percentage is known as the advance rate. Thus, notwithstanding the maximum amount of the line theoretically available to the borrower, revolving loans outstanding may not at any time exceed that stated percentage of eligible receivables, determined monthly or even weekly.

Inventory is also usually used as collateral. To be eligible, inventory will generally have to be of the kind normally sold by the borrower (if the borrower is in the business of selling goods) and will be limited to finished goods boxed and ready for sale, not located in the hands of a retail store or in transit. An advance rate of 50 percent is not uncommon in such circumstances. In addition, some banks will lend against work in process or raw materials. However, a rather low advance rate—perhaps 15 percent—will be applied against such unfinished goods because of the problem a bank would experience in attempting to liquidate such collateral. The bank may also impose an "inventory sublimit"—an absolute dollar ceiling on the amount of inventory-based loans.

What does this method of determining the amount of the loan imply for company operations?

It is important to have accurately calculated the need for working capital at the time the loan is committed for and then to operate within the ceiling and

borrowing formulas imposed by the revolving loan. A heavy penalty falls on the manager who allows inventory to build up, and a lesser but still significant penalty falls on the one who fails to collect receivables promptly. Only 50 or 60 cents can be borrowed for every dollar tied up in finished inventory, and every dollar of uncollected receivables costs the company 10 to 30 cents of inaccessible revenues. Financing practices of the pre-acquisition company may have been much looser, particularly if it was part of a well-heeled conglomerate or run as a family business, and untried chief financial officers can get in trouble very quickly after the closing if they don't understand the business implications of their loan terms.

Are the terms of the commitment letter negotiable?

Yes, but the best, and often the only, time to negotiate is when early drafts of the commitment letter are circulated, or when the loan officer sends the buyer an initial proposal letter before credit committee approval. Buyers should be careful to involve their lawyers and other advisors at that stage, and not wait until later to get into details. Be sure to understand the lender's procedures. The proposal letter may be the only opportunity to negotiate a document in advance; sometimes commitment letters appear only after the credit committee has met. Afterward, expectations of the lender become set, and the loan officer will find it awkward to resubmit the proposed loan to the credit committee. The borrower typically does not know how much latitude the loan officer has to modify the commitment without returning to the credit committee. Because time is of the essence in the typical LBO, and a new credit action can result in delay, it is also frequently not in the interest of the borrower to return to the credit committee.

Once the commitment letter is signed, how long will the commitment remain open?

The lender's commitment to make a loan will typically provide that definitive documentation must be negotiated, prepared, and signed by a certain date. Sometimes the time allowed is quite short: 30 or 45 days. Sometimes closing on the LBO will be protracted because of the need to obtain administrative consents, such as FCC [Federal Communications Commission] consents to change of ownership of television stations. In such cases, the termination date of the commitment must be pushed back to allow reasonable time to accomplish all of the actions necessary to effect the closing of the acquisition.

OTHER PRINCIPAL ISSUES IN SENIOR LOAN AGREEMENTS

What fees are typically charged by banks for lending services?

Bank fees tend to be as varied as the ingenuity of lenders can devise and as high as borrowers can accept. In some cases, the lender may charge a fee upon the delivery of the commitment letter signed by the bank (the "commitment letter fee") and a second commitment letter fee upon its execution by the borrower. Both such fees will probably be nonrefundable, but they may be credited against a third due from the borrower at closing on the loan (the "closing fee").[30]

If the loan has been syndicated, the bank may charge an agency or management fee for its services in putting together the syndicate. This will typically be an ongoing fee (as opposed to the one-time commitment letter and closing fees), payable quarterly or monthly as a percentage of the total facility (0.25 percent per annum is not uncommon).

The total amount of fees charged by a bank at the closing ranges between 1 and 2.5 percent. The percentage depends on the speed demanded of the bank, the complexity of the transaction, the size of the banking group (the more lenders there are, the more expensive it is), and the degree of risk. A short-term bridge loan will probably involve a higher front-end fee than a long-term facility, since the bank has less opportunity to earn profit by way of interest over the life of the loan. Usually, the New York money center banks charge fees at the higher end of this range. In addition to the front-end fees, there will usually be a commitment fee or facility fee (typically, 0.5 percent) on the amount from time to time undrawn and available under the revolver.

If the borrower will need letters of credit, the bank will typically assess a letter of credit fee (typically 1 percent to 1.5 percent per annum) on the amount committed under a standby or commercial letter of credit.

Finally, the bank will often seek early termination fees on the unpaid balance of the term portion of the financing. These are intended to compensate the bank for economic losses it may suffer if the borrower terminates the term loan prior to its maturity because of a cheaper financing source, thus depriving the bank of the anticipated profit on the loan for the balance of the term. These fees may step down in amount the longer the term loan is outstanding. It is usually possible to get the bank to drop these termination fees or at least limit them to terminations occurring in the first year or two. This is worth spending some chips to achieve. If the company does well, the buyer

will probably want to refinance the senior loan as quickly as possible to escape a whole panoply of burdensome covenants, and these fees are likely to be a problem.

What bank expenses is the borrower required to pay?

Typically, whether the loan is made or not, the commitment letter will require that the borrower be liable for all of the lender's out-of-pocket expenses and obligations for fees and disbursements of the bank's outside counsel. This provision is not negotiable; banks never expect to pay their own counsel for work done in connection with a loan. Such fees are always assessed against the borrower or, if the loan does not close, the intended borrower.

What interest rates do banks charge for LBO loans?

Typically, a bank will charge 1.5 to 2 percent over the prime rate or base rate. Contrary to popular belief, *prime* does not necessarily mean the lowest rate a bank charges its customers, as the loan agreement will often admit. Rather, the prime or base rate will be whatever the lending bank from time to time says it is.

Are reference rates other than prime ever used in floating-rate loans?

Yes, and the loan agreement may permit the borrower to switch back and forth between two references, or to charge a premium above a reference rate. The amount of the premium charged by the bank above the reference rate will depend on which reference rate is used, and the present and anticipated differentials between the bank's own prime and the alternative third-party reference rate or rates; premiums are generally about 100 basis points greater for Eurodollar rate loans than they are for prime-rate loans. This is largely, but not completely, offset by the fact that LIBOR is usually a lower rate than prime; the net effect of selecting LIBOR is probably to increase rates about 25 to 50 basis points. LIBOR is more responsive to interest rate changes and will move more quickly. A change in prime represents a significant political decision for a bank, and thus changes in prime come less frequently and in bigger steps.

Are there problems in having more than one lender participate in a loan?

Frequently LBO loans are made by groups of banks, or *syndicates.* In some cases, the banks involved in making the loan will all be parties to the loan agreement, with one of their number designated as the agent bank. In other cases, only one bank will sign the loan agreement, but it will sell off participation interests to other banks. Although the number of participants in a loan makes no difference to the borrower from a legal standpoint, the practical implications of having to deal with multiple lenders can be serious and troublesome.

Because of the high degree of leverage involved, LBO lenders tend to limit their risks by imposing an intrusive array of covenants—negative and affirmative, financial and operational—upon the borrower. These covenants are designed to ensure that the business will be conducted as represented to the bankers and in accordance with the financial projections submitted to the bankers by the borrower. Any deviation, any change in the manner of operation of the business, or any bad financial development is likely to trigger a default. Because it is not always possible for a buyer to foresee all future developments in the way the business will be conducted, it is generally not possible, even in the absence of bad financial news, to operate at all times within the requirements imposed by the loan covenants. Hence, the borrower will generally find it necessary, from time to time, to go back to the lenders to have certain covenants waived or amended. If only one lender is involved, the process can be relatively simple. If the consent of a dozen or more is involved, the process can be expensive, time-consuming, and painful.

Do all the members of a lending group have to approve every waiver and amendment?

Generally, no. But the provisions that relate to interbank matters, such as the percentage of lenders needed to grant waivers, are generally contained in a document (sometimes called the participation agreement) to which the borrower is not a party and, frequently, may not even be allowed to see. Although lender approval arrangements are various, it is not unusual for them to provide that certain changes in the loan (such as changes in interest rates, due date, and principal amount) are so fundamental that all lenders must consent, whereas other changes can be approved by banks holding at least a 51 percent interest (or in some cases, a 66.6 percent interest) in all loans outstanding or in lending commitments.

Can junior lenders ever be paid back before senior lenders?

Not generally. Under a longstanding principle in bankruptcy law called the *absolute priority rule,* junior creditors may not go ahead of senior creditors. There are exceptions—such as the "new capital" exception for junior lenders who invest—but the rule generally prevails.

What is a negative pledge covenant, and why do lenders seek them?

A negative pledge is an undertaking by the borrower not to pledge to someone else assets that may be subject to the bank's lien or to no lien. It generally is used to bar junior liens on collateral that is subject to the bank's senior lien. Although in theory the rights of a junior loanholder should not impinge on the senior lender's rights in the collateral, in practice lenders strongly prefer not to be accountable to a second loanholder with regard to their stewardship over the collateral on which they have a first lien. A junior loanholder is, in the eyes of a senior lender, someone who can second-guess your actions in realizing upon the collateral and sue you if you slip up, or even if you don't.

What kinds of problems are most likely to be encountered in attempting to perfect liens on collateral?

- Prior unsatisfied liens may be discovered. (For this reason, as well as for general due diligence considerations [see Chapter 6], it is prudent to begin a lien search as promptly as possible in all jurisdictions in which record filings may have been made affecting the collateral.)
- Liens on patents, trademarks and trade names, and copyright assignments require special federal filings, which may be time consuming and require the services of specialized counsel.
- Collateral assignments of government contracts and receivables from the U.S. government require federal approval, which involves a potentially time-consuming process.
- Uniform Commercial Code (UCC) filings giving notice to the world of security interests must be made at state and, sometimes, local government offices where the target and its assets are located. Filing

requirements in Puerto Rico and Louisiana, the two non-UCC jurisdictions in the United States, are markedly different from, as well as more elaborate than, filing requirements in other U.S. jurisdictions. Local counsel should be contacted early and will play key roles.

- Security interests in real estate and fixtures require separate documentation and recordation in the localities and states in which they are located. Lenders will often require title insurance and surveys, both of which involve considerable lead time.
- Lenders will often want local counsel opinions as to perfection and priority of liens, and obtaining of these can be a major logistical task.

For interest rate and fee calculations, bankers typically treat the year as having only 360 days. Why?

Because it produces a slight increase in yield over the stipulated rate or fee. This practice has acquired the status of a convention and is not generally subject to negotiation.

What is collateral position?

Collateral position describes where a lender is in relation to other lenders with respect to particular collateral. A senior lender in a two-lender deal would have the first collateral position, while the junior lender would have the second collateral position.

The term also refers to the relationship between the value of collateral pledged in a loan, and the borrower's rate of repayment. In this sense, banks typically operate under policies that dictate a minimum collateral position.[31] To avoid driving a lender to this point, borrowers should maintain awareness of the bank's collateral position with respect to the bank's collateral.

What are default rates?

Loan agreements typically provide for an increase in interest rates in the event of default, or at the time of acceleration of the loan. A premium of 2 or 3 percentage points above the rate normally in effect is not uncommon. A borrower should try to have a default rate go into effect only after the lender

makes a formal declaration of default, since minor technical defaults are all too easy to stumble into and should not be a source of profit to the lender.

Why are mandatory prepayment obligations imposed by lenders?

Reasons for mandatory prepayment requirements vary depending on the bank's perception of the transaction. In some transactions, the lender is anxious to recoup and redeploy its money as swiftly as possible. This desire, and the anticipated availability of cash derived from cash flow projections, will tend to drive in the direction of an aggressive amortization schedule on term debt. (In some cases borrowers may also be asked to amortize revolving lines of credit as well by accepting scheduled reductions in availability over a period of time and making any principal payments required by such reductions.)

In addition, a bank may schedule amortization payments to match the buyer's plans for selling off assets or terminating pension plans, in effect forcing the buyer to honor his or her promises to break up and sell off parts of the acquired business or to terminate such pension plans as represented to the bank. Finally, lenders may require that all or a portion of excess cash flow be paid down to reduce senior term debt. Although the bank may permit distributions of dividends to stockholders of an S corporation for the purpose of paying federal, state, and local income taxes on income of the company and retaining some earnings for capital expenditures, it may also require that the buyer use everything left over after paying off junior debt to pay off any outstanding balance on the term loan.

Why do banks insist on applying prepayments first to the last installments due (in inverse order) rather than the other way around?

Banks reverse the order of LBO loan payments in order to keep the flow of cash coming into the bank and to get the loan paid off as swiftly as possible. If borrowers could prepay the next payments due, they would, in effect, be buying themselves a payment holiday. Sometimes prepayments may result from sale of income-producing assets (or the bank's application of casualty insurance proceeds to prepay principal in lieu of making such proceeds available to the borrower), because such events can reduce the subsequent capacity of the borrower to pay debt service. In such cases, the loan should be recast to lower proportionately the combined total of subsequent interest and principal payments.

Can a letter of credit facility be combined with an LBO loan?

Yes. If the business uses letters of credit in its ongoing operations (for purposes such as assuring payment for raw materials or foreign-sourced goods), it can generally obtain a commitment from the lenders to provide such letters of credit up to a stipulated aggregate amount. The letter of credit facility will typically be carved out of the revolving line of credit, will be collateralized by the same collateral that secures the revolver, and will have the effect of limiting availability under the revolver to the extent of the aggregate letter of credit commitment. Draws on letters of credit will be treated, in such circumstances, as draws on the revolver. Separate fees (frequently ranging from 1 to 1.5 percent per annum) will be charged from time to time by the lenders for outstanding standby letters of credit.

Sometimes companies have a practice of issuing a large letter of credit for all shipments in a certain period and then securing specific orders as they arise. In such cases, it may be possible to limit availability by the amount of claims that can be or have been made against the letter of credit for specific orders, and not by the larger unused balance of the letter of credit.

LBO loan agreements typically contain a lengthy list of conditions to closing. Are there any that are likely to be particularly troublesome?

Although points of sharpest contention vary from transaction to transaction, there are some that crop up regularly. They include the following:

- *Requirements regarding perfection and priority of security interests in collateral.* If, for example, first liens are to be given to the lenders on inventory in various jurisdictions, certain events must occur: *First,* lien searches have to be completed and reports received and reviewed (there are professional companies that can be hired to conduct computerized searches of liens on record in any state or county office); *second,* documents terminating old liens have to be prepared, signed, and sent for filing; and *third,* documents perfecting new liens have to be prepared, signed, and sent for filing.
- *Related filing schedules.* Once all that has been done, filing must be coordinated in each of the jurisdictions so that it occurs contemporaneously with the funding of the new loan and the payoff of the old loan. In a complex, multijurisdictional transaction, such

coordination, if it is to be done successfully, requires a combination of monumental effort and plain old good luck. Not infrequently, lenders have some flexibility about the filing of termination statements in connection with the old loan being discharged and will allow a reasonable period after closing for this to be accomplished.

- *Counsel opinions.* Few deals crater over the failure of counsel for the borrower to deliver required opinions, but it is not unheard of for a closing to be delayed while final points in the opinions are negotiated between counsel for the bank and the borrower. Problems typically occur in local counsel opinions and relate to the validity of the bank's lien in a particular jurisdiction. There is no magic solution, but early involvement of local counsel for the borrower is always a good idea.
- *Auditors' opinions.* Auditors are becoming increasingly reluctant to opine as to the solvency of borrowers or the reliability of financial projections provided by the borrower to the bank. By contrast, they now routinely make assessments of internal controls, because of the requirement under Section 404 of the Sarbanes-Oxley Act as described above.
- *Governmental consents and approvals.* In certain transactions, approval of a governmental entity is a central element in the transaction. For example, a sale of a television station cannot be effected without requisite approvals from the FCC. The timing of such approvals, even if they are reasonably assured, is outside the power of the parties, and the failure of a governmental agency to act when expected can wreak havoc on the schedule for closing an LBO.
- *Material litigation and adverse changes affecting the company.* Some loan agreements give the buyer and/or lender the right to back out if the target gets hit by a major lawsuit that, if successful, could seriously harm the company's business. If this contingency does occur, the burden is on seller's counsel to persuade both the buyer and the bank that the suit is unlikely to succeed or, if successful, would not be material to the company or its operations. Similarly, bad economic news can cause either the buyer or the bank to halt the process, resulting either in a negotiated price reduction or a termination.

Are there continuing conditions that apply to subsequent draws on the revolving line of credit?

Yes. In most loan agreements, the bank's obligation to honor subsequent draws upon the revolver is subject to a variety of conditions. Chief among them is reaffirmation by the borrower that the original warranties and representations made in the loan agreement are still true (including those stating that there have been no material adverse changes in the business since a date generally preceding the closing date) and a requirement that no covenant default exists. If the foregoing conditions are not met, the bank is not required to lend.

What purposes do the representations and warranties in the loan agreement serve?

The representations and warranties are intended to corroborate and complete the acquired company information upon which the lender based its credit decision. They constitute, in effect, a checklist of potential problem areas for which the borrower is required to state that no problem exists, or to spell out (by way of exceptions or exhibits) what the problem is. Thus, typical warranties will state that

- The financial statements of the borrower that have been submitted to the bank are correct. (Although it is comforting to have this conclusion backed by an auditor's certification, usually the auditor's report is laced with qualifications.)
- There are no liens on the borrower's assets, except as disclosed to the bank or permitted pursuant to the loan agreement.
- The transactions contemplated will not conflict with laws or any contracts to which the borrower is a party or by which it is bound (the "noncontravention representation").
- There are no lawsuits pending or threatened against the borrower that are likely to have a material adverse effect on it if decided against the borrower, except as disclosed to the bank.
- The loan will not violate the "margin rules."
- The borrower has no exposure under the Employee Retirement Income Security Act (ERISA).
- The borrower is not a regulated public utility holding company or investment company (since, if it were, various governmental orders would be required).

- The borrower is "solvent" (so as to mitigate concerns about fraudulent conveyance risks).
- The borrower's assets (and principal office) are located in the places specified. (This information is needed to ensure that perfection of security interests in the collateral is effected by filing notices in the correct jurisdictions.)

What happens if a representation is wrong?

A breached representation can have two practical consequences for a borrower: (1) If such a breach occurs, the bank may refuse to make a requested advance, either at or after the closing, and (2) breach of a representation or warranty can trigger a default under the loan agreement.

The first consequence—bank refusal to fund—should not be surprising. The truth and accuracy of the representations is typically a condition to the initial loan made at the time the loan agreement is signed and also to any subsequent draws on the revolving line of credit. If, for example, the borrower has warranted in the loan agreement that it has no significant environmental problems, and subsequently it is discovered that it has been guilty of illegal dumping of hazardous wastes, the bank will probably have the right under the loan agreement to shut off further draws on the line of credit. Such a decision could be catastrophic for a company precluded from financing itself from cash flow because its loan agreement also provides for the "lock boxing" of revenues and mandatory paydown—that is, a requirement that they be deposited in a lock box under the lender's control and used to pay off bank debt.

The second consequence—a default under the loan agreement—triggers the remedies a lender generally has under a loan agreement, one of which is the right to accelerate the loan, that is, to declare all moneys loaned immediately due and payable, even though the amounts due under the term portion may not be otherwise due for several years, and the revolver may not expire until the end of the current year.

The right to accelerate is, in a practical sense, the right to trigger the bankruptcy of the borrower and for that reason is unlikely to be exercised except in those cases where a lender determines that its interests will be better protected by putting the borrower in bankruptcy than through other means. Since bankruptcy is viewed by most secured lenders as risky, slow, and a last resort (and potentially liability producing for the bank), a breached warranty is generally unlikely to bring the house down. But unless the breach is waived by the lender, its existence in effect turns what was originally conceived of as

a term loan into a demand loan, callable by the bank at any time. Frequently, highly leveraged transactions result in the bank having a demand loan even in the absence of a default, so going into default does not make matters much worse; also, some lenders and their counsel try to negotiate loan agreements that are so tight that the company is arguably in default from the moment the agreement is entered into. Banks also impose default rates of interest in some cases, so that the cost of borrowing can go up on a warranty breach. This is a more effective sanction for the bank, provided that the company's fiscal health is not endangered.

Covenants in LBO loan agreements frequently appear more intrusive than those in most commercial loan agreements. Why?

Because in a typical leveraged acquisition the lenders are significantly more at risk than they are in a normal business loan. Both from a balance sheet standpoint (because of the absence of a substantial equity pad under the senior debt) and an operating standpoint (because of the burden that debt service will place on the borrower's cash flow), the lender is likely to view itself as significantly exposed. Lenders attempt to address this problem by imposing covenants on the borrower to achieve the following five results: *First,* to obligate the borrower, by express contractual provision, to operate the acquired business in accordance with the business plan submitted to and approved by the bank; *second,* to provide early warning of divergence from the business plan or of economic bad news; *third,* to protect the collateral; *fourth,* to prevent the leakage of money and property out of the borrower, whether as "management fees" or other payments to related parties, costs of new acquisitions, capital expenditures, or simply as dividends; and *fifth,* to enable the bank to exercise its remedies at as early a stage as possible if things go awry by exercising its right to declare a default as a result of a covenant breach.

What are the covenants a borrower is most likely to be confronted with?

When borrowing funds in a leveraged transaction, the buyer is often asked to sign off on promises that it will comply with the business plan, provide early warning of potential economic trouble, protect collateral, and control expenditures.

How can a seller in a contingency payment deal make sure the buyer will comply with the business plan?

The buyer is typically asked to promise to

- Use the proceeds of the loan only for the stipulated purposes
- Engage only in the kinds of business contemplated by the lenders
- Refrain from merging or selling all or substantially all of its assets, or any portion thereof in excess of a specified value, without the bank's consent
- Limit capital expenditures, lease payments, borrowings, and investments in affiliates and third parties to agreed amounts
- Prevent change in ownership or control of borrower without lenders' consent
- Bar acquisitions of other businesses
- Make changes in the acquisition agreement, subordinated debt instruments, or other material documents

What about covenants designed to give early warning of economic trouble?

The seller involved in a contingency payment deal typically asks the buyer to promise to

- Remain in compliance with financial covenants (discussed below)
- Provide periodic (monthly, quarterly, annual) financial reports, with annual reports to be audited
- Give prompt notice of any material adverse development affecting the operations of the business
- Provide revised and updated projections, on at least an annual basis, prior to the commencement of each new fiscal year
- Permit visits and inspections by bank representatives

How can the seller in a contingency payment deal protect its collateral?

The buyer must typically promise to

- Keep the business and property adequately insured
- Limit sales of property to merchandise sold in the ordinary course of business

- Require property to be kept free of liens (a "negative pledge")
- Bar leases of property by the borrower
- Provide key man life insurance for principal executives of the borrower

What loan agreement covenants can discourage financial leakage out of the borrower?

Lenders will often ask the borrower to agree to

- Cap executive compensation and management fees
- Limit, or often prohibit (at least for a specific time period, or until specified financial tests are satisfied), dividends and other distributions to equity holders
- Prohibit transactions with affiliates, except as expressly agreed upon and except for those provided on an arm's length basis for services definitely required by the borrower
- Lend money or guarantee the obligations of other parties

What kinds of financial covenants are likely to be imposed?

The financial covenants that lenders are most concerned with relate to the company's cash generation and cash distribution. Lenders are vitally concerned about monitoring the company's ability to service current and future obligations to the lender. Thus, in general, they want to limit unnecessary cash outflows such as dividends, excessive capital expenditures, and future payment obligations (that is, additional debt) until their claims are satisfied. In addition, lenders want sufficient advance information about the company's cash inflow relative to debt service requirements. If this ratio starts to deteriorate and approach default levels, the lender will increase monitoring activity and notify management of relevant default consequences. Therefore, the borrower may be required to maintain stipulated ratios for

- Interest coverage (earnings before interest and taxes to interest expense)
- Debt to net worth
- Current assets to current liabilities
- Fixed charges to net income (or cash flow)

In addition, the borrower may be required to attain stipulated minimum goals for

- Net worth
- Cash flow

The borrower may also be required not to exceed stipulated maximum limits for

- Capital expenditures
- Total debt

How do lenders determine financial covenant levels?

Lenders use information provided by the borrower and their own lending experience combined with regulatory guidelines (see above at note 8) to set financial covenant levels. The projected financial statements serve as the basic data for establishing covenant levels. Since financial covenants are usually designed as early warning devices, lenders want covenants that are good indicators of debt service capability. Contrary to popular belief, lenders do not want financial covenants as high as possible. What they try to achieve is an effective filter system, identifying problem loans that merit special attention. If covenants are too high, the lender may waste valuable administrative time on a relatively low-risk situation.

For example, assume a senior lender provides $2,000,000 at 12 percent fixed interest to be paid over five years. The company's projected cash flow and debt service requirements appear in Table 4-1. The projected coverage ratio is calculated by dividing projected cash flow by total debt service.

TABLE 4-1

Sample Company's Projected Cash Flow and Debt Service Requirements (in thousands of dollars)

Year	1	2	3	4	5
Loan balance at 1/1	$2,000	$1,700	$1,250	$800	$350
Interest	240	204	150	96	42
Principal payments	300	450	450	450	350
Total debt service	540	654	600	546	392
Projected cash flow	1,000	1,200	1,400	1,600	1,800
Projected coverage ratio	1.85	1.83	2.33	2.93	4.59

Given these data, the lender will make a judgment about the projected volatility of the company's cash flow. Assuming the company's prospects satisfy the senior lender's loan committee, a projected coverage ratio covenant must be determined. The level selected will probably be a simple discount on expected performance that still provides the lender with reasonable security. Once the company is out of the woods, the lender should be comfortable and should not keep increasing the level of required performance even if the projections indicate that it can be achieved.

The covenant level will probably rise over time to reflect the lender's desire to see the company's cash flow continue to increase. A sample covenant and the resulting minimum cash flow to prevent default appears in Table 4-2. The covenant levels shown in this table require the company in effect to increase cash flow each year until the last, when the lender's risk has been significantly reduced.

Borrowers are faced with an interesting dilemma when presenting a prospective lender with the target company's projected financial performance. A borrower may be motivated to make the target's future performance look good in order to obtain the loan. However, these same projections will form the basis for the lender's financial covenants. If the projected performance were inflated, the company could continually be in default on the loan agreement. On the other hand, if the borrower downplays the future performance of the target company to avoid this possibility, the borrower runs the risk of making the loan relatively unattractive to the lender. Ultimately, both sides benefit the most when forecasts are submitted that genuinely reflect the buyer's expectations for the target.

When are financial covenants usually negotiated?

Very late in the process, usually just before closing. The typical buyer prefers to get the commitment for the loan before negotiating these provisions in

TABLE 4-2

Sample Covenant (in thousands of dollars)

Year	1	2	3	4	5
Covenant ratio	1.4	1.4	1.8	2.1	2.5
Minimum cash flow (covenant ratio × debt service)	$756.0	$915.6	$1,080.0	$1,146.6	$980.0

detail. Often the most reliable financial projections become available only at the last moment, and they provide the base for the covenants. Sometimes, the bank sets the covenants too tightly at the closing, and the negotiating process continues through the initial months of the loan in the form of waivers. This should be avoided if possible.

What events typically trigger default?

- Breach of one or more of the covenants described above (sometimes subject to a right to cure certain breaches within a specified cure period and/or to the qualification that the breach be "material" or have a "material adverse effect" on the borrower).
- Payment defaults (failure to pay interest, principal, or fees when due or, in the case of interest and fees, sometimes within a stipulated grace period—see below).
- Breach of a representation or warranty (sometimes subject to the qualification that the breach be material—see below).
- Cross default (default in the loan agreement triggered by a default in another loan document, such as a security agreement, or in another unrelated but material agreement to which the borrower is a party, such as a subordinated debt instrument). Typically, for a cross default to be triggered, the default in the other instrument must be mature, that is, all cure periods must have expired and the other lender must have the right to accelerate. In addition, defaults on other debts below a specified dollar threshold may be expressly exempted from a loan agreement's cross default provisions.
- Insolvency or voluntary bankruptcy, or involuntary bankruptcy, if not discharged by the borrower within a stipulated period (typically 60 days).
- An adverse final court judgment above a stipulated dollar amount that is not discharged or stayed on appeal within a prescribed period.
- The imposition of a lien (other than a lien permitted pursuant to the loan agreement) on assets of the borrower.
- The occurrence of an event triggering ERISA liability in excess of a stipulated amount.
- The death of the chief executive officer or an individual guarantor or other termination of the employment of certain specified managerial employees.

What techniques can be used to take some of the bite out of default provisions?

There are basically two default softeners: the use of *grace* or *cure* provisions and the concept of *materiality.*

A *grace period* is a period of time, following the due date for the making of a payment, during which payment may be made and default avoided. It is rare, but not without precedent, for a grace period to be accorded to a principal repayment obligation. More common are grace periods for interest payments or fees. Five days' grace beyond the due date is not uncommon; sometimes 10 or even 15 days may be granted.

Cure periods apply to defaults triggered by covenant breaches. Generally, the lender will attempt to limit their application to those covenants that are manifestly susceptible of cure (the duty to submit financial reports at specified dates) but deny them for covenants designed to provide early warning of trouble (breach of financial ratios). Sometimes, the cure period will not begin to run until the lender has given the borrower notice of a failure to perform; in other cases, the cure period will begin to run when the borrower should have performed, whether the lender knew of the borrower's failure or not. Cure periods vary greatly from transaction to transaction and from provision to provision. However, 5-day, 10-day, and 30-day cure periods are seen from time to time, and sometimes the concept of counting only "business days" is used to extend the period by excluding Saturdays, Sundays, and nationally recognized holidays.

The concept of materiality is more commonly applied in the case of defaults triggered by warranty breaches. The borrower will assert that default should not be triggered if a representation turns out to be untrue, but the effect of such inaccuracy is not materially adverse to the borrower or the collateral, or to the lender's position. The concept of a cure right for misrepresentations is not at all common but is not illogical in many cases. In some cases, where the loan agreement does not afford the borrower the right to cure a breached covenant, it is sometimes provided that such a breach will nevertheless not trigger a default if the effect is not material and adverse.

So far, we have been talking about commercial bank loans. What other major sources of financing are there?

In addition to commercial banks, leveraged acquirers can turn to *insurance companies* (for loans), underwriters (to do high-yield/*junk bond issues* or to make *bridge loans*), and *equity investment funds* or other funds, all discussed next.

INSURANCE COMPANY FINANCING

For many years, insurance companies have provided senior fixed-term financing—both secured and unsecured—for terms of up to 10, 12, or 15 years through "private placements." If a company's capital requirements are sufficiently great, one or more additional insurance companies may participate in the transaction as co-lenders. Frequently these groups are assembled by investment bankers. Because the behavior and practices of insurance company lenders differ somewhat from banks, they deserve special attention.

What kind of financing is usually available from insurance companies?

Loans may be secured, unsecured, or a combination of each. All, or any portion, may be senior debt, the remainder being subordinated debt generally bearing a greater rate of interest. Rates are usually fixed for the term of these financings.

Does it make a difference which insurance companies are solicited?

It may, for several reasons. Although lending terms tend to be somewhat standardized, certain companies will lend into a riskier credit, with a rate premium and perhaps a somewhat more onerous set of covenants, although most won't. In addition, over the years several life insurance companies and their attorneys have devised and perfected lengthy, onerous forms of note purchase agreements (essentially the equivalent of loan agreements) with which many borrowers became disenchanted, taking their business elsewhere. Since then, in an effort to regain the lost business, at least one company has developed a new, streamlined, and more readable form of agreement that is definitely preferable to its predecessors from the borrower's point of view. It may be appropriate to agree in advance of documentation that a streamlined form of agreement will be utilized.

How long does it take to obtain insurance company funding?

Insurance companies are generally more bureaucratic than banks, and decision making often seems to take longer. In-house counsel to insurance firms can, in some cases, march to a different drummer, delaying legal responses, but their input is required notwithstanding the presence of an outside law firm.

Although substantial acquisitions have been closed with insurance company funds, these closings did not break any records for speed. Often, if time is of the essence, it is prudent to arrange for a bridge lender to fund initially and be taken out within a period of several months by an insurance company private placement. The bridge lender can even be the bank providing the revolving financing. Even this solution can be difficult to achieve, however, since the principal terms of the takeout financing must be negotiated in advance with the insurance company, and often between it and a senior lender, to be sure the takeout financing can be closed in the future.

How are insurance company private placements generally negotiated?

The deal is negotiated and, frequently, put in the form of a "term sheet" that is circled (approved) by each insurance company; or commitment letters may be issued, particularly if sufficient pressure is placed on the lenders by the borrower or its counsel.

Once a term sheet or commitment letter is agreed to, the lead lender (usually the insurance company taking the largest percentage of the total loan) will have its outside counsel prepare a first draft of the note purchase agreement; such counsel generally acts for the entire lending group, although with varying degrees of authority and effectiveness. The other participants (and their in-house counsels) will generally review this draft before it is forwarded to the borrower and its counsel. The content of this agreement has the potential to change significantly for the worse—from the borrower's perspective—as it progresses through successive drafts, as in-house counsel for each participant gets additional bites at the apple. A strong lead lender, however, can often prevent this from occurring.

How should the borrower or its counsel respond if, during the negotiation of a Note Purchase Agreement, a representative of the insurance company refuses to strike an objectionable covenant, saying that the borrower can request a waiver at a later date if proved necessary?

These agreements should be negotiated as fully as possible prior to closing. Although subsequent waivers are obtainable, a borrower should not be surprised if some payment is required in connection with the waiver, particularly

if interest rates have risen significantly since the funding of the transaction. Even when rates have not risen, some companies have been known to impose fees when waiver requests are made, frequently in order to compensate for their staff time spent in evaluating the requests; of course, the cost of any outside counsel will be the responsibility of the borrower. Furthermore, waivers are generally more readily obtainable from banks, less so from insurance companies. One should act accordingly in negotiating the initial insurance company documentation.

Is it possible to provide for optional prepayments without incurring significant prepayment premiums?

Yes. Generally, prepayment provisions in note purchase agreements have followed a formula that allows for optional annual prepayments in any year in the amount of any specified annual mandatory prepayments without additional charge. If, however, the loan is to be prepaid in any given year by an amount in excess of this permitted optional prepayment, a percentage premium (typically around 9.5 percent) would be applied to this excess with the amount of this percentage declining annually, reaching zero within a year before maturity. The applicable percentage would then be multiplied by the amount prepaid in excess of any permitted optional prepayment; the resulting product is the dollar amount that must be paid, in addition to the outstanding principal balance, in order to prepay the principal indebtedness evidenced by the note purchase agreement or an appropriate portion.

Recently, many life insurance companies have become gun-shy of the fixed premium method for prepayments and are moving toward what is known as a *make-whole* arrangement. This consists of a formula that pays to the lender the net present value of the lost return during each year that the notes issued under the note purchase agreement would have been outstanding, compared with a theoretical reinvestment at an agreed formula rate.

Are other prohibitions on prepayment typically found in insurance company financings?

Yes. Prepayment is usually prohibited if the source of funds for such prepayment is borrowings, or proceeds from the sale of preferred stock, because they have a lower after-tax interest cost to the company than the company's after-tax cost of interest at the rate payable under the insurance company's notes.

Is there any way to structure the borrowing in order to reduce the amount of prepayment premiums?

Yes. If a portion of the amount borrowed is at a variable rate tied to prime or Eurodollar rates, prepayment premiums on that portion can be avoided.

Do insurance companies provide revolving loans, takeout commitments, or other forms of guarantees?

Insurance companies don't do revolving loans. For this reason, they are not suitable for working capital lending. Insurance companies are not organized for the continuous financial monitoring required for revolving lending. Also, unless operating as a surety, insurance companies do not give guarantees. They may not make a loan unless it would be prudent at the time made. Thus, they may not give enforceable commitments to take out or back another lender if the borrower gets into trouble.

What material covenants would you expect to find in a more streamlined insurance company Note Purchase Agreement?

- Typical financial reporting covenants, including requirements for a statement of the principal financial officer of the company setting forth computations pertaining to compliance with financial covenants (including long-term and short-term debt incurrence, secured debt incurrence, and the making of restricted payments).
- Maintenance of corporate existence, payment of taxes and compliance with statutes, regulations and orders of governmental bodies pertaining to environmental and occupational safety and health standards, or even broader governmental statutes and regulations with a materiality standard.
- Maintenance of specified types of insurance.
- Restrictions on debt incurrence (including limits on short-term debt and long-term debt, each of which may be restricted to specified dollar amounts or by formulas relating to consolidated tangible net worth and consolidated net earnings available for fixed charges).

- Restrictions on encumbrances, sales and leasebacks, and payment of restricted payments.
- Maintenance of financial condition—minimum amount of consolidated tangible net worth, minimum ratio of consolidated net tangible assets to consolidated debt, minimum current ratio, maximum long-term rentals, restriction on subsidiary stock dispositions, and issuance of shares by subsidiaries.
- Limitations on amounts of annual capital expenditures.
- Restrictions on mergers and consolidations affecting the company and subsidiaries, and disposition of company or subsidiary assets.

HIGH-YIELD—A.K.A. "JUNK" BONDS

What are junk bonds?

Junk bonds are medium-term to long-term obligations of the target that (1) are subordinated to its senior debt, (2) are normally unsecured, and (3) bear high interest rates. Their rather inelegant name, reportedly coined by Michael Milken in a conversation with Rik Riklis,[32] comes from the fact that they are riskier than senior debt: they get a below-investment-grade rating from one or more of the bond rating services.[33] They generally deserve a better label, however, and are thus called by some underwriters "high-yield securities." Indeed, the term *junk* arguably had the effect of discounting the price, which helped some purchasers realize enormous returns, to the detriment of issuers. Junk bonds are normally not prepayable for an initial period (three to five years), and thereafter only prepayable at a premium.

The main purpose of junk bonds is to provide mezzanine financing for acquisition transactions, filling in the gap between senior secured debt, which pays a lower interest rate, and the seller's takeback financing or the buyer's equity financing, which is the last to be paid back. There is sometimes more than one layer of junk debt—one being senior subordinated and the other junior subordinated debt.

To whom and how are junk bonds sold?

They are commonly sold to large financial institutions—insurance companies, pension funds, and mutual funds, including overseas investors—usually in blocks of $500,000 or more, and are primarily for the sophisticated

investor. Funds that invest in junk bonds often attract supersophisticated money managers, who are known to go in and out of the junk bond market rapidly, causing volatility in prices. Often, but not necessarily, the offerings are registered under the federal securities laws to increase their marketability and are sold in a package with warrants to acquire common stock in the target. If they are privately placed, they often carry registration rights that will enable the holders to require the borrower to register the debt for sale in a public offering. (See the discussion of registration rights below.)

How do warrants relate to junk bonds?

As mentioned earlier, warrants are rights to buy stock from the company at a specified price for a future period of time. Junk bonds offer some of the same high-risk/high-reward characteristics of equity, so it is natural to offer them together with an equity kicker in the form of warrants. Frequently, the institutions buying the bonds sell the warrants (sometimes back to the underwriter), thereby obtaining the junk bonds at a discount.

What is a bond indenture?

The indenture is the basic agreement setting forth the terms of the junk bonds and is entered into between the borrower and a bank, acting as trustee for the bondholders. It serves the same function as the credit or loan agreement executed with the senior secured lender and the note purchase agreement executed with an institutional mezzanine lender. The indenture contains the covenants, events of default, and other material terms of the transaction, including the various responsibilities and rights of the issuer, trustee, and bondholders. If the bonds are issued or subsequently sold pursuant to a public offering, the indenture must qualify under the Trust Indenture Act of 1939. Much of the boilerplate in the indenture is derived from requirements under that law.

The principal objectives of the covenants are to prevent disposition of the assets of the borrower (unless the sale proceeds are reinvested in assets used in the same business by the borrower or used to pay off the junk bonds or senior debt); to ensure that if any merger, consolidation, or change of the borrower occurs, the successor entity is obligated to repay the bonds on the same terms and is in as strong a financial position after the transaction as before; to limit the creation of additional debt and liens (particularly secured debt senior to the bonds); to limit payments of dividends and distributions to stockholders (restricted payments); and to restrict transactions with affiliates.

What covenants do junk bonds normally contain?

Compared with senior debt agreements, unsecured junk bond indentures are simpler, fitting the classic bond indenture mold. Unlike senior debt instruments, which provide for total information flow to lenders, hair-trigger default provisions, and, in theory, extensive second-guessing and approval of management decisions, junk bond indentures tend to rely more on the borrower's good judgment and the value of the company as a going concern and limit themselves to protecting against major restructurings or asset transfers or increases in amounts of senior or secured debt. This difference in approach reflects the longer-term nature of such debt and the impracticality of obtaining consents from a large, diverse group of public bondholders. In the very rare case that the junk bonds are secured, however, a more elaborate set of covenants relating to the protection of collateral will be included.

Generally, borrowers should try to limit the financial covenants in junk bond issues to incurrence tests rather than maintenance tests. In other words, the covenants should not require that any specified level of financial health be maintained and should be breached only by a voluntary act, such as the four normal circumstances: paying a prohibited dividend, incurring prohibited debt, merging or combining with another company or selling assets unless certain tests are met, or dealing with affiliates at less than arm's length. These covenants will often closely restrict operating subsidiaries of the borrower to ensure that all debt is incurred on the same corporate level.

In many transactions the covenants go much further. They may include detailed financial maintenance covenants relating to net worth, current ratios, interest coverage and the like, limitations on investments, and application of asset sale proceeds.

Which bond covenants are particularly subject to negotiation?

The following key issues should be covered in the indenture:

- *Restrictions on mergers and asset sales.* There are a variety of such restrictions. The most onerous require that the surviving entity in the merger or the purchaser of all or substantially all the assets have a net worth not lower than the borrower had before the merger and that the fixed charge coverage ratios (generally the ratio of debt payments to cash flow [pre-debt service]) equal a certain percentage of the ratio that pertained before the merger. The effect of this type

of provision is to preclude a sale of the business in a leveraged buyout that will cause a material increase in total debt of the company after the merger. The borrower thus has fewer means available for disposing of the business.

Some indentures require the borrower to offer to prepay junior debt from asset sale proceeds that are not used to prepay senior debt. (It must be an offer because the debt is usually not prepayable without the consent of the lender.) Senior lenders object to this provision because they believe that it may be necessary for the proceeds to be left in the business, particularly if there is trouble and the asset sale was used to gain needed liquidity for the business. The dispute can usually be solved by allowing, until the senior lender is paid in full, a limited amount of such proceeds to be left in the business before a prepayment offer must be made.

A borrower should always check in advance to learn what the investment banker's standard format is (best done by reviewing indentures from previous transactions). Once you've locked in with an investment banker, you'll hear over and over again that it can't market the debt without the restrictions it is used to. Be prepared with examples of other junk debt with less onerous provisions. If you have any specific plans to sell off assets, be sure they don't violate this provision.

- *Debt incurrence.* Many junk bond indentures have very tight restrictions on debt incurrence by the issuer. The simplest form of restriction is that the issuer cannot issue "sandwich debt" or "interlayer debt," that is, debt subordinated to the senior debt but senior to the junk debt. This restriction allows the issuer to borrow as much senior debt or debt junior to the junk debt as the lenders are willing to lend. The holders of the junk debt are relying on the limitations senior lenders will place on the amount of senior debt that can be incurred.

  Other types of restrictions limit the incurrence of debt to a percentage of the original amount of debt or require the achievement of certain financial ratios before incurring additional debt. The ratios, and any particular provisions necessary for a particular business plan, are all subject to negotiation with the lender. The senior lender will want the borrower to be able to incur new senior debt somewhat in excess of the unpaid amount of the existing senior debt in order to permit minor workout arrangements and to finance some expansion.

- *Restrictions on prepayments.* Most junk bonds preclude prepayments for several (often five) years and thereafter may permit prepayments only on payment of substantial premiums. This restriction is not as troublesome if the covenants in respect of mergers and debt incurrence are not too strict. A long nonprepayment period means that the issuer can't rid itself of the debt except through defeasance of the bonds, if the covenants become too burdensome.
- *Subordination provisions.* See section under the heading "Subordination Provisions."
- *Restricted payments.* These restrictions prohibit dividends and other distributions as well as stock redemptions unless specified conditions are satisfied. The conditions usually prevent payments until a specified minimum net worth level has been attained; thereafter, payments may not exceed a certain percentage (25 to 50 percent) of accumulated net income.

  Be careful of this provision; it may have the effect of precluding a sale of the company through an LBO unless the junk bonds are also prepaid. Such a buyout normally requires the borrower, or a successor obligor under the junk bond indenture, to borrow the acquisition debt and pay the proceeds to the target's shareholders. Such payments probably constitute a restricted payment that may not be made unless the tests are satisfied (and in most such cases they won't be). Even if all the other tests for the merger are satisfied (such as net worth and coverage ratios), this test may present an often insurmountable hurdle.

But won't it be possible to just waive these covenants if they prove to be too restrictive?

No. Prepaying the junk bonds will very likely be either impossible or very expensive because of prepayment restrictions and penalties. In addition, unlike the case of senior lenders, it is often impossible, or at the least very difficult, to obtain waivers of covenants from a multitude of public bondholders. Therefore, the restrictions contained in the junk bond indenture should be something the borrower can live with for a long time. Special care must be taken to ensure that the covenants fit the long-term plans of the company with respect to acquisitions, dispositions of assets, expansions, and so on. Once the covenants are in place, you'll have to live with them pretty much unmodified.

What about default rates for junk bonds?

It varies over time, with a very low chance of default for a year or so, then a higher likelihood in years three and four, and then a decreasing chance after four years.[34]

What is a quasi-junk bond?

A bond that gets a split rating—where one credit rating service gives it a lowest investment grade and another calls it junk.[35]

What recourse do bondholders have in the event of poor bond performance?

Creditor lawsuits against parties involved in failed LBOs have targeted numerous parties, including issuers of junk bonds. Many of these cases are filed under state fraudulent conveyance laws. Few are brought to trial. Many are settled out of court. Junk bondholders often have a say in restructuring or changes of control.

Is there ever insider trading in junk bonds?

Some investors believe there is widespread insider trading—trading based on material nonpublic information—in various debt securities including junk bonds, municipal bonds, government securities, commodities, and futures. A common symptom of such trading, often seen in junk bonds, is a sharp increase in price prior to a positive announcement. Investigation, pursuit, and punishment of such trading has been limited to date, though, because the federal agency with explicit authority to go after insider trading in securities, the SEC, fears that it may not have jurisdiction to pursue such cases. There are also detection problems. Junk bond trading, done only over the counter, is more difficult to track than equity trades, which occur on the major stock exchanges.

BRIDGE LOANS

Underwriters will sometimes offer a buyer immediate short-term financing for an acquisition in exchange for the right to replace that financing with a later junk bond issue.

The risk in bridge lending is that the market will go sour before the loan is repaid and the bonds are sold.

What should be the interest rate on the bridge loan?

The interest rate on the bridge loan, being short-term financing, should initially be 5 to 8 points over the Treasury or federal funds rate, lower than the expected rate on the junk bonds that will be sold to repay the bridge loan. This rate should rise by 0.5 percent or more per annum if the underwriter cannot refinance the bridge loan in a three- to six-month period. The increasing interest rate compensates the underwriter for the bridge financing risk, as does a warrant for a small amount (normally 3 to 5 percent) of the common stock of the target. The underwriter will also receive substantial fees: commonly 2 percent—1 percent upon execution of a commitment letter for the bridge loan and another 1 percent or more when the loan is funded.

What issues arise in the negotiation of a bridge loan/junk bond financing?

The bridge lender is most concerned about ensuring that it will be able to market the refinancing debt, that is, the junk debt that will be used to repay its loan. Thus, it will seek to clarify in advance any potential issue that could arise with the borrower or with other lenders. The bridge lender will also seek utmost flexibility in the terms of the refinancing debt that it can offer (such as interest rate and equity kickers such as warrants) and will further require that the borrower use its best efforts to get the offering done as soon as possible. The bridge lender's prime concern is to get its debt refinanced, and it will seek to build into the contract strong incentives to motivate the borrower toward that end.

The borrower, on the other hand, wants to be sure, if possible, that its permanent mezzanine debt is borrowed on terms it can repay. The borrower should seek to place limits on the terms of the refinancing debt and also to ensure that the bridge lender's debt will roll over into longer-term debt if the refinancing debt can't be placed.

These general concerns are reflected in the following specific points of negotiation:

- *The term of the bridge loan.* In many cases, the bridge loan falls due at the end of a fixed period, usually 3 to 9 months. If the refinancing debt is not placed by then, the bridge loan is in default. The senior lenders are often unwilling to accept this risk, and the borrower should be concerned as well. The refinancing debt may not be marketable on reasonable terms even though the

company is doing extremely well; the problem may simply be a failure of the markets (as in the post-October 1987 and 1989 periods) or in the marketing efforts of the bridge lender. The other parties will have made financial commitments based on the confidence level of the investment banker that the refinancing debt would be available.

For the foregoing reasons, the bridge lender can often be persuaded (particularly in a competitive environment) to commit to a longer-term investment if the refinancing debt doesn't get placed. This often takes the form of a rollover provision where the terms of the note change after the maturity date and it becomes long-term subordinated debt with covenants and other provisions, similar to subordinated junk debt. Another technique is to cast the original bridge note as a long-term note that the borrower is obligated to prepay with the proceeds of refinancing debt or other cash proceeds such as equity offerings. In either case, the extended bridge note will have higher than normal, or increasing, interest rates to encourage refinancing of the bridge debt at the earliest possible time.

- *The terms of the refinancing debt.* The borrower should obtain reasonable limits on the terms of refinancing debt that it will be obligated to accept. The usual formulation is something like "at prevailing market rates and terms," subject to limitations on the interest rate, the term, scheduled principal payments, and the amount of equity that the purchasers of the refinancing debt will be entitled to receive. The borrower may seek a limitation on the amount of cash interest payable annually or, alternatively, on the average yield on the instrument, although it is difficult to bar access of the bridge lender to takeout financing, even if there has been a major interest rate move in the market. The senior lender also will be interested in ensuring that the terms of the refinancing debt don't violate its expectations about coverage ratios and limits on other indebtedness.
- *The covenants and events of default of the bridge loan.* The senior lender and the borrower will generally try to make the bridge loan covenants, events of default, and subordination provisions similar to the refinancing debt that will take out the bridge loan. They resist, often successfully, attempts by the bridge lender to make the bridge loan agreement a tighter, more restrictive document or to have the bridge lender ride on the covenants of the senior lender. Avoidance of overly tight default triggers is especially

important where the obligation of the bridge lender to sell the refinancing debt is conditioned on absence of a default under the bridge note. The tighter the covenants, the greater the risk of a default that could prevent the rollover into the longer-term note and thus could put the company into a financial crisis soon after the acquisition.

EQUITY INVESTMENT FUNDS

Suppose a small group of managers wants funding to buy out a division of a company. What happens then?

One solution might be a private equity fund, also called a buyout fund. Such funds are often used to provide the mezzanine level of financing in a management buyout. The investment fund raises capital from private investors and uses the money to make equity and subordinated debt investments in a portfolio of companies that are in need of mezzanine financing, including companies that have gone private in an MBO. In return for their capital, investors in an investment fund typically receive income from the debt the fund provides to its portfolio of companies and the potential for capital appreciation from the fund's equity investments.

As of April 2006, the largest buyout funds were:

- J. P. Morgan Partners Global 2001 ($7.90 billion)
- Carlyle Partners IV ($7.85 billion)
- Permira Europe III ($6.70 billion)
- BC European Cap VIII ($6.57 billion)
- Blackstone Capital Partners IV ($6.45 billion[36])

Other dominant players have been The Carlyle Group, Clayton & Dubilier, Foreman Associates, Forstmann Little, H.M. Capital Partners, LLC (formerly Hicks-Muse), Kelso & Co., Kohlberg Kravis Roberts, Texas Pacific Group, Thomas H. Lee, and Warburg Pincus Investors. Also, some brokerage firms, such as Deutsche Bank, Goldman Sachs, Merrill Lynch, and Morgan Stanley have organized funds. More recently, the trend has been for divestiture of buyout funds (e.g., Deutsche Bank spinning off Mid-Ocean Partners) because of perceived conflicts of interest with the brokerage firms' lending activities.

Other funds may be organized for specific deals, sometimes called "club deals." The largest such transaction in 2005 was from a consortium of private equity investors who took SunGuard Data Systems private for $11 billion acquisition. This was the largest LBO since KKR acquired RJR Nabisco in 1989. The New York attorney general has reviewed club deals for potential violation of antitrust laws.

How are MBO investment funds structured and who invests in them?

Generally, investment funds are organized as limited partnerships.[37] The interests in the partnerships are considered securities under federal and state securities, laws and, consequently, are offered and sold in a registered public offering or in reliance on an exemption from the registration requirements.

Most commonly, the private equity investment funds have been marketed to a limited number of sophisticated, wealthy individuals; financial institutions; and public and private pension funds in a private placement offering.[38] Proceeds of the offering are used by the investment fund to acquire common equity, preferred stock, and subordinated debt in a series of management buyouts. Investment funds generally make majority investments, although there have been exceptions.

How do the fund investors share in the benefits of the investment?

Fund investors do not directly own any stock or other interests in the company to be acquired. Instead, each participant, or investor, in an investment fund contributes capital to each acquisition vehicle formed and will become a limited partner in the acquisition vehicle, receiving a return on investment in accordance with the partnership agreement. For example, in two private funds sponsored by Forstmann Little & Co. and KKR, respectively, the general partner receives 20 percent (or more) of the realized profits from the investments made by the fund, and the remaining balance is distributed to the limited partners. In certain public funds, income and gain may be distributed 99 percent to the limited partners and 1 percent to the general partner until the limited partners have received distributions of an amount equal to a 10 percent cumulative annual return on their capital contributions. Thereafter, the general partner is permitted to take a larger share of the profits.

Are the acquisitions in which the fund will invest identified in advance?

No. Investment funds are typically structured as "blind pools," meaning that the portfolio of companies in which a fund will invest will not be identified or known at the time each investor purchases his or her interest in the fund. The general partner of the fund will have complete discretion in selecting the companies in which the fund will invest. Generally, the funds do not invest in companies where management is opposed to the acquisition.

What kind of time frame and returns can an investor in an equity fund expect?

Private investment funds are often structured so that each investor enters into a commitment, for an average period of five to six years, to make a capital contribution upon the request of the general partner. The commitment is usually quite large, ranging from $5 million to $10 million; however, investors have control over use of their capital until it is actually invested in a particular acquisition vehicle upon request of the general partner. Returns on equity fund investments vary, especially between equity and debt investors.[39]

What other investments do funds make besides mezzanine and equity financing?

Occasionally, an investment fund will provide bridge financing rather than mezzanine financing. Bridge financing is provided for a short term, typically nine months or less, to supply funds during the interim period before permanent financing is arranged. After the bridge loan is repaid, the fund remains with an equity interest in the acquired company and can roll the loan proceeds over into another acquisition.

In addition, investment funds may be structured to allow the fund to use its capital to finance a friendly tender offer for stock of a publicly held company whereby 51 percent of the stock is acquired in the tender offer and the remaining stock is acquired in a cash merger. This structure permits leveraged purchases of public companies, despite the margin requirements that prohibit acquisition financing secured by more than 50 percent of the value of the securities acquired. The initial 51 percent of the stock acquired in the tender offer is financed half by borrowings and half by equity from the fund. When the cash merger occurs, the additional financing can be supported by

the assets of the target, and all or a part of the initial equity investment can be repaid. (See Chapter 10 on public companies.)

What regulatory controls are imposed on investment funds?

The main federal law affecting funds is the Investment Company Act of 1940, which is likely to apply to any investment fund that raises money from the public (IPOs, secondary offerings) and uses the proceeds to acquire securities of other companies in order to achieve passive income.

Mutual funds such as the Fidelity funds are the most obvious example of investment funds covered by the Investment Company Act. But the law can apply even if no investment fund is involved, especially if the buyer uses the proceeds of publicly held junk bonds for financing.

The law requires a primarily equity-based capital structure raised from public sources, prohibits dealing with affiliates, and imposes various public reporting and fiduciary obligations on the fund's principals. To avoid the effect of the Act, most leveraged buyout funds raise their capital from private placements.

The law does not apply to equity funds that buy controlling shares in operating subsidiaries and manage them in a classic holding company manner. But anyone who is in the business of buying companies, holding them short term (particularly under two years), and selling them, all without actively engaging in their day-to-day management, should check to be sure he or she is not subject to regulation as an investment company under the law. Furthermore, equity funds that are structured as limited partnerships are subject to a growing body of state and federal law governing these structures.[40]

REGISTRATION RIGHTS

What are registration rights?

Registration rights are rights given to an owner of debt or equity securities (1) to require the issuer of the securities to register such securities for public sale under federal and state securities laws or (2) to participate in any such public sale initiated by the issuer or another securityholder. They are key provisions of warrants, preferred stock, and privately placed subordinated debt issues and thus deserve special attention here. They also appear in stockholders'

agreements and agreements with management. (See relevant portions of Chapter 5 on structuring transactions.)

Why do securityholders want registration rights?

Registration rights give securityholders more liquidity. Absent such rights, debt or equity privately placed in connection with an acquisition usually cannot be resold freely to the public. Any such resale either must be made by another private placement or otherwise pursuant to an exemption from the applicable registration provisions of federal and state securities laws or must comply with the holding period and other limitations of Rule 144a of the Securities Act of 1933, which restricts the amount of control, the amounts of restricted or unregistered securities that can be sold at any one time, and the manner in which those securities may be sold.

These restrictions are more than just an administrative nuisance and, because of the decrease in the liquidity of the investment represented by such securities, may reduce substantially their market value. In order to minimize the effect of these restrictions, holders of acquisition debt or equity, particularly holders of privately placed junk bonds, preferred stock, warrants for common stock, or common stock, are usually interested in obtaining from the buyer a promise to include the securities in a registration statement under the Securities Act at the securityholders' request.

Note that shelf registration is not an all-or-nothing process: each registration statement relates only to a particular, specified number of shares or amount of debt obligations of a particular type, and thus some securities of a company may be freely available for sale while others, even if otherwise identical, may still be restricted. In order to protect a securityholder, it is not enough to require that securities of the kind of security held by the holder be registered; rather, the holder's particular securities must be registered.

Why wouldn't the buyer automatically grant registration rights?

There are considerable costs to the company in granting registration rights. The registration process involves substantial expense for preparation of the registration statement, including the fees of accountants, attorneys, and financial printers. These costs usually amount to several hundred thousand dollars. In addition, the registration process is an arduous one for the issuing company and its officers and directors, and it requires company employees to

spend a significant amount of time and attention that would otherwise be focused on management of the company and its business.

Perhaps most important of all, the buyer wants to control when and if the company goes public. The exercise of registration rights may cause the company to become a "reporting company" under the Securities Act, necessitating the filing of periodic reporting documents with the SEC and resulting in additional expenses. Through the registration process, the target subjects itself to various potential liabilities as well as a host of regulations under federal and state securities laws. If the registration rights relate to common or preferred stock, the buyer will, furthermore, not want to go to the public market until its acquisition debt has been paid down and it is sure that the offering will be a success.

What are demand registration rights?

"Demand" registration rights entitle a holder of securities of a company to cause the company to register all or a part of such securities for resale by the securityholder. Usually, the company is required to effect such registration promptly upon demand of the securityholder, or within some other reasonable time frame.

What are piggyback registration rights?

"Piggyback" registration rights entitle a securityholder to cause the company to include all or a part of its securities in a registration of the same or other classes of securities of the company undertaken at the request of a third party, such as a lender. Piggyback registration rights might allow a lender holding warrants, for example, to have the shares of common stock for which his warrants can be exercised included in a registration of common stock or subordinated debt of the company that was undertaken by the company with a view toward raising additional capital.[41]

Piggyback registration rights generally are not exercisable, however, in the issuance of securities in connection with an acquisition or exchange offer, or pursuant to employee benefit plans, including ESOPs.[42] For more on ESOPs, see Chapter 7.

How many times should securityholders be entitled to exercise their registration rights?

Generally, the number of registration rights that securityholders receive is a function of the relative bargaining powers of the buyer-borrower and its

securityholders. It is fairly common for lenders with common stock warrants or privately placed junk bonds to receive one or two demand registration rights. It is often the case, however, that for demand registration rights other than the first demand, certain other terms and conditions of the registration rights, such as payment of expenses and limitations on the number of shares allowed to be included, become more restrictive with respect to the securityholder and more favorable to the borrower.

A greater or unlimited number of piggyback registration rights are often granted to securityholders, with the primary limitations being the time during which such rights are exercisable and the amount of securities that the securityholder can include in the registration.

What time restrictions should apply to demand registration rights?

The company's desire for a period of stability after the acquisition must be balanced against the selling securityholder's desire for liquidity. Therefore, demand registration rights usually will not be exercisable for some fixed period of time, often several years, after the acquisition. In addition, demand registration rights are often not exercisable until after the company has conducted its own initial public offering of its common stock. In this manner the company can control the key decision whether and when to go public. Sometimes, if the company has not gone public before a certain extended deadline, perhaps the date on which warrants will expire, the securityholder can compel registration.

Registration rights should not be exercisable during a stated period, usually six to nine months, following a prior registration of securities by the company. This helps prevent an overhang problem—marketing of the prior offering can be hurt if a large bloc of additional securities is entitled to go to market in the near future.

Securities are sometimes registered by a company for a sale to take place at a future time but the exact date and terms of the sale are not yet determined. Such a registration is referred to as a *shelf registration* because the securities are put on the shelf for later sale, with most of the work on the registration process already done. Demand registration rights usually do not entitle a securityholder to demand registration of its securities in a shelf registration until after the company has already effected such a shelf registration of its own securities, if at all.

What about timing for piggyback registration rights?

Piggyback registration rights raise additional timing issues, since they may be exercisable upon a registration by the company of securities of a type other than the securities to which the rights attach. A holder of common stock, for example, could require inclusion of some or all of its shares in a registration statement that covers debt securities of the company. In the acquisition context, in which the company's ability to sell debt securities during the first months or years after the acquisition may be crucial, care must be taken that piggyback rights do not create competition for the company's own offering. It is thus normal for piggyback registration rights to be restricted only to registrations of equity securities for several years after the acquisition.

When do registration rights terminate?

The exact termination date for registration rights is a matter for negotiation, but it is common for such rights to terminate under any of the following conditions: when the securities of the issuing company are widely held; when the securityholders could otherwise make use of the existing market for such securities to sell their shares without significant limitations; or when a securityholder has sold, or has had the opportunity through piggyback rights to sell, a specified percentage of securities held.

What benefits can accrue from registration rights agreements?

Registration rights agreements usually provide that the holders of a certain percentage of the securities, often as high as a majority, must join together in order to exercise their demand registration rights. The agreements may also provide that a threshold dollar amount must be reached before the offering will be large enough to be marketed efficiently by underwriters. Demand registration rights are usually not exercisable unless the aggregate offering price of the securities to be registered (or market price, if a market exists for such securities) exceeds a certain amount, which may be $5 million or more.

Without such agreements in place, the company could be forced to undertake the expensive and time-consuming process of registration for relatively small amounts of securities. Conversely, even with such agreements in place,

the company can forestall an offering by persuading a substantial number of securityholders that an offering would be inadvisable at any particular time.

What amount of securities may each securityholder include on a demand or piggyback basis in any particular registration statement?

This issue arises when the number of securities sought to be included in the registration is so great that the underwriter cannot place such a large number of securities at a suitable price. Registration rights agreements usually provide that the underwriter is the final arbiter of the question of just how many securities may be included in the registration statement. In such a case, an orderly system for priorities with respect to inclusion of securities in the registration statement must be spelled out in the registration rights agreement.

If the registration is being carried out pursuant to a demand registration right, those making the demand usually have priority. Securityholders with piggyback registration rights often have the next priority, the includable shares being allocated among them on a pro rata basis, depending on the relative bargaining positions of the securityholders. In demand registrations, the company is often the last one that is able to participate and thus may be unable to sell for its own account.

These priorities usually change, however, with respect to registrations of securities initiated by the company in which securityholders are exercising piggyback rights. If the registration involves an underwritten distribution of securities, then the priorities will generally be as follows: First, securities that the company proposes to sell for its own account (this is important in order to permit the company to raise needed capital); and, second, shares of selling securityholders, who may be either members of the investor/management control group or outside securityholders exercising piggyback registration rights. Such selling shareholders will generally participate pro rata according to the relative numbers of shares held by them or the relative number of shares sought to be included in the registration statement by them, although it is a matter of negotiation between the control group and those with piggyback rights as to who gets priority.

Who pays the expenses of registration?

The company generally pays the expenses of registering securities pursuant to demand registration rights. This is true at least with respect to the first

demand registration right exercised by a securityholder. These expenses include SEC filing fees, accountants' and attorneys' fees, and expenses of financial printers. The securityholders including securities in the registration statement will, if such shares are sold by an underwriter, have to pay underwriters' and broker–dealers' commissions from the sale of their shares, as well as applicable stock transfer fees. An open item for negotiation is the payment of any applicable fees and expenses relating to the sale of securities under various state securities laws ("blue sky" fees).

Responsibility for payment of expenses of registering securities pursuant to exercises of demand registration rights (other than the first such exercise) are often the subject of negotiation. They may be payable in whole or in part by the securityholder demanding registration, in order to put some limitation on the exercise of such subsequent demand rights. Sometimes state blue sky commissioners will insist that selling stockholders pay a pro rata share of expenses, particularly if they feel that insiders would otherwise get a free ride; such a possibility should be provided for in the registration rights provision.

Expenses incurred in registering securities included in a registration pursuant to the exercise of piggyback rights are usually relatively small and, except for underwriters' and brokers' commissions, are typically paid by the company.

What indemnification will a securityholder seek in negotiating a registration rights agreement?

Registration rights agreements, because of the potential liabilities involved under federal and state securities laws, generally provide that the company will indemnify the securityholders, including their shares in a registration statement, against liabilities arising through any misstatement or omission of a material fact in the registration statement and the prospectus. This indemnification should not, however, include statements supplied by the selling securityholders themselves for inclusion in the registration statement or prospectus.

A mirror image of this indemnification should be included in the registration rights agreement to provide for indemnification of the company by the securityholders including securities in the registration statement with respect to the information provided by them. The SEC and several court decisions have maintained that indemnification against liabilities under federal and state securities laws are against public policy and therefore unenforceable. In the event that such indemnification is unenforceable,

"contribution" (that is, a right to require pro rata sharing of liabilities) between the company and the securityholders may be allowed, however, and is customarily included in the registration rights agreement as an alternative to indemnification.

Who picks the underwriter?

The company. This is customary even in demand registrations, although sometimes an institutional securityholder will try to get this right.

What special problems arise with respect to registration rights of debt securities and preferred stock?

The company and the debt holders may have planned from the start to sell the debt publicly, in which case the initial placement is really a bridge loan pending the registration, and the registration rights provisions serve to lay out the next stage in the proposed financing sequence. In the alternative, the debt holders may plan to continue to hold the debt, but with a shelf registration in place so as to be able to sell publicly at any time. Under either circumstance, the registration rights provision presents no problems, and the subordinated debt should be issued from the start in a publicly held junk bond format with appropriate covenants and other indenture provisions.

Sometimes, however, the mezzanine debt has been structured to be privately held. The covenants may be tight, so that the company knows that it can operate only on the basis of repeated requests for waivers. This is particularly likely to occur if the subordinated debt holder has also taken a substantial equity position in the company and plans to operate effectively as a business partner of the company. Under such circumstances, the loan agreement with the subordinated debt holder must be completely rewritten before a public registration can occur. It will be necessary either to negotiate in advance and include an entire alternate indenture in the registration rights provisions, or have a brief, more informal, understanding that registration of the debt can occur only under certain conditions—for example, only if the loan covenants are adjusted to a conventional format for a public issue and/or the company has otherwise issued some class of publicly held securities.

Preferred stock raises some of the same issues, since a private placement of preferred stock may contain provisions, such as special exchange or redemption rights, not suitable for publicly held preferred. In addition, demand

or piggyback registration rights create marketing problems when they compel the simultaneous offering of different classes of securities, particularly at the time of an initial public offering of common stock. The company should consider offering the preferred stock holder a right to redeem preferred stock from a specified percentage of the proceeds of the common stock offering in lieu of granting preferred stock registration rights. In the alternative, a demand preferred stock registration should not be permitted until a reasonable time (120 to 180 days) following an initial public offering of common stock, and no piggyback rights should arise on such initial public offering or thereafter without the approval of the common stock underwriter.

INTERCREDITOR ISSUES

What are intercreditor issues?

Intercreditor issues are legal and business conflicts arising between lenders. The major areas of difference relate to (1) subordination provisions and (2) rights to collateral.

Do not underestimate the importance of these issues. Intercreditor issues can give rise to serious negotiating problems and can even imperil the deal itself. Unlike buyers and sellers, both of whom usually have a strong stake in achieving a closing and therefore considerable negotiating flexibility, lenders may feel less impelled to close the deal and may condition their participation on compliance with a rather narrow and specific set of security and return criteria.

Once misunderstandings or conflicts arise as to who is to get what collateral or how subordinated the junior debt will be, they are often very difficult to resolve. For example, if two lenders' negotiators have sold the deal to their loan committees on mutually inconsistent bases, misunderstandings can take weeks to straighten out. Competitor banks or insurance companies, rather than focusing on closing the deal, may try to settle old scores to prove their negotiating skills, to win points with their superiors, or to meet the not-always-appropriate standards of their lending manuals. Nothing can be more alarming and frustrating for buyer and seller than watching lenders' loan officers or counsel come to loggerheads over major or even minor points where neither lender has much incentive or institutional flexibility to accommodate or withdraw gracefully. The situation becomes worse when each lender is not a single entity but a syndicate of banks or insurance companies. For these

reasons, transactions should be structured and planned to minimize and resolve intercreditor conflicts as rapidly and as early as possible.

Why doesn't the buyer simply make clear to each lender from the start which security rights and priorities each will have?

Most intercreditor problems arise when two creditors are negotiating subordination rights or rights over collateral and encounter an issue that has not been raised and resolved as part of their respective loan commitments. Consequently, solution number one is to identify as fully as possible at the commitment stage which priorities, assets, or kinds of assets will be allocated to each lender. Some areas are clear and well accepted: revolving lenders get a first lien on current assets; term lenders get a first position in property, plant, and equipment. Less clear is who gets the first position in intangibles, other than those (such as patents) necessary to use a particular piece of equipment, or licenses necessary to sell inventory, which go with the tangible assets to which they relate.

The buyer may, however, choose to keep this point unclear as a matter of negotiating tactics—the buyer may not want to deprive one lender of a particular piece of collateral unless he or she is sure that another lender will insist on getting it. The lender may be more easily persuaded to get along without the additional collateral once its loan officers are fully involved and appraisals and due diligence have been satisfactorily completed. The buyer may also be trying to keep some assets unencumbered.

Or the buyer may simply miss the point. There is likely to be a lot of time pressure at the stage at which loan commitments are being negotiated, and the buyer may have landed the target by promising to close in two weeks. Furthermore, even if all the major terms can be worked out between the parties, the commitment letter won't cover minor issues, such as how much time the term lender will give the revolving credit lender to complete processing of or to remove the inventory (revolving credit collateral) from the premises before being free to close down and sell the plant (term lender collateral). Even these questions can be troublesome sources of delay or conflict at the late hours of the closing.

How can such intercreditor problems be avoided?

There are two cardinal rules for borrowers to follow in minimizing intercreditor issues: (1) try to resolve the major issues in advance while there is still

competition between potential lenders and before substantial commitment fees are paid; and (2) try for as long as possible to negotiate the issues via shuttle diplomacy between the lenders, forestalling direct negotiation between them.

How do you identify and solve intercreditor issues early in the process?

Prior to signing the commitment letter, the borrower should seek to obtain from each potential lender copies of its most recent executed (as opposed to draft) intercreditor documents. The executed documents will reflect concessions that the drafts will not. The documents should be compared to see which senior and junior lender has the most reasonable provisions, and these should be used as the basis for negotiating with all of the lenders. A comparison of the junior and senior documents will reveal the areas most likely to create material conflicts, that is, those that could imperil the deal, as opposed to those that are susceptible to easy resolution in the course of negotiations.

If the borrower has decided which junior lender it will use and is choosing among competing senior lenders, it is often useful to present the typical language that the junior lender has agreed to with respect to the major intercreditor issues for review by the potential senior lenders. Before the commitment is made final, the borrower should seek senior lender approval of the most important parts of the typical junior lender language. The same process works in reverse if the senior lender has been chosen and there are several potential junior lenders.

Once the conflict areas are identified, the borrower must make a judgment about whether the differences are so great that the issues must be resolved at this stage of the negotiation. This would be the case, for example, where one lender requires provisions that are novel or likely to be provocative.

Where subordinated debt is to be sold in a public offering, investment bankers will often insist on subordination provisions that, they assert, the market expects and demands. If the investment banker is making a bridge loan that depends for its takeout upon having easily marketable junk debt, it will be particularly insistent on the inclusion of these basic provisions in the junk debt. If the senior lender expects substantially different provisions, you are in for big problems. Iron them out at this stage, while you still have time to get a new lender if necessary.

Nothing helps more on such a negotiation than having an in-depth knowledge of the current practices in the marketplace. It's always easier to decide to postpone resolving an issue if you know you can make the argument later to your senior lender that all or most other lenders give in on this point.

Remember that you are engaged in a balancing act between the desire to resolve intercreditor issues early and the other more crucial economic terms of the loan, such as interest rate, fees, term, and prepayment schedule. It is foolish to press hard unnecessarily on intercreditor issues before you have commitments on basic terms, when the result could be adverse trade-offs on material terms. On the other hand, great economic terms are meaningful only if the deal actually closes.

Shouldn't lenders work out intercreditor questions between themselves?

Typically, no—at least not in the initial stages of negotiation. Especially early on, the buyer should try to avoid having the lenders communicate directly with each other about these issues. The buyer will have much more control over the negotiating process if, like Henry Kissinger shuttling between Cairo, Damascus, and Jerusalem, he or she filters the proposals of each party. More important, there is a much better chance of reaching agreement if the buyer can formulate a compromise position and sell it to each party. This is especially true because the intercreditor meetings can involve a cast of thousands—each tier of lenders, the borrower, and sometimes trustees and their respective counsel, each of whom brings its own group of partners and associates. It is far harder to achieve major concessions in such a crowded environment with everyone's ego on display. If you're forced to agree to direct intercreditor negotiation, try to minimize the size of the meeting.

By the late stages of negotiating the loan agreements and the intercreditor agreement the lenders are more likely to come into direct contact, and if the transaction is well advanced and the personalities and relationships of the lenders are suitable, the final minor issues can often be resolved most efficiently directly between them. Even then, however, the buyer should be ready to continue the shuttle diplomacy process right up to the end if any of the lenders or their counsel are difficult or the negotiating atmosphere is tense.

The one exception to the no-early-direct-negotiations rule can arise when the lenders involved have worked together successfully in prior deals and agreed precedents exist between them for resolving intercreditor issues. If one lender says, when you mention the identity of the other, "Oh, is Jim doing it? We'll use the Amalgamated format," you can relax a little. But still keep a close eye on them.

SUBORDINATION ISSUES

What are subordination provisions?

Subordination provisions basically determine who among the lenders gets paid first if the borrower has insufficient money to pay all of the lenders. The subordinated lender (often referred to as the *junior lender*) is the one who gets paid after the lender to which it is subordinated (the *senior lender*). A distinction is commonly made between "substantive" subordination (who gets paid first in the event of trouble?) and "procedural" subordination (when and how can the subordinated lender proceed against the borrower if there is a default in the subordinated loan?). Priority of payment under subordination provisions is different from lien priority, which relates only to the question of which lender has first access to proceeds of sale or foreclosure on the particular asset covered by the lien.

What are the principal subordination provisions?

- In the event of any insolvency or bankruptcy proceeding, the junior lender agrees that the senior lender will be paid in full before the junior lender receives any payment.
- Payment of the junior debt is prohibited if the senior debt is in default. Sometimes only defaults in payment (or certain major financial covenants of senior debt) will block payments of junior debt, or blockage will only occur, in certain types of default, for a limited period. Since any major default in the senior debt can lead to an acceleration of the debt, in theory the senior lender can convert any major covenant default into a payment default, if necessary, to prevent payment of junior debt. Senior lenders do not want, however, to be forced into taking the extreme step of acceleration, which can quickly lead to bankruptcy. Much negotiation of subordination provisions arises from the senior lender's desire to keep the junior lender from (1) being paid even if the senior debt is not accelerated, and (2) being able to force the senior lender to accelerate.
- The junior lender agrees to hold in trust for, and pay over to, the senior lender any amount received by the junior lender not in

accordance with the subordination provisions. This clause, known as a "hold and pay" provision, gives the senior lender a direct right to recover from the junior lender without going through the borrower.

What issues arise in negotiating substantive subordination provisions?

- *Principal payments on junior debt.* The financing is almost always arranged so that no principal payments are scheduled to be made on junior debt until after the final maturity date on the senior debt. The senior loan agreement normally prohibits payments of junior debt ahead of schedule. A common exception to this rule is that senior lenders will often permit prepayment of junior debt with the proceeds of equity offerings or other junior debt. Also, the borrower is often allowed to prepay the junior debt to the extent it could otherwise make dividend or similar payments to shareholders. Where there are notes to the seller, the parties are sometimes able to negotiate financial tests that, if satisfied, will permit principal payments on the notes. This is especially true where the note involves contingent payments to the seller.
- *Priority of ancillary obligations to the senior lender.* The senior lender will often seek (and get) the right to have all of its penalties, fees, and expenses of collection paid before the junior lender gets any payments. If there is conflict with the junior lender over this point, it can usually be resolved by setting a cap on the fees.
- *Priority of refinancings of senior debt.* A very important clause for the borrower in a typical subordination agreement is one that provides that the junior lender continues to be junior to any refinancing or refunding of the acquisition debt. Refinancing eventually occurs in at least half of all leveraged buyouts, and borrowers want to be sure they can replace a senior lender with another one on more favorable terms. They don't want such a transaction to become an opportunity for the seller or any other junior lender to make trouble. This provision is more often an issue with sellers in seller takeback financings than it is with junior institutional lenders, who tend to accept rather broad definitions of senior debt. Senior debt is usually defined in junk bond subordination provisions as any debt for borrowed money that is not

expressly made subordinated to the junior loan. Seller subordinated debt is more likely to define senior debt in terms of specific debt instruments and any refinancings or refundings thereof. Sellers sometimes exclude from the definition of senior debt any debt owed to the buyer or its shareholders.

Both seller and junk bond subordination provisions often will limit the amount of debt to which the junior loan is subordinated to a fixed amount, say 125 to 150 percent of the senior debt on the original date of borrowing. This limitation is designed to prevent the junior lender from being buried under a growing burden of senior debt that could substantially reduce its chances of getting paid.

- *Priority of trade debt.* This issue, again, is particularly likely to arise with sellers. Trade debt is particularly important in buyouts because in a typical LBO the buyer is purchasing a company that has been under the credit umbrella of its parent. Company management has never worried about its trade credit security because everybody knew that it was a subsidiary of a great big parent with all the money in the world, and now it has become a separate, heavily leveraged company on its own. All parties should consider at an early stage the impact that the acquisition will have on all the target's suppliers. It may be necessary in order to preserve supplier relationships that the seller be willing to remain below the suppliers in loan priority. The senior lender may insist on this feature in order to ensure that the company can retain its suppliers if financial storm clouds start to gather.

What issues arise in negotiating procedural subordination provisions?

These tend to be particularly difficult. They can best be divided into *blockage* and *suspension* provisions.

What is blockage?

The blockage provisions are those parts of the subordination agreement that prevent the borrower from making payments to the junior lenders under certain circumstances. Seller subordinated notes frequently provide that, if there is any default of any kind to a senior lender, no payments may be made on the seller note. In the case of institutional and junk bond lenders, payments on the

junior debt are usually barred indefinitely when there is a payment default on the senior loan, and for a limited period of time (anywhere from 90 to 270 days, but usually around 180 days) when a nonpayment default exists, unless the senior lender accelerates its debt, in which case the blockage continues. Such periods of blockage are often available only once each year.

The fact that a payment is blocked does *not* mean that there is no default under the junior loan. The blockage provisions do not by themselves prevent the junior lender from declaring a default, accelerating its loan, and, if appropriate, forcing an involuntary bankruptcy on the borrower, although the "suspension" provisions discussed next may prevent this. Such provisions are merely an agreement between the lenders and the company that no matter what action the junior lender takes, during the blockage period the company may not make the proscribed payments. Because a blocked payment will constitute a default on the junior debt and entitle the junior lender to accelerate the loan, unless prevented by the suspension provisions, a senior lender is likely to waive its right to blockage unless the company is in serious trouble.

What are the suspension provisions?

These are the parts of the subordination agreement that limit a junior lender's rights to take enforcement actions if there is a default on the junior loan. These provisions are prevalent in privately placed subordinated debt. Enforcement actions include suing the borrower, accelerating the loan, and declaring the entire amount due or putting the borrower into bankruptcy. Depending upon the type of loan, these rights may be severely restricted until the senior debt is paid in full or for a significant length of time, or they may be subject to few or no restrictions.

The suspension provisions are also important where both lenders have security interests in the same collateral (that is, a senior and junior lien on fixed assets). In such a case it is not uncommon for the junior lender to be required to refrain from taking any action against the collateral until the earliest to occur of (1) the expiration of a fixed period of time, (2) acceleration of the loan by the senior lender, or (3) the full payment of the senior lender.

What rights do the senior and junior lenders want to have if the borrower defaults?

The senior lender wants to be as certain as possible that its superior position is meaningful in a practical sense. It wants no money leaving the corporation if there is any default on its loan, and it wants to control the timing, pace, and final

resolution of any workout including possible asset sales or restructuring of the business. For that reason it wants to restrict the junior lender to relatively few events of default (generally only those that are a signal of substantial financial difficulties, such as a payment default on the junior loan or acceleration of other significant debt) so that the junior lender will have fewer opportunities to force the borrower into a workout or, worse, bankruptcy. If there are fewer possible events of default under the junior loan, a senior lender may be able to keep the junior lender on the sidelines by keeping the interest payments on the junior debt current while it arranges a workout with the borrower. Once there is actually a default on the junior loan, the senior lender seeks the suspension provisions to forestall efforts by the junior lender to sue the borrower, accelerate the maturity of the junior loan, or throw the borrower into bankruptcy. The effect of all these provisions is to reduce the negotiating leverage of the junior lender.

The junior lender wants to minimize the time it is not participating in the workout and the ability of the senior lender to work out matters with the borrower without its consent or, at least, participation. It basically wants a seat at the table of any workout as soon as possible. It also wishes to keep the blockage periods as short as possible and minimize suspension provisions so that it can pressure the senior lender not to block payments on the junior debt. To gain negotiating leverage, the junior lender will also seek to structure the subordination provisions so that, once there is a default, it can threaten to accelerate its loan and bring down the financial house of cards. In actuality, however, the junior lender is unlikely to accelerate, since it would probably have more to lose than the senior lender in a bankruptcy.

What about the borrower?

The typical borrower is trapped in the middle. It is mainly concerned with not letting these issues kill the deal. It also has a strong interest in having the subordination provisions not create a situation where it will have little or no time or leverage to work out problems with the senior lenders before financial Armageddon arrives. The borrower does not favor an unrestrained senior lender who can sell off all the assets and close down the business to pay its own loan off rather than live with an extended workout that offers a better chance for ultimate survival of the borrower. And it particularly wants to be sure that the seller will be tied down without the ability to compel action by the institutional lenders, both senior and junk bonds. A deeply subordinated seller is more likely to accept 10¢ on the dollar and go away—often a key step in a workout if the borrower's stockholders are to have any incentive to make the additional effort and investment necessary to save the company.

What does the senior lender require with respect to defaults on the junior loan?

A basic objective of the senior lender is to eliminate or at least minimize opportunities for the junior lender to declare a default. Thus, the senior lender will be likely to strongly oppose a "cross-default" provision in favor of the junior lender, that is, that any default under the senior loan is a default under the junior loan. If such a provision is given, it should at least be narrowed to certain specific senior loan defaults and should provide that any waiver by the senior lender or cure of the default terminates the default and rescinds any resulting acceleration on the junior loan as well. The senior lender will also wish to be sure that any default on the junior loan is a default on the senior loan; that is, the senior lender will have a cross-default provision running in its favor, so that the junior lender is never in a position to take enforcement action against the borrower at a time when the senior lender cannot. The senior lender should not object, however, to a "cross-acceleration" clause permitting the junior lender to declare a default and accelerate its loan if the senior lender accelerates the senior loan.

Are subordination provisions generally the same for all junior loans?

Definitely not. First, the subordination provisions and all other intercreditor issues are the subject of negotiation and rarely are two deals exactly the same. Second, the subordination provisions vary greatly depending upon the type of junior lender, and whether the junior debt is privately placed or sold in a public offering. The range of junior debt subordination includes (from most deeply subordinated to least) seller's notes, institutional mezzanine lenders and other privately placed funded debt, and public junk bonds.

Typical provisions for public junk debt, for privately placed institutional debt, and for seller paper are set forth in an appendix at the end of this chapter. Note that there are almost no suspension provisions in the case of public debt and very extensive ones for seller debt.

The public debt provisions are worth special note because of their prevalence in today's transactions. In almost all cases, if a senior lender has plans to deviate from the current norms for blockage periods or other customary provisions, the borrower will run into serious problems in getting a bridge loan from an investment banker. The areas where negotiations do occur are typically: (1) the number of days in a blockage period (120 to 180 days has

been customary) and the number of blockage periods that can occur in any 365-day period; (2) notice periods before the junior loan can be accelerated; and (3) rescission of acceleration by the junior lender resulting from cross-acceleration provisions if the other lender has rescinded its acceleration.

For how long is the subordinated debt subordinated?

Usually the junior debt is subordinated throughout its term or until the senior debt, including refinancings, is paid in full.

Is preferred stock subordinate to all debt?

Preferred stock is subordinated in liquidation to all debt. But preferred stock is a creature of contract between the company and its preferred stockholders, and if it is to be subject to payment restrictions imposed by lenders, the company's articles of incorporation should specifically say so.

In what agreement do subordination terms appear?

Very often, subordination provisions are found in the junior debt instrument itself, but in many cases the lenders prefer to have a separate subordination agreement. This is especially true where the junior lender doesn't want some or all of the subordination provisions to apply after the particular senior loan has been repaid. The borrower must be careful here because if the subordination provisions fall away, the borrower may have a hard time refinancing its senior loan. As discussed previously, it is customary to expect and get continuing subordination of some kind on the part of the junior lenders.

How are subordination issues affected by corporate structure?

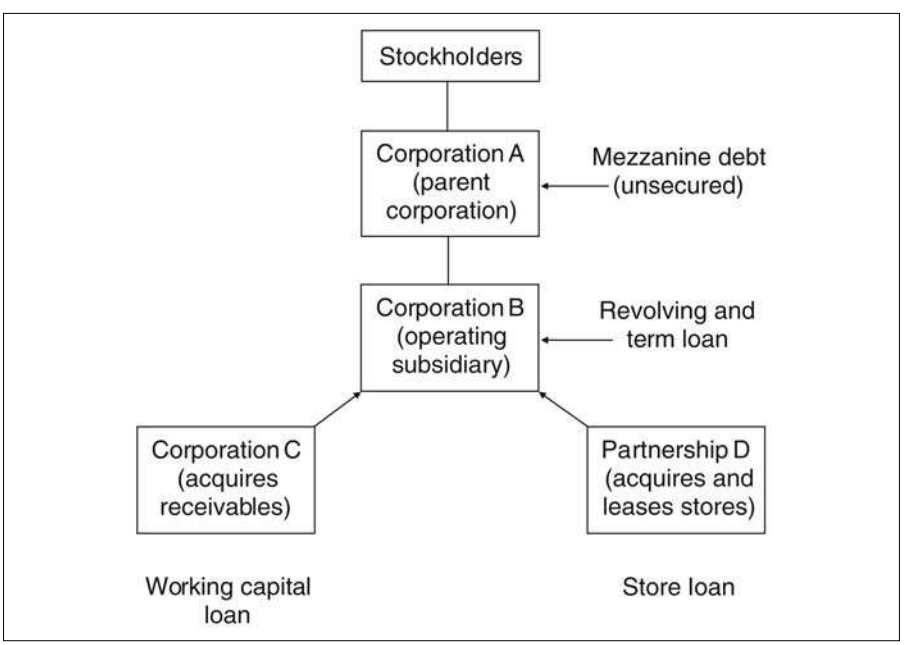
Corporate structure has a powerful effect on relative rights and priorities of lenders, and sometimes is deliberately taken advantage of to keep intercreditor relationships and, thus, problems to a minimum, or to enhance one lender's position against another's. An oversimplified example will illustrate how this works. Suppose the target is a retail company in the form of a parent

corporation with a principal operating subsidiary. The revolving credit and term lender could lend to the operating subsidiary, secured by its current and fixed assets, except the stores. The stores could be financed through loans to a separate partnership that owns them and leases them to the subsidiary. The subsidiary can obtain its working capital by selling certain categories of its accounts receivable to a separate corporation, which would finance the purchase with notes secured by the accounts. The mezzanine debt could be loaned to the parent corporation. The result is shown in Figure 4-1.

Because each lender lends to a different entity, there is minimal contact between lenders and their security rights, and relative priorities are determined by the assets and corporate structure of their respective borrowers. The revolving credit and term lender to Corporation B is in the senior position, except that its rights do not extend to the stores, which are owned by Partnership D, or accounts receivable, which are sold to Corporation C. Proceeds from the sale of accounts receivable are used to pay down both the revolving and term loan and to pay rent on the stores; after these needs are met, the proceeds can be paid out as dividends to Corporation A, which then can pay the mezzanine debt.

FIGURE 4-1

Subordination and Corporate Structure



To the extent that the revolving loan is paid down, Corporation B gains working capital financing through its ability to borrow again under the revolver, assuming sufficient availability. Because no dividends will be paid if Corporation B's revenues cannot cover its debts to the revolving and term lender and Partnership D, the mezzanine debt is automatically subordinated to both the revolving and term lender and Partnership D. Such a structure makes the relationships between lenders clear from the start and minimizes opportunity for conflict between them.

This method of structuring priorities can, at least in theory, give one lender a very strong advantage over another in bankruptcy. (We say "in theory" because no one can predict the behavior of a bankruptcy judge, who has ample power to disregard corporate layers and combine bankruptcy proceedings of different corporations so as to sweep away even the most elegant structural devices.) If, in our example, Corporation B goes bankrupt, the revolving and term lender will be deemed its sole creditor, other than trade credit and Partnership D (but only to the extent of overdue rent). The revolving and term lender can thus control the bankruptcy proceeding without even giving the mezzanine lender a place at the creditor's table. For that reason, the mezzanine debt, which is unsecured, is even more deeply subordinated than it would be if all loans were made to the same entity but subject to the subordination provisions discussed earlier in this chapter. Junior lenders may, consequently, object strongly to being required to lend at the parent level if the senior debt is at the operating level. (For more about bankruptcy, see Chapter 11.)

Lending at different levels can also present state tax problems. Some states do not permit consolidation of parent and subsidiary tax returns. Consequently, in those states, the deductions derived by Corporation A from interest payments on the mezzanine debt cannot be netted against the operating income received by Corporation B. In addition, care must be taken to be sure that loan agreements and corporate laws permit the necessary dividends to be paid so that funds can flow as required between the different corporations. (See also Chapter 5.)

INTERCREDITOR AGREEMENTS

What is an intercreditor agreement?

This is an agreement among lenders to a particular borrower to which the borrower may or may not be a party. It governs, among other things, the priority rights of lenders in collateral and proceeds of collateral and sets forth

which lender or group of lenders shall have the right to make decisions about collateral. It is normally drafted by the most senior lender.

What issues are most likely to come up in negotiations of an intercreditor agreement?

- *Issues of equal or fair treatment.* When one lender has a first priority in some assets and another lender in other assets, each should have parallel rights as to priority, initiation of foreclosure proceedings, exercise of other remedies, payment for related expenses, and the like. A senior lender may seek to write in overbearing provisions with respect to junior liens. It may, for example, try to grant itself the right to foreclose on or sell collateral whether or not at market price. Such provisions should be avoided because they are probably not enforceable and raise the hackles of junior lenders.

  Preserving the form of equal treatment between lenders can be very important. In one situation where the term and revolving lenders had been at each other's throats and the intercreditor agreement was expected to be very difficult to negotiate, no problem arose because despite great differences in the quality and amount of the collateral, the lawyer for the senior lender was careful to keep the clauses of the intercreditor agreement in strict parallel—for every grant of a right to the revolving lender there was a similar (if less valuable) grant for the term lender.
- *Rights of one lender to amend its loan agreement without the consent of another lender.* It is not uncommon for a junior lender to be barred from shortening amortization schedules or the weighted average life of a financing, since senior lenders will not want subordinated lenders paid off while senior debt is still outstanding. Nor will one lender permit another lender to increase interest rates or rate formulas without its consent, because these terms may affect the company's ability to service all of its debt. However, a borrower should be able to agree with any one lender to ease terms of payment or to amend covenants or waive defaults without involving other lenders. Subordinated lenders frequently require that the borrower may not enter into amendments to its loan agreement that could "materially and adversely affect" the junior lender. This is a vague provision that will tend to make the senior lender cautious but

leaves leeway for the run-of-the-mill adjustments and corrections that normally are needed in a loan agreement after the closing. It often provides a reasonable compromise.

- *Changes in status between lenders.* Sometimes one lender is prepared to take a lower priority against another only for a limited period of time or until some external event occurs. If one lender ceases to be secured, another lender may also be willing to release its security. If a senior lender agrees to extend the term of its loan past a certain date, the subordinate lender may demand the right to gain equal seniority, that is, to become *pari passu.*
- *Allocation of shared rights over collateral.* If an intangible right, such as a patent or copyright, is needed for realization of value for assets pledged to two different lenders, or if exercise of its rights by one lender blocks another lender's rights (as, for example, if the term lender's right to foreclose on a factory building blocks the revolving lender's right to remove or complete processing of inventory), these matters should be covered.
- *Voting rights of creditors and other rights in bankruptcy.* Senior lenders try very hard to have control of creditors' committees in bankruptcy. Although such rights may not be enforceable, they may seek to require junior creditors to waive contests of bankruptcy plans, marshaling questions and issues of interpretation of the intercreditor agreement.

FRAUDULENT CONVEYANCE AND OTHER LITIGATION CONCERNS

Lenders worry about fraudulent conveyances in LBOs. Why?

Leveraged acquisitions and buyouts have an unfortunate tendency to attract lawsuits. When buyouts are successful, parties may sue to get a larger share of success; when unsuccessful, parties may sue to reduce their exposure to the failure. Parties suing or sued may include bondholders (senior and junior), shareholders (majority and minority), underwriters, lenders, and officers and directors of the selling company.[43] A bank that lends money to finance the acquisition of a business needs to be assured that, in the event of a bankruptcy of

that business, its lien on the assets will secure the loan, and the note given by the acquired company will be enforceable. However, the lien will be set aside and voided, and even the note can be rendered worthless, if the pledge of assets and the giving of the note are determined to be "fraudulent conveyances or transfers" under the Federal Bankruptcy Code or under comparable state law—either the Uniform Fraudulent Conveyance Act (UFCA) or its successor, the Uniform Fraudulent Transfer Act (UFTA), discussed at length in Chapter 11 of this book. Shareholders in leveraged buyouts are also at risk: if a transaction is judged to be a fraudulent conveyance, they may have to return the proceeds received from selling their shares.

Can a pledge of collateral, or a note or guaranty, be a fraudulent conveyance even though there is no intent to defraud anyone?

Yes. Both the Federal Bankruptcy Code and comparable provisions of state law permit the voiding of a lien or obligation as "fraudulent" without the requirement of malign intent. These laws may, in effect, be utilized to protect the interests of general creditors of acquired companies where the transactions financed by the banks have the effect of depriving the acquired company of the means to pay its debts to its general creditors, whether those transactions are actually intended to do so or not.

Is there a special risk of creating an unintended fraudulent conveyance in an LBO loan as opposed to an ordinary corporate loan?

Yes. Under Section 548 of the Federal Bankruptcy Code and comparable provisions of state law, a lien given by the acquired company on its assets, or the note secured by that lien, will be deemed "fraudulent" if the company receives less than "reasonably equivalent value" in exchange and one of the following three conditions exists: (1) the company was "insolvent" at the time of such transfer or became "insolvent" as a result of the transfer; (2) the company was left with "unreasonably small capital" as a result of the transfer; or (3) the company incurred or intended to incur debts beyond its ability to pay.

In an LBO loan, no matter how the transaction is structured (whether as a cash merger, stock purchase, or asset purchase), most of what the bank lends winds up not in the hands of the acquired company, but in the pockets

of the sellers. On the date after closing, the acquired company is, by definition, "highly leveraged." It has a great deal of new debt, and liens on all its assets, but a large portion of the money raised by such debt (which the company is required to repay) has gone to the previous stockholders. It is not hard to see why an unsecured creditor of the company, viewing the new debt obligations of the company and the encumbrance of its assets, would complain that the company (as opposed to its former owners) did not receive "reasonably equivalent value" in the transaction.

Assuming that the lack of reasonably equivalent value may be a problem in all LBO loans, can't the problem be solved by showing that none of the other three conditions that would trigger a fraudulent conveyance exists?

It can, if each of the three conditions can be shown not to exist, but that is not always easy to do in the typical LBO. Of the three conditions—(1) insolvency, (2) unreasonably small capital, and (3) ability to pay debts—the last two are the easiest to overcome. To the extent that the company and the bank can demonstrate, through well-crafted, reasonable projections, that the company will have sufficient revenues and borrowing capacity to meet its reasonably anticipated obligations (including servicing the acquisition debt), it should be possible to establish that the company's capital, although small, is adequate, and that the company will be able to pay its debts. Solvency, however, is another matter.

Why is it difficult to show that an acquired company is solvent for fraudulent conveyance purposes?

Because the definition of solvency as used in the Federal Bankruptcy Code and state counterpart legislation is different from that used under GAAP. Solvency under GAAP can mean having sufficient assets to pay debts as they mature, or having book assets that are greater than book liabilities. In the typical LBO, at least one of the tests for GAAP solvency can usually be met. But for fraudulent conveyance purposes, a company is solvent only if the "fair, salable value" of its assets is greater than its probable liabilities. In valuing assets, the approach should be conservative, using liquidation value rather than book value or other measures.

Why is the "fair, salable value" test difficult to meet for many companies?

As mentioned, the fair, saleable value of assets has to be greater than the value of liabilities. Some companies lack hard assets having "fair, salable value" at least equal to their direct and contingent liabilities. Also, probable liabilities are not limited to GAAP balance sheet liabilities. All probable liabilities, contingent as well as direct, must be considered.

For example, consider the current push toward disclosure of such contingencies for environmental losses. In 2004, the Government Accountability Office recommended that the SEC go beyond the current standard, Staff Accounting Bulletin No. 92 on Reporting and Accounting for Environmental Loss Exposure, to improve the "tracking and transparency of information related to its reviews of companies' filings, and to work with the Environmental Protection Agency (EPA) to explore ways to take better advantage of EPA data relevant to environmental disclosure."[44] Shareholders, too, are pushing the SEC to require more disclosure in this regard.[45]

The upper right side of the balance sheet is also becoming more burdened by reporting of pension and healthcare liabilities. Whereas in the past, companies had a degree of flexibility in reporting these, there are stricter standards now.[46]

In the early days of LBOs, companies were generally sold at prices that reflected the actual cash value of hard collateral—plant, machinery, and equipment—rather than a relatively high multiple of earnings. As the LBO field became more crowded and stock market multipliers increased as well, prices were bid up, with the result that pro forma balance sheets for acquired companies began to reflect more and more goodwill. In addition, companies with relatively little in the way of hard assets, such as advertising agencies, came into play. Although such deals could be financed on the basis of their cash flow performance and projections, with the acquisition debt loaded on, they would typically flunk the GAAP balance sheet test for solvency.

Is the "fraudulent conveyance" problem inescapable for all LBOs?

Each sophisticated lender who is willing to make an LBO loan has made a bottom-line decision that it can live with the risk of unclear law in this area. The classic case on the subject, *Gleneagles,* actually involved intentional

misconduct, although the court's reasoning in that case cast a cloud over innocent LBOs as well. A number of commentators in the late 1980s, supported by some court decisions (*Kupetz, Credit Managers*), argued that the fraudulent conveyance doctrine should not be employed as a blunt instrument against LBOs. Courts in recent years have also shown a range of opinions in the matter.

Although it is not possible yet to say how the law will develop in the twenty-first century, a reasonable compromise might be that creditors who predate the acquisition and did not consent to it have a right to exact realistic standards for solvency at the time of the acquisition, while subsequent creditors who knew or could have known of the terms of the acquisition loan and its security arrangements should not be entitled to the benefit of fraudulent conveyance laws.

Are there structural arrangements in LBOs that can trigger fraudulent conveyance problems?

Yes. In addition to the issue of lack of "reasonably equivalent value" to the company, lenders and borrowers can get into trouble in transactions involving multicompany groups. These problems are not unique to LBOs, but they can occur in such transactions. Typically they occur when collateral is provided by a subsidiary to secure a borrowing by its parent (upstreaming) or when collateral is provided by one subsidiary to secure a borrowing by a sister subsidiary (cross-streaming). Similarly, upstream and cross-stream guaranties can run afoul of the fraudulent conveyance prohibitions. By contrast, guaranties and pledges by a parent to support a borrowing by its subsidiary (downstreaming) do not present fraudulent conveyance problems.

Why are upstreaming and cross-streaming bad?

Because the donor entity—the one providing the collateral or the guaranty—is not getting "reasonably equivalent value," which is going instead to its affiliate. Thus, one of the triggers (although not the only one) for fraudulent conveyance is tripped. In addition, each subsidiary is typically asked to guarantee all the senior debt of its parent, yet the assets of the subsidiary represent only a fraction of the total acquisition. The result is that each subsidiary, taken by itself, cannot repay the full acquisition debt and may be

rendered insolvent if the guarantee is called against it alone. This illogical result would be avoided if the test of solvency took into account that all the subsidiaries would share in meeting the guarantee obligation. Some cases give support for this conclusion, but the law is unfortunately not clear enough to eliminate the risk.

Are there ways to solve upstreaming and cross-streaming problems?

Yes. If the transaction passes each of the three additional tests—(1) no insolvency, (2) not unreasonably small capital, and (3) ability to pay debts—there is no fraudulent conveyance. However, to guard against the risk of flunking one of the tests, two kinds of additional solutions can be explored: (1) merging the entity providing the collateral or guaranty with the borrower before the acquisition is consummated; or (2) dividing up the loan into two or more distinct credit facilities, each collateralized by (and commensurate with) the collateral provided by each borrower. Care should be taken, if the latter course is used, to avoid having the loan proceeds simply pass through one of the borrowers into the hands of another borrower or affiliated entity. The loan proceeds can be used to pay off bona fide intercorporate debt, but if the cash flow among the borrowing entities indicates that the separate loans are shams, the transaction runs the risk of being collapsed in a bankruptcy proceeding. In such a case, the liens and guaranties could be voided.

Are upstream or cross-stream guaranties that are limited to the net worth of the guarantor fraudulent conveyances?

No. Indeed, limiting the guaranty (and the lien collateralizing it) to the amount of the guarantor's net worth at the time of delivery of the guaranty can provide an ingenious way to ensure that the guarantor is not rendered insolvent by delivery of the guaranty and consequently should eliminate any fraudulent conveyance problem. However, the guarantor must have the requisite net worth in the bankruptcy sense, and not just GAAP net worth, in addition to being able to pay its debts and not having unreasonably small capital. Net worth guaranties have yet to be tested in a bankruptcy proceeding, and although they appear conceptually sound, there are no certain predictions on what the courts will say.

Will accounting firms give solvency opinions?

No. Such opinions were given from time to time in the past to provide reassurance to lenders. After adverse outcomes on some such opinions in early 1988, the American Institute of Certified Public Accountants (AICPA) prohibited all accounting firms from rendering solvency letters, and they are unlikely to reappear soon. Some appraisers or valuation consultants will give such opinions, however.

Will law firms give opinions that fraudulent conveyance laws have not been violated? Almost never. Law firms generally refuse to give fraudulent conveyance opinions, largely because they cannot evaluate the question of solvency, and because lawyers have traditionally refused to predict what actions a bankruptcy court may take under a set of unforeseeable circumstances. Lenders usually understand and accept this reluctance, although sometimes some skirmishing occurs at the closing on this point.

What are some other types of litigation that inappropriate financing can spur?

Shareholder suits can certainly advance fraudulent conveyance type arguments. These suits may be derivative or class action suits.

What happens when bondholder and equity holder interests clash?

This is a timely question. In recent years, after a period of conservatism, LBOs have returned to being highly leveraged, and disputes have arisen between holders of equity and debt. The ultimate exit strategy for a buyout is to sell the entire company, or to sell a majority of its shares in a public offering. In this way, the shares that private investors took off the market (by buying back from the public) get resold to the public in a new IPO. But as LBOs have become more highly leveraged, investors have found it more difficult to exit via a sale or initial public offering. Instead, equity investors have been insisting on dividends payments. The outflow of funds to equity holders has, in turn, raised concerns with bondholders.

A case in point is Neiman Marcus, which was bought out by two private equity funds in 2005. In early 2006, both equity holders and bondholders made sacrifices to accommodate each others' needs. Bondholders agreed to forego cash interest payments and instead receive new bonds (called payments

in-kind [PIKs]). At the same time, they requested that the cash the company saved should stay in the company, and not be paid out in dividends.[47]

REFINANCING ISSUES

Just as financing fueled 1980s, *re*financing has been sustaining the 1990s. Strategies to meet creditor obligations and/or maintain creditor relations include

- Renegotiating loan terms
- Changing or adding lenders
- Selling or restructuring assets, debt, or stock to gain cash
- Combinations of the above

Although each of these can be employed up front as a way to find initial financing, they are often used after an acquisition or buyout to pay that financing back.

How does one go about renegotiating loan terms? A deal's a deal, isn't it?

Yes, a deal is a deal when it comes to leveraged transactions, as in others, but the higher the loan amount and the more sophisticated the lender, the more likely it is that the terms of a loan can be changed, despite the numerous technical provisions discussed earlier in this chapter. (For ample evidence of the flexibility of creditors when they are hard-pressed, see Chapter 11.) On the other hand, lenders, too, may wish to renegotiate loan terms, particularly during periods of falling interest rates.

What about changing lenders?

Some companies with postmerger debt heirs do change or add on banks, but this is not the only way to switch horses in midstream. In considering a change or expansion of lenders, refinancing teams should not forget corporate sources, including potential future acquirers who might be willing to loan funds or take over loans in exchange for an option to acquire.

How can leveraged buyers sell off assets? Doesn't this violate covenants protecting lender collateral?

Many leveraged acquirers include specific asset sales in their strategic plans approved by lenders. As long as such sales do not come as a surprise and are

priced well, they generally meet with lender approval. On the other hand, the kind of wholesale dismantling of going concerns for mere cash flow purposes has fallen into disfavor even at the planning stage. One way to preserve company integrity and still generate cash from assets is to pursue sale-leasebacks.

How can selling debt—corporate paper—help to pay back other debt? Isn't it just another leverage burden?

If a company can sell its paper, this can be preferable from the point of view of interest obligation. Average high-grade commercial paper tends to pay rates lower than the LIBOR, which is a baseline for much bank lending.

So high-grade commercial paper issuers can get away with paying low interest rates. What's the catch? Why don't all companies use this approach?

First, not every company can achieve and sustain a high credit rating from the credit rating agencies. Second, the paper is issued with short maturities, ranging from 14 to 270 days. Issuers must find new buyers or convince present buyers to roll over their investments. This is why many companies take out standby lines of credit from banks to back up their paper in the event that they have trouble in rolling over their commercial paper lines.

What are some ways companies can restructure the debt they issue?

With so many types of corporate debt finding their way to market, opportunities to restructure obligations are limited only by an issuer's imagination and the quality of underlying company values. Some strategies include

- Offering to buy back debt from holders at less than its original price
- Offering to trade debt for new issues that mature later
- Asking bondholders to trade their holdings for equity

What are the chief benefits and drawbacks of selling stock as a means of refinancing if a company is already a public company?

On the upside, there is financial flexibility. When a company issues stock, it receives cash for it but incurs no obligation. It can seem like free money. On the downside, stock sales may decrease

- Control of original owners
- Earnings per share (as the shares denominator decreases, the earnings numerator increases)
- Market value (when management sells, the market may, too)

If a company is privately owned as a result of an LBO, what are the pros and cons of going public again (reverse LBOs)?

The burdens, risks, and rewards of being a public company are treated exhaustively in other sources, but the best teacher is experience. To get a good sense of the private vs. public trade-off, study the fortunes of the public companies that went private and then returned to public markets. There is no lack of examples, both good and bad.

Examples from both Big Board and smaller exchanges include Ann Taylor Stores, Burlington Industries, Coltec Holdings Inc., Duff & Phelps, Duracell International Inc., Enquirer/Star, Forstmann & Co., Equity Coleman Co., Gulfstream Aerospace Corp., Haemonetics, Holopark Technologies Inc., Hospital Corporation of America, International Specialty, Owens-Illinois, Perrigo, Reliance Electric Co., R. P. Scherer, Scotts Co., Stop & Shop, Toastmaster Inc., Warnaco, and York International Corp.

Do refinancing methods differ by industry?

Yes. For example, in the financial services industry there are several creative refinancing techniques that are relatively foreign to other industries. Some commercial banks use a *good bank, bad bank* technique. This involves placing nonperforming and other lower quality assets into a *collecting bank,* or liquidating trust, that is sold or spun off to shareholders. Insurance companies sometimes employ *securitization,* the sale of several chunks, or *tranches,* of securities backed by the mortgages or junk bonds held by the insurance company. Insurance companies and savings and loans can raise capital by convert-

ing from depositor-owned mutual organizations to stockholder-owned structures, called *stocking*. As one expert has said, "Securitizing life portfolios by going to the capital markets, as Swiss Re has been doing recently, frees up additional capital for investments. This in turn facilitates the financing of acquisitions."[48]

What are some recent innovations in refinancing?

One new stock-based refinancing method used in private placements is called the preferred equity redemption cumulative stock (*PERCS*), a security designed by Morgan Stanley. PERCS offer a higher dividend than would be received in the underlying common stock. They are automatically convertible on a share-for-share basis but are subject to the issuer's earlier call.

CONCLUDING COMMENTS

The choice to grow through acquisition begins with strategy. What is best for the company and its owners? If a company makes the right strategic choices, the financing will be there. In this chapter, we have provided an overview of the kinds of financing available, focusing on debt financing, which is the most easily and broadly available. In the next chapter, we will show how to translate strategic and financial considerations into the actual structure of an M&A transaction.

APPENDIX 4A

Typical Subordination Provisions of Publicly Issued Notes

Section 1.1. Agreement to Subordinate. The Company agrees, and the holders of the Subordinated Notes by accepting the Subordinated Notes agree, that the Indebtedness evidenced by the Subordinated Notes is subordinated in right of payment, to the extent and in the manner provided in this Article, to the prior payment in full of all Senior Debt of the Company and that the subordination is for the benefit of the holders of Senior Debt of the Company, but the Subordinated Notes shall in all respects rank *pari passu* with all other Subordinated Debt of the Company.

Section 1.2. Default on Senior Debt of the Company. No direct or indirect payment by the Company of principal of or interest on the Subordinated Notes whether pursuant to the terms of the Subordinated Notes or upon acceleration or otherwise shall be made if, at the time of such payment, there exists a default in the payment of all or any portion of principal of or interest on any Senior Debt of the Company (and the Trustee has received written notice thereof), and such default shall not have been cured or waived. In addition, during the continuance of any other event of default with respect to such Senior Debt pursuant to which the maturity thereof may be accelerated, upon the receipt by the Trustee of written notice from the holders of Senior Debt, no such payment may be made by the Company upon or in respect of the Subordinated Notes for a period of [180] days from the date of receipt of such notice; provided, however, that the holders of Senior Debt may give only [one] such notice in any 360-day period, and provided, further, that this provision shall not prevent the payment of an installment of principal of or interest on the Subordinated Notes for more than [180] days.

Section 1.3. Liquidation, Dissolution, Bankruptcy. Upon any distribution of the assets of the Company in any dissolution, winding up, liquidation, or reorganization of the Company (whether voluntary or involuntary and whether in bankruptcy, insolvency, or receivership proceeding or upon an assignment for the benefit of creditors or any marshaling of the assets and liabilities of the Company or otherwise):

1. Holders of Senior Debt of the Company shall be entitled to receive payment in full on the Senior Debt of the Company before the holders of the Subordinated Notes shall be entitled to receive any payment of principal of, or premium, if any, or interest on the Subordinated Notes; and
2. Until the Senior Debt of the Company is paid in full, any distribution to which the holders of the Subordinated Notes would be entitled but for this Article shall be made to holders of Senior Debt of the Company as their interests may appear. Consolidation or merger of the Company with the sale, conveyance, or lease of all or substantially all of its property to another corporation upon the terms and conditions otherwise permitted in this Agreement shall not be deemed a dissolution, winding up, liquidation, or reorganization for purposes of this Article.

Section 1.4. When Distribution Must Be Paid Over. If distributions are made to the holders of the Subordinated Notes that because of this Article should not have been made, the holders of the Subordinated Notes who received the distribution shall hold it in trust for the benefit of the holders of Senior Debt of the Company and pay it over to them as their interests may appear.

Section 1.5. Subrogation. After all Senior Debt of the Company is paid in full and until the Subordinated Notes are paid in full, the holders of the Subordinated Notes shall be subrogated to the rights of holders of Senior Debt of the Company to receive distributions applicable to Senior Debt of the Company. A distribution made under this Article to holders of Senior Debt of the Company that otherwise would have been made to the holders of the Subordinated Notes is not, as between the Company and the holder of the Subordinated Notes, a payment by the Company on Senior Debt of the Company.

Section 1.6. Relative Rights. This Article defines the relative rights of the holders of the Subordinated Notes and holders of Senior Debt of the Company. Nothing in this Agreement shall:

1. Impair, as between the Company and the holders of the Subordinated Notes, the obligation of the Company, which is absolute and unconditional, to pay principal of, premium, if any, and interest on the Subordinated Notes in accordance with their terms; or
2. Prevent the holders of the Subordinated Note from exercising their available remedies upon a Default, subject to the rights of holders of Senior Debt of the Company to receive any distribution otherwise payable to the holder of the Subordinated Notes.

Section 1.7. Subordination May Not Be Impaired by Company. No right of any holder of Senior Debt of the Company to enforce the subordination of the Subordinated Notes shall be impaired by any act or failure to act on the part of the Company or its failure to comply with this Agreement.

Section 1.8. Modification of Terms of Senior Debt. Any renewal or extension of the time of payment of any Senior Debt or the exercise by the holders of Senior Debt of any of their rights under any instrument creating or evidencing Senior Debt, including without limitation the waiver of any default thereunder, may be made or done without notice to or assent from the holders of Subordinated Notes or the Trustee.

No compromise, alteration, amendment, modification, extension, renewal, or other change of, or waiver, consent, or other action in respect of, any liability or obligation under or in respect of any Senior Debt or of any of the terms, covenants, or conditions of any indenture or other instrument under which any Senior Debt is outstanding, shall in any way alter or affect any of the provisions of this Article or of the Subordinated Notes relating to the subordination thereof.

Section 1.9. Reliance by Holders of Senior Debt on Subordination Provisions. The holders of the Subordinated Notes by accepting the Subordinated Notes acknowledge and agree that the foregoing subordination provisions are, and are intended to be, an inducement and a consideration to each holder of any Senior Debt, whether such Senior Debt was created or acquired before or after the issuance of the Subordinated Notes, to acquire and continue to hold, or to continue to hold, such Senior Debt and such holder of Senior Debt shall be deemed conclusively to have relied on such subordination provisions in acquiring and continuing to hold, or in continuing to hold, such Senior Debt.

Section 1.10. This Article Not to Prevent Events of Default. The failure to make a payment pursuant to the Subordinated Notes by reason of any provision in this Article shall not be construed as preventing the occurrence of a Default or an Event of Default. Nothing in this Article shall have any effect on the right of the holders of the Subordinated Notes to accelerate the maturity of the Subordinated Notes.

Section 1.11. Definition of Senior Debt. "Senior Debt" means the principal of, premium, if any, and interest on (1) all indebtedness incurred, assumed, or guaranteed by the Company, either before or after the date hereof, which is evidenced by an instrument of indebtedness or reflected on the accounting records of the Company as a payable (excluding any debt that by the terms of the instrument creating or evidencing the same is not superior in right of payment to the Subordinated Notes) including as Senior Debt (a) any amount payable with respect to any lease, conditional sale, or installment sale agreement or other financing instrument, or agreement that in accordance with generally accepted accounting principles is, at the date hereof or at the time the lease, conditional sale, or installment sale agreement, or other financing instrument or agreement is entered into, assumed, or guaranteed by the Company, required to be reflected as a liability on the face of the balance sheet of the Company; (b) all borrowings under any lines of credit, revolving credit

agreements, or promissory notes from a bank or other financial renewals or extensions of any of the foregoing; (c) any amounts payable in respect of any interest rate exchange agreement, currency exchange agreement, or similar agreement; and (d) any subordinated indebtedness of a corporation merged with or into or acquired by the Company and (2) any renewals or extensions or refunding of any such Senior Debt or evidences of indebtedness issued in exchange for such Senior Debt.

APPENDIX 4B

Typical Subordination Provisions of Privately Placed Institutional Notes

Section 1.1. Agreement to Subordinate. The Subordinated Notes shall be subordinated to Senior Debt to the extent set forth in this Article, and the Subordinated Notes shall not be subordinated to any debt of the Company other than Senior Debt.

Section 1.2. Default on Senior Debt of the Company. In the event of a default in any payment of interest or principal in respect of any Senior Debt, whether at the stated maturity, by acceleration or otherwise, then no payment shall be made on account of principal of or interest or premium, if any, on the Subordinated Notes until such default shall have been cured or waived.

Section 1.3. Liquidation, Dissolution, Bankruptcy. In the event of (i) any insolvency, bankruptcy, liquidation, reorganization, or other similar proceedings or any receivership proceedings in connection therewith, relative to the Company or its assets, or (ii) any proceedings for voluntary liquidation, dissolution, or other winding up of the Company, whether or not involving insolvency or bankruptcy proceedings, then all principal of and interest (including postpetition interest), fees (commitment or other), expenses, and premium, if any, then due and payable on all Senior Debt shall first be paid in full, or such payment shall have been duly provided for in the manner set forth in the proviso to the next sentence, before any further payment on account of principal or interest, or premium, if any, is made upon the Subordinated Notes. In any of the proceedings referred to above, any payment or distribution of any kind or character, whether in cash, property, stock, or obligations, which may be payable or deliverable in respect

of the Subordinated Notes shall be paid or delivered directly to the holders of the Senior Debt (or to a banking institution selected by the court or Person making the payment or delivery as designated by any holder of Senior Debt) for application in payment thereof, unless and until all Senior Debt shall have been paid in full, provided, however, that in the event that payment or delivery of such cash, property, stock, or obligations to the holders of the Subordinated Notes is authorized by a final non-appealable order or decree which takes into account the subordination of the Subordinated Notes to Senior Debt, and made by a court of competent jurisdiction in a reorganization proceedings under any applicable bankruptcy or reorganization law, no payment or delivery of such cash, property, stock, or obligations payable or deliverable with respect to the Subordinated Notes shall be made to the holders of Senior Debt. Anything in this Article to the contrary notwithstanding, no payment or delivery shall be made to holders of stock or obligations which are issued pursuant to reorganization, dissolution, or liquidation proceedings, or upon any merger, consolidation, sale, lease, transfer, or other disposal not prohibited by the provisions of this Agreement, by the Company, as reorganized, or by the corporation succeeding to the Company or acquiring its property and assets, if such stock or obligations are subordinate and junior at least to the extent provided in this Article to the payment of all Senior Debt then outstanding and to payment of any stock or obligations which are issued in exchange or substitution for any Senior Debt then outstanding.

Section 1.4. When Distribution Must Be Paid Over. In the event that the holder of any Subordinated Note shall receive any payment, property, stock, or obligations in respect of such Subordinated Note which such holder is not entitled to receive under the provisions of this Article, such holder will hold any amount so received in trust for the holders of Senior Debt and will forthwith turn over such payment to the holders of Senior Debt in the form received to be applied on Senior Debt. In the event of any liquidation, dissolution, or other winding up of the Company, or in the event of any receivership, insolvency, bankruptcy, assignment for the benefit of creditors, reorganization or arrangement with creditors, whether or not pursuant to bankruptcy laws, sale of all or substantially all of the assets, or any other marshaling of the assets and liabilities of the Company, holders of Subordinated Notes will at the request of holders of Senior Debt file any claim or other instrument of similar character necessary to enforce the obligations of the Company in respect of the Subordinated Notes.

Section 1.5. Subrogation. Upon payment in full of all Senior Debt the holders of the Subordinated Notes shall be subrogated to the rights of the holders of Senior Debt to receive payments of distributions of assets of the Company applicable to Senior Debt until the principal of the premium, if any, and interest on the Subordinated Notes shall have been paid in full, and, for the purposes of such subrogation, no payments to the holders of Senior Debt of any cash, property, stock, or obligations which the holders of Subordinated Debt would be entitled to receive except for the provisions of this Article shall, as between the Company and its creditors (other than the holders of Senior Debt) and the holders of the Subordinated Notes, be deemed to be a payment by the Company to or on account of Senior Debt.

Section 1.6. Relative Rights. The provisions of this Article are for the purpose of defining the relative rights of the holders of Senior Debt on the one hand, and the holders of the Subordinated Notes on the other hand, against the Company and its property; and nothing herein shall impair, as between the Company and the holders of the Subordinated Notes, the obligation of the Company, which is unconditional and absolute, to pay to the holders thereof the full amount of the principal thereof, and premium, if any, and interest thereon, in accordance with the terms thereof and the provisions hereof, and to comply with all of its covenants and agreements contained herein; nor shall anything herein prevent the holder of any Subordinated Notes from exercising all remedies otherwise permitted by applicable law or hereunder upon Default hereunder or under any Subordinated Note, subject to the rights, if any, under this Article of holders of Senior Debt to receive cash, property, stock, or obligations otherwise payable or deliverable to the holders of the Subordinated Notes and subject to the limitations on remedies contained in sections 1.5 and 1.9.

Section 1.7. Subordination May Not Be Impaired by the Company. No present or future holder of any Senior Debt shall be prejudiced in the right to enforce the subordination of the Subordinated Notes by any act or failure to act on the part of the Company.

Section 1.8. Modification of Terms of Senior Debt. Each holder of Subordinated Notes consents that, without the necessity of any reservation of rights against such holder of Subordinated Notes, and without notice to or further assent by such holder of Subordinated Notes, (a) any demand for payment of any Senior Debt may be rescinded in whole or in part and any

Senior Debt may be continued, and the Senior Debt, or the liability of the Company or any other Person upon or for any part thereof, or any collateral security or guaranty therefor or right of offset with respect thereto, and any Senior Debt, may, from time to time, in whole or in part, be renewed, extended, modified, accelerated, compromised, waived, surrendered, or released and (b) any document or instrument evidencing or governing the terms of any Senior Debt or any collateral security documents or guaranties or documents in connection therewith may be amended, modified, supplemented, or terminated, in whole or part, as the holders of Senior Debt may deem advisable from time to time, and any collateral security at any time held by such holder or any collateral agent for the benefit of such holders for the payment of any of the Senior Debt may be sold, exchanged, waived, surrendered, or released, in each case all without notice to or further assent by the holders of Subordinated Notes which will remain bound under this Agreement, and all without impairing, abridging, releasing, or affecting the subordination provided for herein, notwithstanding any such renewal, extension, modification, acceleration, compromise, amendment, supplement, termination, sale, exchange, waiver, surrender, or release. Each holder of Subordinated Notes waives any and all notice of the creating, renewal, extension, or accrual of any of the Senior Debt and notice of or proof of reliance by any holders of Senior Debt upon this Agreement, and the Senior Debt shall conclusively be deemed to have been created, contracted, or incurred in reliance upon this Agreement, and all dealings between the Company and the holders of Senior Debt shall be deemed to have been consummated in reliance upon this Agreement. Each holder of Subordinated Notes acknowledges and agrees that the lenders in any refinancing have relied upon the subordination provided for herein in entering into such refinancing and in making funds available to the Company thereunder. Each holder of Subordinated Notes waives notice of or proof of reliance on this Agreement and protest, demand for payment, and notice of default.

Section 1.9. Limitations on Rights of Subordinated Noteholders to Accelerate. The right of the holders of Subordinated Notes to declare the Subordinated Notes to be immediately due and payable pursuant to this Agreement upon the occurrence and continuance of an Event of Default under this Agreement shall be subject to the following:

1. If such Event of Default shall arise solely out of a default in specified financial covenants, then such holders may only so

declare the Subordinated Notes due and payable if the holder of any Senior Debt shall have declared to be due and payable any obligations of the Company in respect of Senior Debt by reason of a default in respect thereof;

2. If such Event of Default shall arise out of a failure to make payments on the senior debt then such holder may not so declare the Subordinated Notes due and payable until the earliest to occur of (a) the continuance of such Event of Default for 180 consecutive days, (b) the day upon which the next payment is actually made of principal of or interest on any Senior Debt, or (c) the day upon which holders of Senior Debt declare to be due and payable before its normal maturity any obligations of the Company in respect of Senior Debt.

Section 1.10. Definition of Senior Debt. "Senior Debt" means Debt which is not by its terms expressly subordinated in right of payment to other Debt.

"Debt" of any Person means (i) all indebtedness of such Person for borrowed money or for the deferred purchase price of property, (ii) all obligations under leases which shall have been or should be, in accordance with generally accepted accounting principles (GAAP, as defined herein), recorded as capital leases in respect of which such Person is liable as lessee, (iii) all indebtedness referred to in clause (i) or (ii) above secured by (or for which the holder of such indebtedness has an existing right, contingent or otherwise, to be secured by) any lien, security interest or other charge or encumbrance upon or in property (including, without limitation, accounts and contract rights) owned by such Person, (iv) all indebtedness referred to in clause (i) or (ii) above guaranteed directly or indirectly in any manner by such Person, or in effect guaranteed directly or indirectly by such Person through an agreement to pay or purchase such indebtedness or to advance or supply funds for the payment or purchase of such indebtedness, or to otherwise assure a creditor against loss, and (v) liabilities in respect of unfunded vested benefits under Plans and withdrawal liability incurred under ERISA by such Person or by such Person as a member of the Controlled Group to any Multiemployer Plan, provided that Debt shall not include trade and other accounts payable in the ordinary course of business in accordance with customary trade terms and which are not overdue for a period of more than 60 days, or, if overdue for a period of more than 60 days, as to which a dispute exists and adequate reserves in accordance with GAAP have been established on the books of such Person.

APPENDIX 4C

Typical Subordination Provisions of Seller Notes

Section 1.1. Agreement to Subordinate. The obligations of the Company in respect of the principal of and interest on the Subordinated Notes shall be subordinate and junior in right of payment, to the extent and in the manner set forth in this Article, to any indebtedness of the Company in respect of Senior Debt.

Section 1.2. Default on Senior Debt of the Company. No payment of principal of or interest or distribution of any kind on the Subordinated Notes shall be made at any time when a default has occurred and is continuing under any Senior Debt, and, if any such payment or distribution is made, then the holder of the Subordinated Notes will hold the same in trust and pay it over to the holders of the Senior Debt.

Section 1.3. Liquidation, Dissolution, Bankruptcy. (a) In the event of any insolvency or bankruptcy proceedings, and any receivership, liquidation, reorganization, arrangement, readjustment, composition, or other similar proceedings in connection therewith, relative to the Company or to its creditors, as such, or to its property, or in the event of any proceedings for voluntary liquidation, dissolution, or other winding up of the Company, whether or not involving insolvency or bankruptcy, or in the event of any assignment by the Company for the benefit of creditors or in the event of any other marshaling of the assets of the Company, then the holders of Senior Debt shall be entitled to receive payment in full of all principal, premium, interest, fees, and charges on all Senior Debt (including interest thereon accruing after the commencement of any such proceedings) before the holder of the Subordinated Notes is entitled to receive any payment on account of principal or interest upon the Subordinated Notes, and to that end the holders of Senior Debt shall be entitled to receive for application in payment thereof any payment or distribution of any kind or character, whether in cash or property or securities, which may be payable or deliverable in any such proceedings in respect of the Subordinated Notes.

(b) In the event that the Subordinated Notes are declared due and payable before their expressed maturity because of the occurrence of an Event of Default (under circumstances when the provisions of the foregoing clause (a) shall not be applicable), the holders of the Senior Debt outstanding

at the time the Subordinated Notes so become due and payable because of such occurrence of such Event of Default shall be entitled to receive payment in full of all principal of, and premium, interest, fees, and charges on, all Senior Debt before the holder of the Subordinated Notes is entitled to receive any payment on account of the principal of, or the interest on, the Subordinated Notes.

Section 1.4. Relative Rights and Subrogation. The provisions of this Article shall not alter or affect, as between the Company and the holder of the Subordinated Notes, the obligations of the Company to pay in full the principal of and interest on the Subordinated Notes, which obligations are absolute and unconditional. In the event that by virtue of this Article any amounts paid or payable to the holder of the Subordinated Notes in respect of the Subordinated Notes shall instead be paid to the holders of Senior Debt, the holder of the Subordinated Notes shall to this extent be subrogated to the rights of such holders; provided, however, that no such rights of subrogation shall be asserted against the Company until the Senior Debt has been paid in full.

Section 1.5. Subordination May Not Be Impaired by the Company. No present or future holder of Senior Debt shall be prejudiced in his right to enforce the subordination of the Subordinated Notes by any act or failure to act on the part of the Company. This subordination of the Subordinated Notes, and the rights of the holders of Senior Debt with respect thereto, shall not be affected by any amendment or other modification of any Senior Debt or any exercise or nonexercise of any right, power, or remedy with respect thereto.

Section 1.6. Modification of Terms of Senior Debt. The holders of Senior Debt may, at any time, in their discretion, renew or extend the time of payment of Senior Debt so held or exercise any of their rights under the Senior Debt including, without limitation, the waiver of defaults thereunder and the amendment of any of the terms or provisions thereof (or any notice evidencing or creating the same), all without notice to or assent from the holder of the Subordinated Notes. No compromise, alteration, amendment, modification, extension, renewal, or other change of, or waiver, consent, or other action in respect of any liability or obligation under or in respect of, any terms, covenants, or conditions of the Senior Debt (or any instrument evidencing or creating the same) and no release of property subject to the lien of the Senior Debt (or any instrument evidencing or creating the same), whether or not such release is in accordance with the provisions of the Senior Debt (or any

instrument evidencing or creating the same), shall in any way alter or affect any of the provisions of the Subordinated Notes.

Section 1.7. Restrictions on Holders of Subordinated Notes. (a) The terms of the Subordinated Notes shall not be modified without the prior written consent of the holders of the Senior Debt.

(b) The holder of the Subordinated Notes shall not take any action against the Company with respect to any Event of Default until and unless (i) any event described in Section 1.3(a) has occurred, or (ii) a holder of Senior Debt shall have accelerated payment of any Senior Debt obligation of the Company, or (iii) the Senior Debt shall have been paid in full.

(c) The holder of the Subordinated Notes shall provide to the Company, at any time and from time to time, at the Company's request and at no expense to the holder of the Subordinated Notes, a written acknowledgment by the holder of the Subordinated Notes addressed to any holder of Senior Debt to the effect that such holder is a holder of Senior Debt, provided that prior to furnishing such acknowledgment, the holder of the Subordinated Notes shall have received from the Company such information as the holder of the Subordinated Notes shall reasonably request demonstrating to the holder of Subordinated Notes reasonable satisfaction that such holder is a holder of Senior Debt.

Section 1.8. Definition of Senior Debt. "Senior Debt" means (i) any indebtedness of the Company in respect of a certain Revolving Credit and Security Agreement between the Company and [the specific Lender], including any advances or readvances under refunding or refinancings with the same or other lenders of the aforementioned loan agreement, (ii) [specific existing long-term indebtedness of the Company] and (iii) all trade debt of the Company.

NOTES

1. Borrowed cash obtained from commercial banks is only one of many sources of financing. In a 2006 survey of 402 business owners, the National Small Business Association found the following primary sources of financing for small businesses: personal savings (36 percent), commercial bank loans (20 percent), community bank loans (14 percent), credit cards (11 percent). Remaining sources were loans backed by the Small Business Administration (6 percent), credit union loans (1 percent), and others (12 percent). An earlier survey conducted by Small Business United had similar results, but asked for all sources (rather than primary only) and had these responses as well: vendor

credit, personal and home equity loans, leasing (16 percent); private loans, asset-based loans or selling/pledging accounts receivable, and private placement or stock (3 percent); and venture capital (2 percent).

2. For a list of 400 basic types of financing, see http://businessfinance.com. This is an excellent list for brainstorming sessions on financing.
3. This Financing Overview section is excerpted and updated from Alexandra R. Lajoux and J. Fred Weston, *The Art of M&A Financing: Sources and Instruments for Growth* (New York: McGraw-Hill, 1999). For an in-depth review of investment banking from two transactional experts, see Joshua N. Rosenbaum and Joshua D. Pearl, *Investment Banking: Modern Valuation Techniques and Transactional Analysis* (New York: South-Western Publishing/Thomson, 2007).
4. An accredited investor is defined under Regulation D, Rule 501(a) to include wealthy individuals, entities with substantial net worth, certain institutional investors, and executive officers and directors of the issuer. Anyone who does not fit within the definition of "accredited" is considered nonaccredited.
5. The *lender's cost of funds* is the dollar cost of interest paid or accrued either on funds acquired from various sources within a bank or on borrowed funds acquired from other banks. The *prime rate* is a "reference or base rate" that banks use to set the price or interest rate on many commercial loans and some consumer loans. The *federal funds rate* is the rate banks charge each other in the so-called interbank or federal funds market for purchases of excess reserve balances. These are balances that exceed bank reserve requirements set by central banking authority (in the United States, this would be the Federal Reserve System). *LIBOR* is the interest rate that the banks charge each other for loans (usually in Eurodollars). The prime rate exceeds and tracks fairly closely with LIBOR and the overnight federal funds rate. As of April 2006, the prime rate is around 7.75000, LIBOR is around 5.1256 (three-month U.S. dollar), and the overnight federal funds rate is around 4.750. These spreads are fairly typical. Prime is typically 2–3 points above LIBOR, which is typically about half a percentage point higher than the Fed funds rate.
6. See nceo.org and besappraisals.com/ESOPAlternative.pdf.
7. This kind of fund is popular among investors who practice Islamic principles of investing, which forbid usury (collection of interest on loans).
8. This kind of fund is popular with individual venture capitalists, sometimes called angels. See www.angelcapitalassociation.org/dir_documents/Summit4_Notes.pdf.
9. The items in this list are based on the current description of financing practice at Morgan, Lewis & Bockius, LLP, www.morganlewis.com. Definitions are by the authors of this book.

10. An earlier survey conducted by Small Business United had similar results, but asked for all sources (rather than primary only) and had these responses as well: vendor credit, personal and home equity loans, leasing (16 percent); private loans, asset-based loans or selling/pledging accounts receivable, and private placement or stock (3 percent); and venture capital (2 percent).
11. This description of high-end financing is based on the way Gibson Dunn, a global law firm, described its services in global finance. The firm's practice description posted May 2006 gives a fairly representative description of the state of modern finance: www.gibsondunn.com/practices/detail/full/id/620/?pubItem=6208.
12. More Detail regarding regulatory size limitations is included in www.sba.gov/library/cfrs/13cfr121.pdf.
13. In addition, *Specialized Small Business Investment Companies* (SSBICs) help only small businesses owned by socially or economically disadvantaged persons. For related programs see www.sba.gov/INV/NVMC/ www.sba.gov/inv/RBIP
14. Source: "Federal Government Venture Capital," December 1, 2005, Entrepreneur.com
15. After two decades of application, the authoritative standard is still the 12-page "Examining Circular on Highly Leveraged Transactions," distributed by the Controller of the Currency to its key personnel (Executive Communication 245, December 14, 1988), as revised in February 1990. In a press release dated March 13, 2006, the Comptroller of Currency was quoted as saying that "agencies will maintain the leverage ratio as a fundamental capital backstop for unanticipated risks faced by banks, including the risk that Basel II may not work as intended." Basel II is a reference to the international financial standard described elsewhere in this chapter.
16. For example, the Federal Deposit Insurance Corporation has a policy that says residential real estate loans that are delinquent 90 days or more and that have loan-to-value ratios greater than 60 percent should be classified "substandard." Furthermore the policy says that if delinquency exceeds a certain level, the institution should "evaluate its *collateral position* and classify as 'loss' any loan amount that exceeds the value of the collateral."
17. Tim Loughran and Anand M. Vijh, "Do Long-Term Shareholders Benefit from Corporate Acquisitions?," *The Journal of Finance,* Spring 1998. Another article in that same issue, Gregor Andrade and Steven N. Kaplan, "How Costly is Financial (Not Economic) Distress? Evidence from Highly Leveraged Transactions that Became Distressed" found that "The net effect of the HLT and financial distress (from pretransaction to distress resolution, market- or industry-adjusted) is to increase value slightly." Such findings have been supported by subsequent research, such as Paul Andre, Maher Kooli, Jean-Francois L'Her, "The long-run Performance of Mergers and Acquisitions: Evidence from the

Canadian Stock Market," *Financial Management* (Financial Management Association), Winter, 2004.

18. As of 2006, since its founding in 1978, Forstmann Little has invested more than $10 billion in some 30 companies, including former holdings Gulfstream Aerospace, The Topps Company, General Instrument, Revlon, and Dr Pepper; current holdings include Citadel Broadcasting and IMG. It is led by the surviving founding group member, Ted Forstmann. Although the firm's telecommunications investments have done poorly, the firm's overall record has been good. A *Fortune* article in 2004 reported: "Up until five years ago, Teddy Forstmann had been an expert on winning. At that point, Forstmann Little had raised more than $8 billion over 21 years in six funds—and every fund had made its investors money. Indeed, the average Forstmann Little equity fund racked up annual returns of almost 60% for its (mostly) corporate pension fund investors. Most astounding of all, with rare exceptions, Forstmann Little never lost money on the individual companies it took private in LBOs. It transformed companies that the rest of the leveraged-buyout pack was convinced were headed for the trash heap—among them Dr Pepper in 1984 and Gulfstream Aerospace and General Instrument in 1990—into multibillion-dollar winners." Adam Lashinsky, "How Teddy Lost His Groove," *Fortune,* July 24, 2004.

19. As Adam Lashinsky reported in "How Teddy Lost His Groove" (op. cit, note 18), the firm invested $2.5 billion in two telecommunications companies, McLeodUSA and XO Communications, during the height of the telecom bubble. Of that amount, $125 million came from the state of Connecticut, which sued to get it back. In early July, a split jury led to a ruling that Forstmann Little was negligent in its investments but not liable for any damages.

20. For research favoring transactions financed with cash rather than equity, see note 3.

21. In its May 27, 2005, report on AT&T, Proxy Governance Advisory Service notes, "The proxy statement indicates that during the week of January 24–28, 2005, the attorneys for the respective sides essentially completed the proposed merger agreement, including presumably all of the 'social considerations,' such as Dorman becoming president of the combined company and being elected to the SBC board (along with two other AT&T directors) as well as his very lucrative compensation contract, while the critical question of the financial exchange ratio was put to one side." AT&T, Proxy Governance Advisory Service, May 27, 2005, p. 12. This internal client report is quoted with permission.

22. As discussed in Chapter 5, successful MBOs often include large interest deductions, aggressive writeups, accelerated depreciation of asset values, and sometimes the adoption of an employee stock ownership plan. In his classic

study of 27 early MBOs, Louis Lowenstein found some or all of these elements present in all 27 of the buyouts he studied. Louis Lowenstein (1985), "Management Buyouts," *Columbia Law Review,* 4, 730–84 (1985).

23. Shortly before the KKR acquisition, the Canadian part of Beatrice Foods separated from its United States counterpart to become Beatrice Foods Canada Ltd., operating as a dairy. Beatrice grew through acquisition until Parmalat Finanziaria S.p.A of Italy acquired it. Parmalat, the world's largest dairy company, suffered financial fraud and filed for bankruptcy in June 2004. As we go to press, litigation continues. In April 2006, for example, Deloitte & Touche sued the company, alleging fraud. Source: "Deloitte Brings Damages Claim Against Parmalat," *Business Insurance,* April 18, 2006.

24. Commercial paper sometimes appears as a part of a buyout, but only as an element of working capital financing. Commercial paper refers to very short-term (usually nine months or less) low interest rate notes, or paper, sold to large corporations and institutions. It needs to be highly secure and thus is usually backed by a takeout commitment from the senior lender and can be thought of as part of the revolving credit financing. Sales of commercial paper are usually transacted under securities registration requirements stipulating that the proceeds be used for working capital.

25. Equity-based financial instruments that may be involved in a subordinated financing structure include: *Seller's preferred stock,* perhaps exchangeable for a subordinated note, usually appearing as an alternative to the previous item; *preferred or common stock sold to an independent third party,* perhaps to a leveraged buyout investment fund or to one of the lenders; *common stock sold to the buyer* or its principals, key managers, and employees; *warrants or options* to acquire common stock granted to any of the parties providing financing or to the seller. These do not provide financing directly but provide inducements to other financing participants.

26. After two decades of application, the authoritative standard is still the 12-page "Examining Circular on Highly Leveraged Transactions," distributed by the Controller of the Currency to its key personnel (Executive Communication 245, December 14, 1988), as revised in February 1990. In a press release dated March 13, 2006, the Comptroller of Currency was quoted as saying that "agencies will maintain the leverage ratio as a fundamental capital backstop for unanticipated risks faced by banks, including the risk that Basel II may not work as intended." Basel II is a reference to the international financial standard described elsewhere in this chapter.

27. Source: Bank for International Settlements: www.bis.org/publ/bcbs118.htm.

28. The rules for the accounting treatment of leases are covered by Financial Accounting Statement 13 (U.S.), which distinguished between an operating lease, which can be treated off balance sheet, and a capital lease, which should

be treated as an on balance sheet transaction. Both finance leases and installment contracts are forms of capital leases. For a good article on this standard, see Helen Sha2, "FASB on Recalculating Leveraged Leases," January 23, 2006, cfo.com.

29. See for example letters submitted to the SEC prior to its May 10, 2006, Roundtable on Second-year Experiences with Implementation of Sarbanes-Oxley Internal Control Reporting and Auditing Provisions, www.sec.gov/news/press/4-511.shtml.

30. Borrowers should pay fees only to reputable institutions. Advance-fee loan rackets have proliferated in recent years. Check with your local Better Business Bureau offices.

31. See note 16 re FDIC guidelines in this area.

32. "Mike" Milken, of course, is the financier who rediscovered and popularized junk bonds in the 1980s. Through him, his employer Drexel Burnham Lambert became famous—and then notorious. Rik Riklis is CEO of Rapid American Corp. Their story is chronicled in Connie Bruck, *The Predators' Ball* (New York: Penguin Books, 1989).

33. The major bond rating services—Duff & Phelps, Moody's Investor Services, and Standard & Poor's—use different symbols and sometimes arrive at different conclusions. The most well-known rating system is S&P, which is, from the top, as follows: AAA, AA, A, BBB for investment grade; BB, B, CCC, and lower for noninvestment grade S&P uses an "r" rating for bonds of any grade that carry a relatively high risk factor.

34. Credible scholarship has shown a bell curve for annualized cumulative default rates of noninvestment grade bonds rated BB, B, and CCC, in descending order of quality.

35. See Miles B. Livingston, Andy Naranjo, and Lei Zhou, "Asset Opaqueness, Split Bond Ratings, and Rating Migration" (June 2005). Available at SSRN: http://ssrn.com/abstract=734324.

36. Source: Private Equity Intelligence Ltd., cited in Matthew Benjamin, "Deal Mania," *U.S. News & World Report,* April 18, 2006. As of late 2006, the largest funds were listed as follows:

K.K.R.	$16.5 bn
Blackstone	$15.6 bn
TPG	$14.5 bn
Permira	$14.0 bn
Apollo	$10.1 bn

Source: James Quinn, "KKR to Unveil World's Largest Buyout Fund," Sept. 28, 2006, telegraph.co.uk.

37. Another type of fund increasingly—although still rarely—used for investment is a tax-exempt money market or mutual fund. The tederal tax code and

the Investment Company Act of 1940 require mutual funds to be at least 75 percent diversified, but up to 25 percent of the fund may be invested in a single company, leaving the door open for control-seeking investments.

40. For more on LPs, see Chapter 10.

41. Banks should note, however, that when they provide both lending and underwriting services, they may be sued for violation of the Bank Holding Company Act. Under that law, regulators and bank customers may sue banks on these grounds.

42. ESOPs in and of themselves can be used to finance a deal. For thorough guidance on structuring an ESOP-financed transaction, see resources at nceo.org.

43. A case often cited is the 1991 Chancery Court decision in *Credit Lyonnais* (*Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.,* 1991 WL 277613 (Del. Cn. Dec. 30, 1991)). This case has been widely interpreted as saying that company officers and directors owe a special duty to creditors when a company is in the zone of insolvency. However, in 2004, a decision in a 2004 Delaware case involving Production Resources Group LLC, an entertainment technology firm, had a more positive verdict. The court decided in that because there was no fraud, officers and directors were protected against the fiduciary claims of creditors by the business judgment rule, which protects director decisions made in good faith with due care, even if the decisions turn out to have negative consequences. The *Production Resources* decision "reversed a trend among some courts and commentators of imposing a new set of fiduciary duties on directors in favor of creditors of insolvent corporations or those in the zone of insolvency," according to an article by Cooley and Godward. "New Delaware Decision Clarifies the Duties of and Protections Afforded to Directors of Insolvent Companies," March 22, 2005. Cooley & Godward LLP.

44. Source: www.gao.gov/cgi-bin/getrpt?GAO-04-808.

45. Item 303 of Regulation S-K requires companies to disclose any known risks and uncertainties that are likely to affect future financial performance. However, in a recent complaint, activist shareholders claimed that of the more than 5,000 proceedings initiated by the SEC over the last 25 years, only three were based on alleged insufficient disclosure of environmental liabilities. And they said that during that same period, the SEC has filed only one civil action against a company on the grounds of inadequate environmental disclosure.

46. See FASB Statement No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans. On December 7, 2006, the FASB issued a proposed FSP FAS 158-a for exposure, with plans to discuss in 2007. See www.fasb.org/project/postretirement_benefits.shtml.

47. Ronald Fink, "Bondholder Backlash," *CFO Magazine,* February 1, 2006.

48. "S&P, Swiss Re Predict More Securitization, M&A's in Life Market," *Insurance Journal,* January 9, 2006.

CHAPTER 5

Structuring Transactions: General, Tax, and Accounting Considerations

INTRODUCTION

The structuring of a transaction—the determination of what form it will take—is often the most challenging aspect of any deal. The range of available forms (asset sales, stock transfers, mergers of a variety of types, tender offers, and so on), coupled with the variety of relevant factors (legal, accounting, tax, and so on), give dealmakers both tools to use and traps to avoid as they respond to the many and often conflicting goals of buyers, sellers, investors, and lenders—not to mention taxing authorities.

Historically in the United States, structuring choices included poolings of interest accounting treatment, available for merger transactions that met certain restrictions. The repeal of poolings accounting earlier this decade removed this choice and lifted many of these previous restrictions. The demise of pooling accounting simplified structuring choices, and brought the United States into parity with merger accounting in the rest of the developed world.

This chapter can help managers determine the most efficient and desirable form of each transaction. It will be particularly helpful in structuring friendly transactions involving privately owned companies. (Issues unique to change of control in public companies, particularly hostile tender offers and proxy contests, are covered in Chapter 10.)

Although the first part of this chapter discusses general structuring factors, the final choice of transaction structure often depends on specific tax and

accounting details. For example, structuring a transaction as an asset sale can enable a buyer to avoid assuming the liabilities of the seller and inheriting any disputes about them. But in some industries, structuring a transaction as an asset sale may be impossibly impractical because of tax or accounting issues.

So do not skip this chapter's sections on taxes and accounting simply out of fear that they may be arcane or complex. They are designed to accommodate both the neophyte and the old hand. Of particular importance in this edition of *The Art of M&A* is a more detailed discussion of tax-deferred reorganizations. Also, we take an exhaustive look at how the repeal of poolings of interest increases not only structuring flexibility, but also the risk of a post-deal write-down of goodwill.

This chapter concludes with a discussion of structuring matters unique to management buyouts, including special tax considerations affecting management compensation, and special considerations for employee benefits and stock ownership. We encourage readers who desire even greater detail about techniques for mitigating financial, legal, and tax risk in M/A/B transactions, as well as strategic alliances, minority investments, and workouts, to pick up a copy of *The Art of M&A Structuring.*[1]

One caveat: All tax laws and accounting principles are subject to change. In some areas, the pace of change is glacial. In others, it can happen with lightning speed. Keep an eye out for all major changes in the tax law—they almost always affect merger taxation. And *always* consult with qualified tax and accounting professionals. (If dealing with a major accounting firm remember that nearly every local office has an M&A specialist and sometimes a special department at headquarters. This also applies to law firms. Make sure your legal counsel has recent experience in the M&A area.)

GENERAL CONSIDERATIONS

When one company acquires another, what are the various forms that the transaction can take?

Three general forms can be used for the acquisition of a business: (1) a purchase of the assets of the business, (2) a purchase of the stock of the target owning the assets, and (3) a statutory merger of the buyer (or an affiliate) with the target. It is possible to combine several forms so that, for example, some *assets* of the business are purchased separately from the *stock* of the company that owns the rest of the assets, and a merger occurs immediately thereafter

between the buyer and the acquired company. Or a transaction may involve the purchase of assets of one corporation and the stock of another, where both corporations are owned by the same seller.

Structuring Asset Transactions

What happens in an asset transaction?

The target transfers all of the assets used in the business that is the subject of the sale. These include real estate, equipment, and inventory, as well as intangible assets such as contract rights, leases, patents, trademarks, and so on. These might be all or only part of the assets owned by the selling company. The target executes the specific kinds of documents needed to transfer the specific assets, such as deeds, bills of sale, and assignments.

When is an asset transaction necessary or desirable?

Many times, the choice of an asset transaction is dictated by the fact that the sale involves only part of the business owned by the selling corporation. Asset sales are generally the only choice in the sale of a product line that has not been run as a subsidiary corporation with its own set of books and records.

In other cases, an asset deal is not necessary but is chosen because of its special advantages:

- Where the seller will realize a meaningful taxable gain from the sale (that is, where the "tax basis" of the assets in the acquired company is materially lower than the selling price), the buyer generally will obtain significant tax savings from structuring the transaction as an *asset* deal, thus stepping up the assets' basis to the purchase price. (An asset's tax basis, as explained more fully later in this chapter, is the value at which the taxpayer carries the asset on the tax balance sheet. An asset's basis is initially its historical cost to the taxpayer.)
- Conversely, if the seller will realize a tax loss, the buyer is generally better off inheriting the tax history of the business by doing a *stock* transaction, and thus keeping the old high basis.

Taxes tend to be a zero-sum game: what is best for the buyer might not be best for the seller, who might lose tax advantages by structuring the deal in favor of the buyer. This conflict can and should give rise to lively negotiations—and

even an adjustment of price in favor of the conceding party. We discuss the concepts of stepped-up versus carryover tax basis in greater detail later in this chapter.

As mentioned, as a legal matter, the buyer in an asset sale generally assumes only the liabilities that it specifically agrees to assume. This ability to pick and choose among the liabilities generally protects the buyer from undisclosed liabilities of the seller. Exceptions do apply, however.

In an asset purchase, will the buyer be able to avoid all liabilities that it doesn't expressly assume?

The general rule is yes, but there are several exceptions:

- In certain jurisdictions, most notably California, the courts require the buyer of a manufacturing business to assume the tort liabilities for faulty products manufactured by the seller when it controls the business.
- There is also the bulk sales law, explained in greater detail later in the chapter. This is found in the UCC, and it is applicable in one form or another in all jurisdictions in the United States (except Louisiana). If the parties fail to comply with that law, and there is no available exemption, the buyer can be held responsible for certain liabilities of the seller.
- Under certain state statutes, if the transaction constitutes what is known as a *fraudulent conveyance,* the assets acquired by the buyer can be reached by creditors of the seller. Such statutes do not require actual fraud but can be applicable where the purchase price is not deemed fair consideration and the seller is left insolvent or without sufficient capital to finance operations and to meet its debts as they come due.
- In certain jurisdictions, if a buyer buys an entire business and the shareholders of the seller become the shareholders of the buyer, some courts may apply a doctrine known as the *de facto merger doctrine* that treats the transaction as a merger. (In a merger transaction, the buyer takes on all of the seller's liabilities.) This is undesirable for the buyer because it increases the buyer's liabilities. (Note, however, that the de facto merger doctrine is generally not applicable in Delaware, where most major U.S. corporations are incorporated.)
- Buyers cannot usually terminate a collective bargaining contract under any structural condition, including even an asset sale.[2]

What are the disadvantages of an asset sale?

First and foremost is its potentially high tax cost. An asset acquisition is frequently subject to double taxation (a corporate-level tax for the seller, as well as shareholder tax upon distribution of the proceeds).

Second, an asset transaction is usually more time-consuming and significantly more costly than the alternatives because of legal, accounting, and regulatory complications. An asset transaction requires a legal transfer of each asset. In certain industries, this might not be feasible.

- For instance, in wholesale distribution, hundreds of exclusive distribution agreements might be in force, and the costs of preparing a large number of new contracts with manufacturers might be prohibitive.
- As another example, in the oil and gas industry, each pipeline requires numerous permits, and land rights can be complex, involving both surface and subsurface rights.
- Many industries involve real estate, and real estate transfers are often subject to significant state and local transfer and recordation taxes. Such transfers may also motivate local tax assessors to increase the assessment of the property and thereby significantly increase the real estate tax burden on the company. If the property is spread over numerous jurisdictions, different forms might be required for each jurisdiction.

Third, many intangible assets and leases might not be assignable without the consent of the other party to the transaction. Assuming the other party is willing to consent (and this is rare), you can expect this consent to exact a price. This can be especially true where the seller has leases providing rent below the then-prevailing rental rates. It is possible that consent might then be obtained only by agreeing to significant rent increases. The same is true of other types of contracts with terms that are favorable for the target. The loan agreements of the target must also be carefully reviewed to ensure that the asset transaction will not trigger default provisions.

Fourth, many businesses have local licenses needed to operate, and a transfer of ownership may involve lengthy hearings or other administrative delays as well as a risk of losing the license. Similarly, many businesses are grandfathered, and thus exempt, from requirements mandating costly improvements to their property under local fire codes or rules relating to access for persons with disabilities. The asset transfer route can require the implementation of costly improvement programs to conform to such rules.

Finally, the asset transaction may require compliance with the bulk sales law, discussed in greater detail later in the chapter.

For these reasons, before plunging into an asset transfer, be sure to conduct an in-depth review of all of the legal arrangements of the business to determine whether such a deal is feasible. If problems are discovered, the parties must negotiate to decide who should bear the costs, such as the expense of obtaining consents. Usually, it is the buyer's responsibility, because the purchase price has been premised upon certain cash flows that might be impaired without the consents. Increasing rents or other fees can lower the value of the company and might require renegotiation of the purchase price.

What is the bulk sales law, and what effect does it have on asset transactions?

The bulk sales law, subject to variations among states, requires the purchaser of a major part of the material, supplies, merchandise, or other inventory of a seller whose principal business is bulk sales—the sale of merchandise from inventory—to give a certain amount of advance notice of the sale (typically at least 10 days' notice) to each creditor of the seller. The notice must identify the seller and the buyer and state whether or not the debts of the seller will be paid as they become due. If orderly payment will not be made, further information must be disclosed. In addition, many states require the buyer to ensure that the seller uses proceeds from the sale to satisfy existing debts, and to hold in escrow an amount sufficient to pay any disputed debts.

Although the requirements of the law are straightforward, its applicability to particular sellers and to specific transactions can be ambiguous. Also, states can amend or repeal this law as they so choose.[3] Acquirers should consult qualified legal counsel to ensure compliance when and if necessary.

Are any stockholder approvals required for an asset transaction?

Yes. Under Delaware law, for example, a sale of all or substantially all of the assets requires the approval of a majority (more than 50 percent) of common stockholders, and the company's charter and/or bylaws might even require a higher percentage (known as a *supermajority provision*).[4]

Where is a supermajority provision more likely to be found—in the charter or bylaws?

Such a provision is likely to be found in the bylaws document, rather than in the charter document. Charters, more technically known as *articles of*

incorporation, are filed in the state of incorporation as a matter of public record. As such, they do not generally contain substantial detail beyond the name of the company, its location, the nature of its business, state of incorporation, shares issued, powers to amend bylaws or elect directors, and director and officer indemnification. Bylaws, which can run five times the length of charter documents, cover the rules a corporation sets for itself. They typically repeat charter language but provide more detail and outline additional areas.

Does an asset transaction always involve a cash payment to the seller?

No. Payment for the assets can be made in any form of consideration acceptable to the seller, including the stock of the buyer.

Structuring Stock Transactions

What happens in a stock transaction?

The seller transfers its shares in the target to the buyer in exchange for an agreed-upon payment. Usually the transfer involves all company shares. Although the buyer may buy less than all of the stock in a public company (through a tender offer), this rarely occurs in purchases of private corporations. Such partial acquisitions of private companies usually happen only when some previous stockholder decides to stay (or become) active as a manager of the company and retains a stock interest.

When is a stock transaction appropriate?

A stock transaction is appropriate whenever the tax costs or other problems of doing an asset transaction make the asset transaction undesirable. Asset transfers simply produce too onerous a tax cost in many major transactions. Apart from tax considerations, a stock deal might be necessary if the transfer of assets would require unobtainable or costly third-party consents, or where the size of the company makes an asset deal too inconvenient, time-consuming, or costly.

Sellers frequently prefer a stock deal because the buyer will take the corporation's entire business including all of its liabilities. This may not offer as big an advantage as it appears, though, because the buyer will usually seek to be indemnified against any undisclosed liabilities.

Will a stock deal always avoid the problem of obtaining third-party consents that often arise in an asset transaction?

No. The pertinent documents must be carefully reviewed for "change of control" provisions. Many recently drafted leases, for example, require consent if there is a change in the control of the tenant. Other contracts or local permits or leases might have similar requirements.

What are the disadvantages of a stock deal?

There are two major disadvantages:

- First, it might be more difficult to consummate the transaction if there are a number of stockholders. Assuming that the buyer wants to acquire 100 percent of the company, it must enter into a contract with each of the selling stockholders, and any one of them might refuse to enter into the transaction or might refuse to close. The entire deal might hinge on one stockholder. As will be shown, the parties can achieve the same result as a stock transfer through a merger transaction and obviate the need for 100 percent agreement among the stockholders.
- The stock transaction might result in tax disadvantages after the acquisition that can be avoided only by choosing an asset transaction. Under Section 338 of the IRC, however, it is possible to have most stock transactions treated as asset acquisitions for federal income tax purposes. Under a so-called Section 338 election, the tax benefits can be achieved while avoiding the nontax pitfalls of an asset transaction. We describe Section 338 elections in greater detail later in this chapter.

Structuring Merger Transactions

What happens in a merger transaction, and what are the differences among a reverse merger, a forward merger, and a subsidiary merger?

A *merger* is a transaction in which one corporation is legally absorbed into another, and the surviving corporation succeeds to all of the assets or liabilities

of the absorbed corporation. There are no separate transfers for the assets or liabilities; the entire transfer occurs by operation of law when the certificate of merger is filed with the appropriate authorities of the state.

In a *forward merger,* the target merges into the buyer, and the target shareholders exchange their stock for the agreed-upon purchase price. When the dust settles, the buyer owns all the assets and liabilities of the target. For federal income tax purposes, such a transaction is treated as if the target sold its assets for the purchase price, and then made a liquidation distribution (that is, as if it liquidated the company and distributed the money to the target's shareholders).

In a *reverse merger,* the target absorbs the buyer. The shareholders of the buyer get stock in the target, and the shareholders of the target receive the agreed-to considerations. For example, in an all-cash deal, the shareholders of the target will exchange their shares in the target for cash. At the end of the day, the old shareholders of the target are no longer shareholders, and the shareholders of the buyer own the target. For federal tax purposes, a reverse merger is often treated essentially like a stock deal.

Although both forms of merger convey the target's assets to the buyer in the same simple manner, in the forward merger assets end up in another corporate shell. In certain jurisdictions, this might violate lease and other contract restrictions the same way a direct asset transfer does. Similarly, in some jurisdictions, so-called recordation taxes might be due after a forward merger when the buyer seeks to record the deeds in its name to reflect the merger.

A *subsidiary merger* is simply a merger where the buyer corporation incorporates an acquisition subsidiary that merges with the target. In a *forward subsidiary merger,* the target is merged into the acquisition subsidiary; in a *reverse subsidiary merger,* the acquisition subsidiary merges into the target.

Both kinds of subsidiary mergers offer the benefit of speed. Generally speaking, mergers must be approved by the stockholders of each corporation that is a party to the merger, but this requirement does not usually apply to a merger of a subsidiary into its parent. Although state corporation laws typically require that the board of directors approve the transaction on behalf of the acquiring entity, such approval is not necessarily required from shareholders.

Another benefit of subsidiary mergers is accounting clarity. After a subsidiary merger, the buyer owns the target's business in a subsidiary. This has the effect of keeping the businesses legally separate and not subjecting the assets of the parent to the liabilities of the acquired business.

The reverse subsidiary merger offers the special advantage of enabling the acquirer to make a Section 338 election.[5] The reverse subsidiary merger form also precludes the lease and other contract restrictions because the target is the surviving corporation, albeit now a subsidiary of the buyer.

What steps must be taken to effect a merger?

Generally, the board of directors of each corporation that is a party to the merger must adopt a resolution approving a merger agreement. Shareholders owning a majority of the stock must also approve the transaction. In some cases, the corporate charter and/or bylaws might require a higher percentage for shareholder approval under a supermajority provision. The merger becomes effective upon the filing of a certificate of merger. Under Delaware law, the approval of the surviving corporation's stockholders is necessary only if its certificate of incorporation will be amended by the merger and if the shares of the survivor issued to the sellers comprise less than 20 percent of the outstanding shares of the survivor.[6]

The agreement between buyer and seller in the case of a merger is essentially the same as in a stock or asset deal, except that the means of transferring the business will be the statutory merger as opposed to a stock or asset transfer.

What are the advantages of using a merger?

A merger transaction has many of the advantages of a stock deal: it is simple and will generally avoid the problems of an asset transaction.

In fact, a merger agreement is even simpler than a stock purchase agreement, because a merger agreement is executed only with the target company—not with its owners. Although mergers generally must be approved by a majority or some specified higher percentage of the stockholders, it does not depend upon reaching an agreement with each individual stockholder. The stockholders who dissent from the transaction are forced to go along as a matter of law, subject to certain statutory protections for minority investors, or *dissenters' rights.*

In a leveraged buyout that uses a merger structure, mergers are the best form of transaction from the secured lender's point of view. In this format, the lender lends to the surviving corporation (either directly or to a holding company that owns it) and obtains a security interest in the assets of that corporation; the loan proceeds are used to satisfy the obligation to pay off the stockholders of the target.

Can a transaction combine a merger and a stock acquisition? If so, how does this work?

In certain cases, a stock deal is combined with a merger transaction in a *two-step transaction.* The first step is an acquisition of the target's stock (usually at least a majority); the second step is a merger with the target.

Such transactions are useful if the buyer wishes to pay a majority stockholder a premium for the control block, a payment that generally is permissible under most state laws. The buyer purchases that stock separately and then, in a second vote, a majority of stockholders approves a merger transaction. The selling shareholders exchange the balance of their stock (i.e., the shares the buyer did not obtain in the first step) in the merger for a lesser purchase price that reflects the absence of a control premium. For publicly held targets, offerors must conform to Rule 14d-10(a)(1) of the Securities Exchange Act of 1934, which says that offers to purchase a class of securities must be open to all holders of the securities in that class.[7]

Another use for two-step transactions arises where part of the consideration consists of notes or preferred stock in the survivor and there is a desire to limit the persons to whom the noncash payments are to be made. The first step would consist of a stock deal with certain of the stockholders where the consideration includes noncash payments. The second step would be an all-cash merger.

This might be important, for example, if there are many individual shareholders and the distribution of the securities to all of them would constitute a public offering that would require the filing of a registration statement under the securities laws. This also might be useful where some of the sellers want to encourage a positive vote of the stockholders by absorbing the risk of holding notes or equity in the target and allowing the other stockholders to receive the full purchase price in cash.

Two-step transactions are very common in public company acquisitions where the first step is the acquisition of a control block through a tender offer and the second step is a merger in which the minority is bought out.

What is the most typical form for a leveraged buyout?

The buyer usually creates an acquisition vehicle solely for the purpose of merging with the acquired company. Usually, the acquisition vehicle does a reverse merger into the acquired company. If the buyer wants a holding company structure—that is, wants the acquired company to be a subsidiary of a holding company—it forms a holding company with an acquisition corporation subsidiary. After the merger, the holding company will own all of the stock of the acquired company, and the buyer will own all of the stock of the holding company.

When do senior lenders prefer lending to a holding company, and how does this work?

Senior lenders might prefer this when the real value of the company lies in a sale of the business as a going concern rather than in a piecemeal transaction. This is true where the business depends upon a valuable license, or where there are relatively few assets producing substantial earnings. The acquired company might own a number of operating subsidiaries and might wish to keep litigation or other potential liabilities of each subsidiary separated. With separate subsidiaries, an extraordinary loss by one subsidiary generally won't taint the operations of the others.

In such cases, the senior lender might prefer to have a transaction structured in a holding company arrangement. In such a structure, a holding company borrows money from a senior lender to purchase the stock of the acquired corporation. The senior lender obtains a senior security interest in the stock of the acquired company, and if there are loan defaults the lender can foreclose and sell the stock to pay off the debt. For this structure to succeed, all the layers of financing must be made at the holding company level.

In addition, the senior lender in a holding company structure will often ask for a secured guarantee from the acquired corporation, notwithstanding the fraudulent conveyance risks. Junior lenders often ask for a backup guarantee in such a case. This adds a layer of complexity to the intercreditor negotiations, and to the structure of financing and refinancing.

What is the role of federal and state securities laws in acquisition structuring?

State securities laws tend to have their greatest impact when the acquired corporation is publicly traded. But these laws also affect the structure of corporate acquisitions of private companies. When a buyer issues consideration other than cash—say, notes, stock, and/or warrants—or where the merger agreement provides that the stockholders of the target will receive noncash payment in exchange for their stock, the noncash consideration will almost certainly be classifiable as a security for federal and state securities law purposes.

When the sellers receive securities in connection with a merger or a sale of assets requiring approval of the acquired corporation's stockholders (because securities will be distributed to them), Rule 145 under the Securities Act of 1933 provides that the transaction is an offer to sell the securities. If the offer constitutes a public offering, the transaction might not take place unless there is a registration statement that has been declared effective under the Securities Act. These rules would apply, for example:

- Where a buyer uses a reverse merger and where the acquired company survives as a subsidiary of the buyer, and the acquired company's stockholders receive notes or preferred stock or warrants of the acquired company or of the buyer (if the buyer is a corporation)
- Where the buyer sets up a corporation that buys the stock of the acquiree in exchange for cash and notes or other securities of the corporation[8]

What is a private placement?

A *private placement* is a transaction in which securities are offered and sold in reliance on an exemption from the registration requirements under federal and state securities laws. Typically, the entity selling its securities (the *issuer*) will rely on the exemption from registration provided by Rules 501 to 508 of Regulation D of the Securities Act of 1933. The registration procedure requires the preparation and filing of documents that provide detailed information about the issuer, the offering, and the securities being sold. Rules 501 through 503 set the ground rules, followed by exemptions under Rule 504 (for transactions of $1 million or under), Rule 505 (for transactions $5 million or under), Rule 506 (limited offerings), and other general exemptions.

In a private placement, a brief notice of sale on federal Form D must be filed with the SEC for informational purposes. There is, however, no federal review or comment process for a Regulation D private placement.

Recent changes to Regulation D broadened the availability of the exemption from registration by permitting up to 35 nonaccredited investors to participate in a Regulation D private placement and an unlimited number of accredited investors. An *accredited investor* is defined under Rule 501(a) of Regulation D to include wealthy individuals, entities with substantial net worth, certain institutional investors, and executive officers and directors of the issuer. Anyone who does not fit within the definition of *accredited* is considered nonaccredited.

Suppose participants in a private placement want to sell the stock they bought?

Rule 144 of the Securities Act of 1933 allows public resale of restricted and control securities (including so-called Regulation D securities) if a number of conditions are met. Filing with the SEC is required prior to selling restricted and control stock, and the number of shares that may be sold is limited. Rule

114 AA is an additional safe harbor for resale of certain restricted securities to "qualified institutional buyers." For other exemptions, such as Rules 505 and 506 of Regulation D, a company may sell its securities to accredited investors.

ACCOUNTING CONSIDERATIONS

How do acquirers account for their acquisitions under generally accepted accounting principles (GAAP)?

Historically, there were two accepted methods of accounting for business combinations according to the Accounting Principles Board (APB), predecessor to the FASB. APB No. 16 described two acceptable methods of accounting for business combinations: the *purchase method* and the *pooling of interests method* (also referred to as *poolings* for short).

In general, the *purchase method,* which is the only method permitted today following FASB Statement 141, accounts for a business combination as the acquisition of one company by another. The purchase price and costs of the acquisition are allocated to all of the identified assets acquired (both tangible and intangible) and liabilities assumed, based on their fair values. (As will be discussed in more detail, the current rules governing the purchase method contemplate a substantially greater number of intangible assets than APB No. 16 historically did.) If the purchase price exceeds the fair value of the purchased company's net assets, the excess is recorded as goodwill. Earnings or losses of the purchased company are included in the acquiring company's financial statements beginning on the closing date of the acquisition.

The *pooling of interests method,* which is no longer permitted for new business combinations initiated after June 30, 2001, accounted for a business combination as a uniting of ownership interests of two companies by the exchange of voting equity securities. No acquisition was recognized because the combination was accomplished without disbursing resources of the constituents. In pooling accounting, the assets, liabilities, and retained earnings of each company were carried forward at their previous carrying amounts. The operating results of both companies were combined for all periods prior to the closing date, and previously issued financial statements were restated as though the companies had always been combined. Transactions had to meet a great number of criteria to qualify as poolings.[9]

Why are poolings no longer permitted?

The purchase versus poolings methods created unequal financial results for otherwise similar transactions—clearly an undesirable outcome from a public policy perspective. For example, acquirers that favored paying cash for acquisitions theoretically had lower earnings and financial returns compared to companies that typically used stock as acquisition currency.[10] (The inconsistency in earnings was due to the additional goodwill amortization expense on a cash acquirer's income statement, while the discrepancy in financial returns was influenced by lower asset values—including goodwill—on its balance sheet, compared to a stock acquirer. Purchased goodwill, for instance, increases the shareholders' equity of a stock acquirer, which initially lowers the acquirers' return on equity.) Also, because poolings accounting was unique to the United States, it raised concerns among the global accounting community for the same reasons.

If poolings are no longer permitted, why are they still important to understand?

There are many reasons, though three are particularly important:

- For the most part, the historical choice between poolings of interest and purchase accounting never impacted the true underlying economics of a potential M/A/B transaction. However, in some cases where purchase accounting was the only practical choice, the resulting annual goodwill expense was unusually high—particularly where a prospective acquisition target's principal asset was intangible, such as proprietary technology, brand name, market share, and so on. In such cases, an acquisition would have been perceived as having a prohibitively negative impact on the GAAP earnings of the purchaser. Under the new accounting rules of Statement 141, the annual goodwill amortization expense does not occur; as a result, certain transactions that were not practical under poolings might be appealing today. For dealmakers with more than five years of experience, this might require a shift in mindset.
- While transactions previously consummated under pooling treatment remain unaffected under Statement 141, an acquisition structured under the previous pooling of interest rules might have led to unrecognized goodwill that still exists today. As will be discussed in more detail, the acquirer might use this unrecognized

goodwill as a cushion in a goodwill impairment test to offset against deteriorating goodwill values in other areas of the reporting unit.

- In evaluating the balance sheets and financial returns of companies that previously were aggressive acquirers, the financial statements of otherwise comparable businesses might initially appear greatly dissimilar unless the reader understands the history of poolings and purchase accounting.

Has the repeal of poolings had any other long-term effect on the M&A landscape?

The repeal also increased the complexity and expense of transactions. As will be described in more detail, poolings were generally attractive to acquirers from a financial reporting perspective, but the accounting requirements needed to achieve such reporting restricted acquisitions to plain vanilla structures. With the rigidity of poolings lifted, acquirers have been more likely to propose more complex transaction structures, such as earnouts (described later in this chapter), in order to address risks in certain transactions.

Are all types of transactions covered under Statement 141?

No. Transactions that are excluded from the scope of Statement 141 include: (1) the formation of a joint venture, (2) the transfer of net assets or an exchange of shares between enterprises under common control, (3) a partial equity purchase, and (4) a combination of two not-for-profits.

How is the purchase price of the target determined for accounting purposes under the purchase method?

Statement 141 "carries forward, without reconsideration," the provisions of APB No. 16, which followed principles normally applicable under historical cost accounting to recording acquisitions of assets and issuance of stock. The purchase price recorded depends on the nature of the transaction:

- If the target is acquired by *exchanging cash or other assets,* the purchase price is the amount of cash disbursed or fair value of other assets distributed.

- If the target is acquired by *incurring liabilities,* the purchase price is the *present value* of the amounts to be paid. Present value is determined by calculating what an asset will be worth at a specified future time at a specified rate of interest, and imputing that value to the present.
- If the acquirer is *paying stock* for the target, the recorded purchase price is the fair market value of this stock. For public companies, this value would be determined by the market value of the stock on the date of closing or other date specified by the acquisition agreement. For private companies, this value is harder to determine because there is no public market for the shares. In this case, the acquirer might have to commission a valuation study by a third party. However, in practice, it is relatively rare for a seller to accept stock in a privately held acquirer as transaction consideration because the seller doesn't achieve any liquidity from the transaction. Very frequently, such liquidity is the driver behind a company's sale.

Cash paid, liabilities incurred, and securities issued constitute the major portion of the purchase price of most acquisitions. Numerous other items, however, must be considered for inclusion in the purchase price. Here are some of them:

- Direct expenses, such as finder's and directly related professional fees (legal, investment banking, accounting, appraisal, and environmental consulting)
- Premium or discount on a debt security issued or assumed, with the imputed liability adjusted to present value based on current interest rates, if stated rates differ significantly from current market rates
- A negotiated adjustment to the purchase price related to assumption of a contingent liability such as a lawsuit or tax examination

Under the purchase method, how should the buyer's cost be allocated to the assets acquired and liabilities assumed?

Under Statement 141, the buyer's cost is allocated to individual assets and liabilities at their relative fair values at the time of acquisition (the same process as under APB No. 16). *Fair value* is defined as "the amount at which an asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or

liquidation sale." Independent appraisals may be used in determining the fair value of some assets and liabilities. Subsequent sales of assets might also provide evidence of values.

The following are general guidelines for assigning amounts to certain individual assets acquired and liabilities assumed:

- Present value, determined at appropriate current interest rates, of receivables (net of estimated allowances for uncollectibility and collection costs, if necessary); accounts and notes payable, long-term debt, and other claims payable; and other liabilities, such as warranty, vacation pay, deferred compensation, unfavorable leases, contracts, and commitments, and plant closing expenses incident to the acquisition
- Current replacement cost of raw materials inventories and plant and equipment, adjusted to remaining economic lives
- Net realizable value of marketable securities and property and equipment to be sold or to be used temporarily
- Finished goods and merchandise at estimated selling prices less the sum of (1) the cost of disposal and (2) a reasonable profit allowance for the selling effort of the acquiring corporation
- Work-in-process inventory at estimated selling prices of finished goods less the sum of (1) the cost to complete, (2) the cost of disposal, and (3) a reasonable profit allowance for the completing and selling effort of the acquiring corporation based on profit for similar finished goods

The excess of the purchase amount over the fair value amounts assigned to the tangible assets, the financial assets, and identifiable assets is evidence of an unidentified intangible asset or assets, or goodwill.

Neither previously recorded goodwill, nor deferred income taxes, of the acquired company are recognized in the purchase price allocation. A deferred tax liability or asset shall be recognized for differences between the assigned values and the tax bases of the recognized assets acquired and liabilities assumed in accordance with Statement 109, "Accounting for Income Taxes in Consolidation." (*Statement 109*) If the acquired company sponsors a single-employer-defined benefit pension plan, the assignment of the purchase price to the individual assets acquired and liabilities assumed shall include a liability for the projected benefit obligation in excess of plan assets, or an asset for plan assets in excess of the projected benefit obligation.

Intangible assets and goodwill are discussed in the context of Statement 142 in the following section.

How does Statement 109 treat net operating losses?

The statement mandates recognition of the tax consequences of a transaction or an event in the same period that the transaction or event is recognized in the enterprise's financial statements.[11]

Under Statement 109, the FASB adopted a liability approach to comprehensive tax allocation, consistent with the approach used under its predecessor standard (Statement 96), but changed its conclusion in asset recognition and adopted the one-event approach. The FASB decided that the crucial event for recognition purposes is the event that gives rise to the deductible temporary difference or tax credit or net operating losses (NOL) carryforward. Once that event occurs, those tax benefits should be recognized subject to an impairment challenge.

Under Statement 109:

- Deferred tax liabilities are recognized for future taxable amounts, deferred tax assets are recognized for future deductions and operating loss and tax credit carryforwards, and the liabilities and assets are then measured using the applicable tax rate.
- A valuation allowance is recognized to reduce deferred tax assets to the amounts that are more likely than not to be realized, and the amount of the allowance is based on available evidence about the future.
- Deferred tax expense or benefit is computed as the difference between beginning and ending balance of the net deferred tax asset or liability for the period.
- Generally, deferred tax assets and liabilities are classified as current or noncurrent in accordance with the classification of the related asset or liability for financial reporting purposes.
- The effects of changes in rates or laws are recognized at the date of enactment.

There are two particularly important issues to consider upon application of Statement 109:

- *Operating loss and tax credit carryforwards and carrybacks.* Enterprises must identify the availability of NOL and tax credit carryforwards, their expiration dates, and limitations on their use, for each taxing jurisdiction. Statement 109 presumes that the enterprise will be able to use these benefits, subject to an impairment challenge. Under either of the predecessor standards,

tax credit carryforwards that could not be used to reduce recorded deferred tax liabilities were not recognized but were disclosed in the notes to the financial statements.

- *Valuation allowance.* A key concept underlying the measurement of net deferred assets is that the amount to be recognized is the amount of deferred tax benefit expected to be realized. In its deliberation, the FASB considered how high the recognition threshold should be. The FASB concluded that if it allowed asset recognition only if realization was ensured beyond a reasonable doubt, some assets would not be recognized even though they were expected to be realized. This led to the conclusion that a lower threshold—recognition if realization is more likely than not—would be preferable.

Realization of tax benefits is dependent on whether there will be sufficient future taxable income of the appropriate character in the period during which deductible temporary differences reverse, or within the carryforward period established under the tax law. If, based on available evidence, it is more likely than not that all or a portion of the deferred tax asset will not be realized, then the asset must be reduced by a valuation allowance.

How are the differences between the market or appraised values of specific assets and liabilities and the income tax bases of those assets accounted for?

A purchase business combination can result in goodwill or negative goodwill. Negative goodwill, discussed later in this chapter, occurs when the purchase value is made below fair market value. Becuse goodwill is amortized one way for tax purposes (over 15 years) and another way for financial reporting purposes (not to exceed 40 years), there can be a temporary or permanent difference between the two numbers. Statement 109 offers guidance on which differences should be treated as permanent and which should be treated as temporary. Nonetheless, the facts and circumstances of each transaction need to be evaluated.

How much time does a buyer have to complete the accounting under the purchase method?

The so-called *allocation period,* during which the buyer identifies and values the assets acquired and the liabilities assumed, ends when the acquiring

enterprise is no longer waiting for information that it has arranged to obtain and that is known to be available or obtainable. Although the time required varies with circumstances, the allocation period should usually not exceed one year from the consummation of a business combination. The existence of a pre-acquisition contingency for which an asset, liability, or an impairment of an asset cannot be estimated does not, of itself, extend the allocation period.

At what date should a buyer report combined results of the purchase and begin counting target operating results as its own?

The acquisition date of a company ordinarily is the date assets are received and other assets are given or securities are issued. In certain situations, however, the acquisition date might be "as of" a date earlier than the closing date. These include, for example, situations in which the parties intend to fix a determinable price as of a specified date other than the closing date or to develop a formula whereby changes in earnings or market price between the specified date and the closing date will be considered in the final purchase price. If a date earlier than the closing date is considered appropriate, the following conditions should be met in order for the earlier date to be used as the date on which the buyer includes the results of operations of the target:

- The parties reach a firm purchase agreement that includes specifying the date of acquisition other than the closing date. Effective control of the acquired company (including the risks and rewards of ownership) transfers to the acquiring company as of the specified date.
- The time period between the specified date and the closing date is relatively short.

What are pre-acquisition contingencies and how should they be considered in the allocation of purchase price?

A *contingency* is an existing condition, situation, or set of circumstances involving uncertainty as to possible gain or loss to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur. A *pre-acquisition contingency* is a contingency of the acquired enterprise that is in existence before consummation of a business combination; it can be a contingent asset, a contingent liability, or a contingent impairment of an asset. Examples of pre-acquisition contingencies include pending or

threatened litigation, obligations relating to product warranties and product defects, and actual or possible claims or assessments. These include income tax examinations, assessments by environmental agencies, guarantees of indebtedness of others, and impairment of the carrying amount of productive assets used in the business.

A pre-acquisition contingency is included in the allocation of purchase price based on an amount determined as follows:

- If the fair value of the pre-acquisition contingency can be determined during the allocation period, that pre-acquisition contingency is included in the allocation of purchase price based on that fair value.
- If the fair value *cannot* be determined during the allocation period, that pre-acquisition contingency shall be included in the allocation of the purchase price only if information available prior to the end of the allocation period indicates that it is probable that a contingent asset existed, a contingent liability had been incurred, or an existing asset might be impaired at the consummation of the business combination. Implicit in this condition is that it must be probable that one or more future events will occur confirming the contingency, and that the amount of the asset or liability can be reasonably estimated.

Contingencies that arise from the acquisition and that did not exist prior to the acquisition are the buyer's contingencies rather than pre-acquisition contingencies of the acquired company.

What are typical forms of contingent consideration in an acquisition, and how should such consideration be included in determining the cost of an acquired company?

A business combination might provide for the issuance of stock or the transfer of cash or other consideration contingent on specified transactions or events in the future. Agreements often provide that a portion of the consideration be placed in escrow and distributed or returned when the specified event has occurred. In general, to the extent that the contingent consideration can be determined at the time of the acquisition (or if the contingent consideration is subject to some minimum), the present value of such amount should be included in determining the cost of the acquired company. For example, amounts held in escrow for standard representations and

warranties that are nonsubjective in nature (that is, their outcome is determinable beyond reasonable doubt) should be included in the purchase price as of the acquisition date.

As is often the case, however, the amount of the contingent consideration might not be known at the time of the acquisition. For example, additional consideration might be contingent on maintaining or achieving specified earnings levels in the future. When the contingency is resolved or resolution is probable and additional consideration is payable, the acquiring company shall record the current fair value of the consideration paid as an additional cost of the acquired company. This subsequent recognition of additional cost requires an adjustment to the initial amounts recorded at the date of acquisition. Generally, the amount of goodwill is adjusted for the amount of additional consideration paid.

What accounting is required for acquisition-related expenses?

Direct acquisition costs incurred by an acquiring company effecting a business combination (including fees paid to investment bankers, legal fees, accounting fees, appraisal fees, and other consulting fees) are included as part of the purchase price of the target company. By contrast, direct acquisition costs incurred by an *acquired* company, or its major or controlling shareholders, should generally *not* be included as part of the cost of the acquired company. These costs are presumed to be taken into account by the acquiring company in setting the purchase price, either indirectly or directly (if, for example, the acquiring company agrees to reimburse the acquired company's major or controlling shareholders for acquisition costs incurred by them).

Fees paid to an investment banker in connection with a business combination accounted for as a purchase when the investment banker is also providing interim financing or debt underwriting services must be allocated between direct costs of the acquisition and debt issue costs.

What disclosures about a business combination are required under Statement 141, on "Business Combinations"?

At this edition, the FASB is considering increasing the level of disclosure about business combinations. But under now-current standards, Statement 141 requires disclosure regarding five items:

1. In the period that a material business combination is completed, the acquirer should disclose the following information:
   a. The name and a brief description of the acquired enterprise and the percentage of shares acquired
   b. The primary reasons for the acquisition, including a description of the factors that contributed to a purchase price that results in the recognition of goodwill
   c. The date from which the results of the acquired enterprise are included in the income statement of the combined entity
   d. The cost of the acquired enterprise and, if applicable, the number of shares issued or issuable, the value assigned to those shares, and the basis for determining that value
   e. A condensed balance sheet disclosing the amount assigned to each major asset and liability of the acquired enterprise
   f. Contingent payments, options, or commitments specified in the acquisition agreement and the accounting treatment that will be followed should each contingency occur
   g. The amount of purchased research and development assets acquired and written off in the period and the line item in the income statement in which the amounts are written off
   h. For any purchase price allocation that has not been finalized, that fact and the reasons; in subsequent periods, the nature and amount of any material adjustments to the initial allocation of the purchase price
2. In the period that a material business combination is completed, if the amounts assigned to goodwill or other intangible assets are significant in relation to the total cost of the acquired entity, the following information should be disclosed:
   a. For intangible assets subject to amortization:
      - The total amount assigned and the amount assigned to any major intangible asset class
      - The amount of any significant residual value, in total and by major intangible asset class
      - The weighted average amortization period, in total and by the amount assigned to any major intangible asset class
   b. For intangible assets not amortized, the total amount assigned and the amount assigned to any major intangible asset class

   c. For goodwill:
      - The total amount of goodwill and the amount expected to be deductible for tax purposes
      - The amount of goodwill by reportable segment

3. In the case of business combinations that by themselves are not material, but taken together are material, the following information should be disclosed:

   a. The number of entities acquired and a brief description of those entities

   b. The aggregate cost of the acquired entities, number of shares of stock issued or issuable, and values assigned to the shares

   c. The aggregate amount of contingent payments, options, or commitments and the accounting treatment that will be followed should the contingency occur

   d. The information described in item 2, if the aggregate amount assigned to goodwill or to other intangible assets acquired is significant in relation to the aggregate cost of the acquired enterprises

4. If the combined entity is a public company, the notes to the financial statements should include the following supplemental information on a pro forma basis for the period in which a material business combination occurs:

   a. Results of operations for the current period as if the business combination had been completed at the beginning of the period.

   b. Results of operations for the comparable period as if the business combination had been completed at the beginning of that period if comparative financial statements are presented.

   c. At a minimum, the supplemental pro forma information should display revenue, income before extraordinary items, and cumulative effect of an accounting change, net income, and earnings per share (EPS). Pro forma presentation of results is limited to the current period and the immediately preceding period. Disclosure also will be made of the nature and amount of any material nonrecurring items included in the reported pro forma results of operations.

5. The information required in items 1 and 2 if a material business combination is completed after the balance sheet date but before the financial statements are issued.[12]

(Later in this chapter we explain more about pro forma financial statements.)

What quarterly disclosures are currently required under Statement 141?

If a material business combination is completed during the current year up to the date of the most recent quarterly balance sheet presented, the acquirer should disclose the following information:

- Disclosures a through d in item 1.
- Supplemental pro forma information disclosing the results of operations for the current quarter and current year to date as though the business combination had been completed at the beginning of the period. The same information required in item 4 is required.

How does Statement 142, "Goodwill and Other Intangibles," define intangible assets?

Appendix F of Statement 142 defines *intangible assets* simply as "[a]ssets (not including financial assets) that lack physical substance."[13] While goodwill would generally be thought of as an intangible asset, for the purposes of Statement 142, the term *intangible asset* refers to intangible assets other than goodwill. One of the FASB's objectives in developing Statement 142 was to make the recognition criteria for intangible assets more operational so that more intangibles would be recognized separate from goodwill.

When must an acquirer recognize an intangible asset under Statement 142?

Under Statement 142, an intangible asset acquired in a business combination must be recognized as an asset apart from goodwill if (1) it arises from a contractual or legal right, or (2) it is separable. An intangible asset is considered *separable* if the acquirer is able to separate or divide it from the target and subsequently sell, license, rent, exchange, or otherwise transfer the asset to another entity. Thus, a contractual or legal right might give rise to an intangible asset even if it cannot be separated and/or sold, while a separable asset likewise represents an intangible asset regardless of the acquirer's intent to subsequently sell the asset. Examples include:

- *An acquired customer list*—while not a contractual right, the list is separable and thus represents an intangible asset. However, a walk-in customer base is not an intangible asset because it is not separable.
- *An acquired patent that expires in 15 years*—regardless of intent to sell or otherwise dispose of it, the patent represents a legal right and thus is an intangible asset.
- *Technology that cannot be patented*—while not based on a contractual or legal right, the technology is separable and thus represents an intangible asset.
- *An employee's five-year noncompete agreement*—the agreement is based on a contractual right and thus is an intangible asset. However, an at-will employee workforce is generally not considered an intangible asset unless the employees are subject to some form of employment agreement.

If an asset acquired in a business combination does not qualify as an intangible asset under one of these two criteria provided by Statement 142, the asset must be included in the amount initially recorded as goodwill.

How is goodwill calculated under Statement 142?

Goodwill is calculated under Statement 142 as the excess of the purchase price of the target over the fair market value of the net assets acquired. As was the case under APB No. 16, net assets are derived as the target's tangible and intangible (excluding goodwill) assets less assumed liabilities. Another way of thinking about goodwill under Statement 142 is that goodwill is equivalent to the sum total of intangible assets that do not specifically meet the legal or separability requirements previously discussed.

How are intangibles treated in a business combination?

If an acquirer purchases an intangible asset in a business combination, the acquirer must follow the initial measurement procedures of Statement 142, which generally involves four steps:

- First, the acquirer must recognize each qualifying intangible asset at fair value. *Fair value* is generally defined as the estimated value at which the asset could be bought and sold between two willing

parties (i.e., not liquidation value). This is the same principle that existed under APB No. 16.

- Second, the acquirer must estimate the intangible asset's *useful economic life*—the period over which the acquirer expects the asset to contribute directly or indirectly to future cash flows. At the end of its useful economic life, the intangible asset is assumed to have no residual value unless the asset meets certain criteria. There is no maximum potential useful economic life.
- Third, the acquirer deducts an amortization expense against the intangible asset in each reporting period. Typically, the amortization method is assumed to be straight-line (with amounts allocated equally to each year) unless some other method better reflects the underlying pattern of economic consumption of the asset. In each reporting period, the acquirer must reevaluate the remaining useful economic life of the asset to determine if the assumed estimated life is still reasonable.
- Fourth and finally, the acquirer must test the intangible asset for impairment if and when there is an indication that the asset might be impaired. The impairment methodology to be followed is contained in Financial Accounting Statement No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" (*Statement 144*). Note that, for an intangible asset with a definite life, the timing of an impairment test (i.e., the time when there is an indication that the asset might be impaired) is different from the timing of an impairment test for goodwill or for an intangible asset with an indefinite life, which generally must occur at least annually. From a practical perspective, it is likely that the acquirer's external accountants will evaluate an intangible asset with a finite life for impairment each year in conjunction with their annual audit, as accounting standards generally require assets to be carried at the lower of cost or market.

How does this analysis differ if the intangible asset's useful economic life is indefinite?

If the useful economic life of the intangible asset extends beyond the foreseeable future, its life is deemed indefinite (not infinite), and the asset is not amortized until such time that its life is determined to be finite. An intangible asset might have an indefinite useful life if no factor (i.e., legal, contractual,

economic, etc.) limits its useful life. Any brand owned by a company, if separable, is an intangible asset with an indefinite life, while a patent or copyright (both of which have finite lives under the law) is not.

For so long as the useful economic life of an intangible asset is deemed to be indefinite, the acquirer must test the intangible asset for impairment at least annually, or more frequently if circumstances warrant. The impairment test methodology in this situation is relatively straightforward—the acquirer compares the fair value of the intangible asset to the asset's book value to determine whether a write-down is appropriate.

What are some examples of intangible assets' estimated useful economic lives under Statement 142?

Appendix A of Statement 142 provides nine examples. Three are summarized here:

- *Example 1: An acquired customer list.* A direct mail company acquired a customer list and expects that it will benefit from the information on the acquired customer list for at least one year but no more than three years. Statement 142 treatment: The customer list would be amortized over 18 months, management's best estimate of its useful life, following the pattern in which the expected benefits will be consumed or otherwise used up. Although the acquiring entity might intend to add customer names and other information to the list in the future, the expected benefits of the acquired list relate only to customers on that list at the date of acquisition (a so-called *closed-group* notion).
- *Example 2: An acquired patent that expires in 15 years.* The product protected by the patented technology is expected to be a source of cash flows for at least 15 years. The reporting entity has a commitment from a third party to purchase that patent in five years for 60 percent of the fair value of the patent at the date it was acquired, and the entity intends to sell the patent in five years. Statement 142 treatment: The patent would be amortized over its five-year useful life to the reporting entity following the pattern in which the expected benefits will be consumed or otherwise used up. The amount to be amortized is 40 percent of the patent's fair value at the acquisition date (residual value is 60 percent).

- *Example 3: An acquired broadcast license that expires in five years.* The broadcast license is renewable every 10 years if the company provides at least an average level of service to its customers and complies with the applicable FCC rules and policies and the FCC Communications Act of 1934. The license might be renewed indefinitely at little cost and was renewed twice prior to its recent acquisition. The acquiring entity intends to renew the license indefinitely, and evidence supports its ability to do so. Historically, there has been no compelling challenge to the license renewal. The technology used in broadcasting is not expected to be replaced by another technology any time in the foreseeable future. Therefore, the cash flows from that license are expected to continue indefinitely. Statement 142 treatment: The broadcast license would be deemed to have an indefinite useful life because cash flows are expected to continue indefinitely. Therefore, the license would not be amortized until its useful life is deemed no longer indefinite.

How should an acquirer estimate an intangible asset's fair value?

The ideal fair value is based on a quoted market price in an active market. However, this scenario typically only exists where the asset is a commodity, and unfortunately (from a practical perspective) intangible assets are rarely such fungible goods, even if they are separable for the purposes of Statement 142. Alternatively, the acquirer should consider using one of three methods:

- *Income approach.* This is the most commonly used approach and involves a DCF analysis of the asset's expected future cash flows, as discussed in Chapter 3. Like other DCF analyses, the present value to which the cash flow is discounted is particularly sensitive to the acquirer's choice of discount rate.
- *Cost approach.* This method estimates the asset's value at its replacement cost. The approach is not very effective when the asset at issue is unique or highly proprietary, as it might not be easily replicated at a reasonable or otherwise appropriate cost.
- *Market approach.* This third and final approach looks to purchase prices of comparable assets in other arm's-length transactions. This type of analysis is common in M&A, which frequently incorporates

comparable companies or comparable transactions analyses in the valuation process. However, the market approach is more difficult to apply to the valuation of intangible assets because a market for the asset often does not exist or the prices are not widely reported.

Does the application of Statement 142 depend on whether the business combination is initiated before or after the statement's effective date?

No. An acquirer must account for intangible assets under the provisions of Statement 142 regardless of when the acquirer purchased such assets. This is an important point to understand because Statement 142 defines intangible assets more narrowly than APB No. 17 did. As a result, an acquirer might have purchased certain intangibles in a business combination prior to the effective date of Statement 142 that were properly recorded as goodwill under APB No. 17, but which are considered intangible assets under Statement 142. In that scenario, the acquirer must reclassify historical goodwill into the appropriate intangible asset classes, as provided by Statement 142. Likewise, items that were previously classified as nongoodwill intangible assets under the APB No. 17 rules must be reexamined to determine if they still qualify as intangible assets under Statement 142. If not, they must be reclassified as goodwill.

How does Statement 142 impact deal structures?

From a practical perspective, Statement 142 has had at least three impacts on deal structuring:

- First, it has affected the amount of goodwill a company unit reports, and might influence a decision to integrate it into one or more other reporting units.
- Second, it makes valuation models more complex, as the measurement of intangible assets has become more specific.
- Third, the new accounting pronouncement has had an impact on an acquirer's reported earnings. A greater number of intangible assets can increase amortization expense of nongoodwill intangibles. This in turn can lower reported earnings in the first few years following the transaction. After those intangible assets are fully amortized, however, the earnings of the combined company are likely to

increase, because the surviving company is no longer required to deduct goodwill amortization expense.

What disclosures are currently required under Statement 142 in the period of acquisition?

Statement 142 expands the disclosure requirements for goodwill and recognized intangible assets. Three items must be disclosed in the period of acquisition:

1. Intangible assets subject to amortization:
   - The total amount assigned and the amount assigned to any major intangible asset class
   - The amount of any significant residual value, in total and by major intangible asset class
   - The weighted-average amortization period, in total and by major intangible asset class
2. Intangible assets not subject to amortization—the total amount assigned to any major intangible asset class
3. The amount of purchased research and development assets acquired and written off in the period and the line item in the income statement in which the amounts are written off

What disclosures are currently required under Statement 142 in each balance sheet?

Statement 142 requires three disclosure items in each balance sheet:

1. Intangible assets subject to amortization:
   - The gross carrying amount and accumulated amortization, in total and by major intangible asset class
   - The aggregate amortization expense for the period
   - The estimated aggregate amortization expense for each of the five succeeding fiscal years
2. Intangible assets not subject to amortization—the total carrying amount and the carrying amount for each major intangible asset class
3. The changes in the carrying amount of goodwill during the period, provided in total and for each reportable segment, including:
   - The aggregate amount of goodwill acquired

- The amount of goodwill included in the gain or loss on disposal of all or a portion of a reporting unit
- The aggregate amount of impairment losses recognized

What is an impairment loss?

An *impairment loss* is the difference between the asset's recorded value carried on a financial statement and its market value when the market value is lower than the carrying value. It is described in Statement 144.

What disclosures are required under Statement 142 in periods when an impairment loss on an intangible asset is recognized?

There are four items that a company must disclose when an impairment loss on an intangible asset is recognized:

1. A description of the impaired intangible asset and the facts and circumstances leading to the impairment
2. The amount of the impairment loss and the method for determining fair value
3. The caption in the income statement where the impairment loss is recorded
4. If applicable, the segment that includes the impaired value

What disclosures are required under Statement 142 in periods when a goodwill impairment loss is recognized?

The following three items must be disclosed when a goodwill impairment loss is recognized:

1. A description of the facts and circumstances leading to the impairment
2. The amount of the impairment loss and the method for determining fair value of the reporting unit (whether based on quote market prices, prices of comparable businesses, a present value or other valuation technique, or a combination thereof)

3. If a recognized impairment loss is an estimated loss that has not been finalized, that fact and the reasons and, in subsequent periods, the nature and amount of any material adjustments made to the initial estimate of the impairment loss

GOODWILL IMPAIRMENT TESTING

How is goodwill treated under Statement 142?

Instead of requiring goodwill amortization, Statement 142 generally requires that goodwill be tested for impairment at least annually. The acquirer must evaluate preexisting goodwill (i.e., goodwill on the balance sheet of the acquirer at the time it adopts Statement 142) for impairment within one year of adopting the new standard and then generally at least annually thereafter. This is in contrast to the treatment of goodwill under APB No. 17, whereby goodwill was capitalized and amortized over a period not to exceed 40 years.

On the acquisition date, an acquirer must allocate goodwill and all other assets and liabilities associated with the target to one or more reporting units. As discussed in more detail later in this chapter, Statement 142 defines a *reporting unit* as "an operating segment or one level below an operating segment" as that term is defined in paragraph 10 of FASB Statement No. 131, "Disclosures about Segments of an Enterprise and Related Information" (*Statement 131*). An asset (including goodwill) or liability may be allocated to more than one reporting unit if two criteria are met: (1) the asset or liability is employed in, or relates to, the operations of more than one reporting unit, and (2) the asset or liability would be included in a sale of the reporting unit as a stand-alone entity.

Goodwill is divided among the reporting units that are expected to benefit from the synergies of the business combination, permitting some management discretion. That is, management must assign goodwill among the reporting units using a methodology that is reasonable, supportable, and applied in a consistent manner. For example, the acquirer could allocate the goodwill based on the anticipated revenue or cash flows from the acquisition to each reporting unit. Alternatively, the acquirer could allocate the goodwill based on the relative fair value of each different reporting unit that is expected to benefit from the transaction.

In any event, the acquirer should give careful consideration to the initial methodology it chooses because the acquirer will be required to continue using that methodology. For existing goodwill, allocation occurs on the date

the reporting company implements Statement 142. Allocating existing goodwill accumulated over a number of years from various acquisitions can be very difficult.

What is negative goodwill?

In some transactions, the amounts assigned to the acquired net assets of the target exceed their cost. The FASB's view is that the excess, sometimes known as *negative goodwill,* is usually due to measurement errors in the purchase price allocation. Where negative goodwill is deemed to exist, the amount should be allocated on a pro rata basis to all intangible assets with the exception of assets that have an inalterable value, such as financial assets (e.g., cash), assets earmarked for sale, deferred tax assets, and prepaid assets relating to pension or other postretirement benefit plans. For more on pension and benefit plans, see Chapter 9.

How should a company identify a reporting unit for the purposes of testing goodwill?

A reporting unit is the same level as, or one level below (known as a *component*), an operating segment reportable under Statement 131, mentioned previously. Determining whether a component of an operating segment is a reporting unit is a matter of judgment based on an entity's individual facts and circumstances. While Statement 142 includes a number of characteristics that must be present for a component of an operating segment to be a reporting unit, no single factor or characteristic is determinative. How an entity manages its operations and how an acquired entity is integrated with the acquiring entity are key to determining the reporting units of the entity.

Management is required to define the reporting unit at the component level (i.e., one level below the operating segment) if two criteria are met: the component has (1) discrete financial information available, and (2) economic characteristics different from the operating segment's other components. Accordingly, the acquirer should group together multiple components with similar economic characteristics within an operating segment to form a single reporting unit. Factors that should be considered in evaluating economic similarities include:

- The manner in which an entity operates its business and the nature of those operations

- Whether goodwill is recoverable from the separate operations of each component business or from two or more component businesses working in concert (which might be the case if the components are economically interdependent)
- The extent to which the component businesses share assets and other resources, as might be evidenced by extensive transfer pricing mechanisms
- Whether the components support and benefit from common research and development projects

The fact that a component extensively shares assets and other resources with other components of the operating segment might be an indication that the component either is not a business or might be economically similar to those other components.

Components that share similar economic characteristics but relate to different operating segments may not be combined into a single reporting unit. For example, an entity might have organized its operating segments on a geographic basis. If its three operating segments (e.g., Americas, Europe, and Asia) each have two components (A and B) that are dissimilar to each other but similar to the corresponding component in the other operating segments, the entity would *not* be permitted to combine component A from each of the operating segments to make reporting unit A.

How does testing for goodwill impairment under Statement 142 differ from the prior accounting rules?

Like other assets on the balance sheet, goodwill has always been subject to a test for impairment. That is, if there was reason to suspect that the amount recorded on the balance sheet was no longer recoverable from future operations, it was tested to see if it had, in fact, diminished in value. If so, it was written down with a charge to earnings. Statement 142 differs from previous GAAP in two important respects: the frequency and mechanics of impairment testing.

How frequently must a company conduct a goodwill impairment test?

Under Statement 142, a company generally must conduct a goodwill impairment test at least once a year. The test can be undertaken at any point during

the year, so long as it is performed at the same time every year. The company can test different reporting units for goodwill impairment at different times during the year.

However, after a company has conducted an initial goodwill allocation under Statement 142, the company may presume that the current fair value of a specific reporting unit exceeds its carrying value if three criteria are met: (1) the assets and liabilities of the reporting unit have not changed significantly; (2) the previously calculated fair value of the reporting unit substantially exceeded its carrying amount; and (3) no adverse events occurred that would indicate a likelihood that the unit's current fair value has fallen below its carrying amount. But to paraphrase an old saw, "stuff happens." The following question discusses a handful of adverse events that might prompt a goodwill impairment test.

When must a company conduct an interim impairment test?

A company should conduct an interim test for goodwill impairment if "an event occurs or circumstances change that would more likely than not reduce the fair value . . . below its carrying value." Examples include the following:

- A significant adverse change in legal factors or in the business climate.
- An adverse action or assessment by a regulator.
- Unanticipated competition.
- A loss of key personnel.
- A more-likely-than-not expectation that a reporting unit or a significant portion of a reporting unit will be sold or otherwise disposed of.
- A significant asset group is being tested for recoverability.
- Recognition of a goodwill impairment loss in the financial statements of a subsidiary that is a component of a reporting unit.

What are the mechanics of Statement 142 goodwill impairment testing?

Goodwill is measured under Statement 142 using a two-step impairment test:

- *Step 1: Compare the fair value of the reporting unit with its book value.* In the first step of the impairment test, the acquirer

determines the fair value of the reporting unit using one or more of the approaches discussed previously (income approach, cost approach, and market approach). The acquirer compares this estimated fair value to the reporting unit's book value. If the fair value is greater than the book value, the impairment test ends and there is no charge to earnings. If the fair value is less than the book value, the impairment test continues on to Step 2.

- *Step 2: Compare the implied fair value of goodwill to its recorded value.* In the second step, the acquirer estimates the fair value of the reporting unit's goodwill. This is accomplished by allocating the fair value of the reporting unit calculated in Step 1 to the individual assets and liabilities in the reporting unit. In effect, this requires a hypothetical purchase accounting allocation at the testing date. (Note that this is only done to test goodwill for impairment. The actual assets and liabilities of the reporting unit are not revalued on the balance sheet.)

The excess of the fair value of the reporting unit over the sum of the fair values of the net assets is the implied goodwill. The impairment charge is the excess of the goodwill recorded on the balance sheet over the implied fair value of the goodwill. However, while the charge resulting from this test is limited to the recorded goodwill, there may be additional write-downs resulting from the application of Statement 144 to other assets in the reporting unit. Also, once written down, goodwill cannot be written back up.

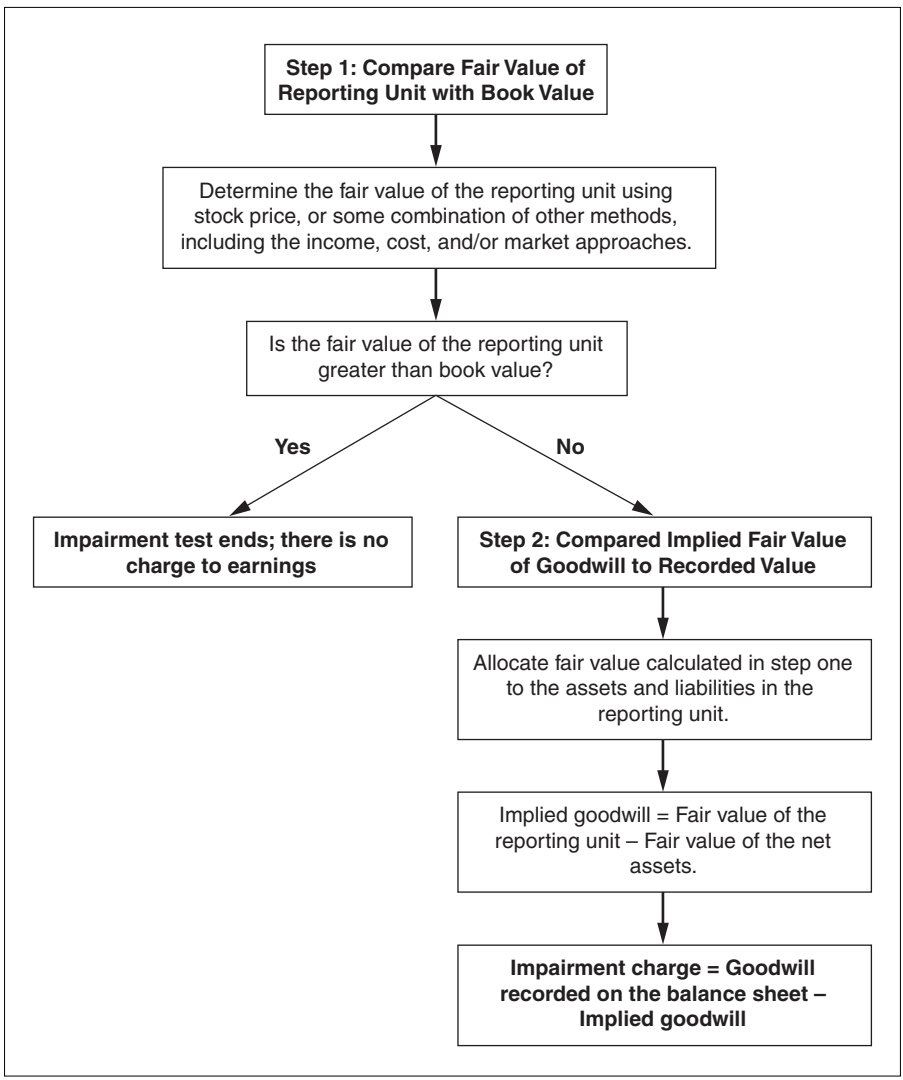
Figure 5-1 illustrates the two-step impairment test required under Statement 142.

Can you provide examples of the goodwill impairment test?

- *Example 1: No impairment charge.* Consider Corporation A with a custom magazine publishing component that comprises a reporting unit. Assume that the fair value of the unit is determined to be $5 million, the carrying value of the unit on Corporation A's balance sheet is $3 million, and the carrying value of the unit's goodwill is $1 million. Under Step 1 of the goodwill impairment test, Corporation A would compare the unit's fair value, $5 million, and its carrying value, $3 million, and conclude that the fair value of the reporting unit is greater than its book value. As a result, the impairment test would end and there would be no need to evaluate the carrying value of the unit's goodwill.

FIGURE 5-1

Statement 142 Goodwill Impairment Test



Source: Statement 142, Bear Stearns & Co. Inc.

- *Example 2: Impairment charge required.* Assume further that Corporation A also has a paper manufacturing component that comprises a second reporting unit with a fair value of $25 million, a carrying value of $30 million, and goodwill with a carrying value of $10 million.
- *Under Step 1,* the fair value of the reporting unit, $25 million, is less than its carrying value, $30 million, so Corporation A would move on to the second step.
- *Under Step 2,* management would determine the fair value of each identifiable physical and intangible asset, and each identifiable liability, using a purchase price allocation method as if Corporation A had just acquired the reporting unit. Assume the fair value of the unit's tangible assets is $14 million, its intangible assets is $6 million, and the unit has no debt. The reporting unit's implied goodwill is $5 million, calculated as the difference between the unit's tangible and intangible assets, $20 million, on the one hand, and the fair value of the reporting unit, $25 million, on the other hand. Corporation A would have to record an impairment charge of $5 million, calculated as the carrying value of the unit's goodwill, $10 million, less the implied goodwill at the time of the impairment test, $5 million.

Can the manner in which the acquirer structures its reporting units influence the results of a goodwill impairment test?

Yes. The acquirer can generally organize its internal reporting units in order to best fit its needs with respect to goodwill impairment tests. For example, if the acquirer has a unit with previously unrecognized goodwill (i.e., goodwill that does not appear on the unit's balance sheet), the acquirer can fold the acquired company into the unit and use the unrecognized goodwill as a cushion against future impairment tests.

An acquirer may have unrecognized goodwill from internal development efforts such as research output, advertising, brand name, workforce in place, market share, and franchise value. (For this reason, a large reporting unit might be less susceptible to a goodwill impairment charge than a small unit.) In addition, an acquirer may have unrecognized goodwill from a company previously acquired under past pooling-of-interest accounting rules.

As a result, a company that historically had growth through acquisitions that qualified for poolings treatment might have an inherent advantage over

businesses that were either less acquisitive or that historically chose purchase accounting over poolings of interest: the past poolings-acquirer might be less likely to report goodwill impairment, all else being equal. This might result in more consistent earnings.

TAX CONSIDERATIONS

What are the principal goals of tax planning for a merger, acquisition, or divestiture?

From the purchaser's point of view, the principal goal of tax planning is to minimize, on a present value basis, the total tax costs of not only acquiring, but also operating, and even selling the acquired corporation or its assets. In addition, effective tax planning provides various safeguards to protect the parties from the risks of potential changes in circumstance or in the tax laws. Moreover, the purchaser should attempt to minimize the tax costs of the transaction to the seller in order to gain advantage as a bidder. (Of course, to realize this advantage, the buyer needs to point out the advantages to the seller, who may not be familiar with tax implications of particular structures.)

From the seller's point of view, the principal goal of tax planning is to maximize, on a present value basis, the after-tax proceeds from the sale of the acquired corporation or its assets. This tax planning includes, among other things, deciding how to structure the transaction, developing techniques to provide tax benefits to a potential buyer at little or no tax cost to the seller, and structuring the receipt of tax-deferred consideration from the buyer.

Are the tax planning goals of the buyer generally consistent with those of the seller?

No. More often than not, the most advantageous tax plan for the buyer is the least advantageous plan for the seller. The phrase *win-win* usually cannot apply. For example, the tax benefit of a high basis in the assets of the acquired corporation might be available to the purchaser only at a significant tax cost to the seller. (The first section of this chapter will define the term *basis.*) But buyers rarely if ever pursue tax benefits at the seller's expense, because the immediate and prospective tax costs of a transaction are likely to affect the price. Generally, the parties will structure the transaction to minimize the aggregate tax costs of the seller and buyer, and allocate the tax burden between them through an adjustment in price.

What tax issues typically arise in an acquisition or divestiture?

There is no definitive checklist of tax issues that might arise in every acquisition or divestiture. The specific tax considerations for a transaction depend upon the facts and circumstances of that particular deal. Certain tax terms and issues, however, many of which are interrelated, are more common than others:

- To have a useful impact on tax matters, participants in a transaction must grasp certain contacts, such as *earnings and profits* or *distribution.* We discuss this later in this chapter.
- A primary issue is the *basic structure of the transaction:* whether the transfer is devised as a stock acquisition or an asset acquisition, and whether the transaction can be structured as a tax-free reorganization or if the transfer will be immediately taxable. The optimal structure is generally the one that maximizes the aggregate tax benefits and minimizes the aggregate tax costs of the transaction to the acquired corporation, the seller, and the buyer.
- Another initial question to be resolved in many acquisitions is the so-called *choice of entity* issue: whether the operating entity will be a C corporation, an S corporation, a general or limited partnership, a limited liability company (LLC), or a trust.
- The tax implications of the *financing* (cash, debt, and/or equity) must also be analyzed.
- The issue of *management participation and compensation* should also be addressed. Top-level managers of the company being acquired might be invited to purchase stock, or they might be granted stock options, stock appreciation rights, bonuses, or some other form of incentive compensation. Different structures of management participation can create vastly different tax results.
- In addition, tax advisors (particularly for the purchaser) should examine the *tax effects* that the proposed structure will have on the post-acquisition operations of the company. For example, consideration should generally be given to net operating losses, credit carrybacks and carryforwards, amortization of intangible assets (other than goodwill), the alternative minimum tax, planned asset dispositions, elections of taxable year and accounting methods, integration of the company's accounting methods into the buyer's existing operations, foreign tax credits, and the

interrelationships among the differing tax systems of the countries in which the combining companies do business.

- Tax advisors should also give attention to other matters, including the *effects of state tax laws,* the tax consequences of future *distributions* of the acquired company's earnings, and the ultimate *disposition* of the acquired company or its assets.

These issues should be analyzed with an eye on pending and recent M/A/B-related tax legislation, keeping retroactivity in mind.

Does the IRS play a direct role in business acquisitions?

Generally speaking, no. Unlike certain transactions regulated by federal agencies such as the FCC and the FTC, advance approval from the IRS is not required before consummating an acquisition, divestiture, or reorganization. Ordinarily, the IRS will not have occasion to review a transaction unless and until an agent audits the tax return of one of the participants.

An important and often useful exception to this rule is that the parties to a transaction can often obtain a private letter ruling issued by the National Office of the IRS. Such a ruling states the agency's position with respect to the issue raised and is generally binding on the IRS. Requesting such a ruling is a serious business and should never be undertaken without expert legal help.

Basic Tax Concepts and Definitions

What is basis?

A taxpayer's basis in an asset is the value at which the taxpayer carries the asset on its tax balance sheet. An asset's basis is initially its historical cost to the taxpayer. This *initial basis* is subsequently increased by capital expenditures and decreased by depreciation, amortization, and other charges, becoming the taxpayer's *adjusted basis* in the asset. Upon the sale or exchange of the asset, gain or loss for tax purposes is measured by the difference between the amount realized for the asset and its adjusted basis.

The basis of the asset represents, in effect, the amount at which the cost of the asset may be recovered free of tax through depreciation deductions and adjustments to gain or loss upon disposition.

What are earnings and profits?

The phrase *earnings and profits* is a term of art in the tax code. For financial reporting purposes, the amount of a corporation's earnings and profits is roughly equivalent to a corporation's net income and retained earnings as distinguished from current or accumulated taxable income. The primary purpose of the earnings and profits concept is to measure the capacity of a corporation to distribute a taxable dividend. If the IRS believes that a corporation, by virtue of its current and accumulated earnings and profits, can pay a taxable dividend, it may view certain nonliquidating distributions as dividends and tax them as such—even if the corporation does not (and never has) issued a dividend.

What is a distribution?

A *corporate distribution* means an actual or constructive transfer of cash or other property (with certain exceptions) by a corporation to a shareholder acting in the capacity of a shareholder. (The phrase, "acting in the capacity of a shareholder," is admittedly a mouthful, but essentially means that the shareholder receives the payment because of the status as an owner of the corporation.) For tax purposes, a transfer of property to a shareholder acting in the capacity of an employee or lender, in contrast, is not a corporate distribution.

What is a liquidation?

Corporate liquidation occurs when a corporation ceases to be a going concern. At this point, its actions are limited to winding up its affairs, paying its debts, and distributing its remaining assets to its shareholders. A liquidation for tax purposes may be completed prior to the actual dissolution of the corporation under state law.

What is a liquidating distribution?

A *liquidating distribution* is generally a distribution (or one of a series of distributions) made by a liquidating corporation in accordance with a plan of complete liquidation.

What is a nonliquidating distribution?

A *nonliquidating distribution* is any distribution by a corporation to a shareholder that is not a liquidating distribution. A nonliquidating distribution is

generally either a dividend or a distribution in redemption of some (but not all) of the corporation's outstanding stock.

What are the tax consequences to corporations of distributions of property to their shareholders?

The taxation of corporate distributions involves myriad complex rules, many with exceptions and qualifications. In general, however, the tax consequences to corporations of distributions of property depend upon three factors: (1) whether the property distributed is cash or property other than cash; (2) whether the recipient shareholder is an affiliated corporation; and (3) whether the distribution is a liquidating or nonliquidating distribution.

Distributions of cash, both liquidating and nonliquidating, generally have no tax consequences to the distributing corporation, except that the amount distributed reduces the corporation's earnings and profits.

Distributions of appreciated property, both liquidating and nonliquidating, generally trigger the recognition of gain to the distributing corporation to the extent of the appreciation in the asset.

What is an affiliated group of corporations?

An *affiliated group of corporations* consists of two or more member corporations where the parent corporation controls, directly or indirectly, the stock of each of the subsidiary corporations. More precisely, the parent corporation must generally own a certain percent (usually 80 percent) of the voting power and equity value of at least one of the subsidiary corporations. Other members of the group have similar ownership levels in the other subsidiaries. Certain corporations, such as foreign corporations, are not permitted to be members of an affiliated group.

What is a consolidated federal income tax return?

It is a single federal income tax return made by an affiliated group of corporations in lieu of a separate return for each member of the group.

What are the advantages of filing consolidated federal income tax returns?

The principal advantages of a consolidated return are as follows:

- Losses incurred by one member of the group may be used to offset the taxable income of another member.
- The tax consequences of many intragroup transactions are either deferred or wholly eliminated.
- Earnings of the subsidiary corporations are reflected in the parent's basis in the stock of the subsidiary, so that such earnings are not taxed again on the sale of such stock by the parent.

Is there such a thing as a consolidated state income tax return?

Yes, but not all states allow an affiliated group of corporations to file a combined (consolidated) tax return. Some states do not allow combined returns at all; others allow them only in limited circumstances.

What is a tax year?

Every entity and individual that is required to file a tax return must do so on the basis of an annual accounting period. For individuals, the annual accounting period is almost always the calendar year. For other entities, however, the tax accounting period may be either a calendar year or a fiscal year ending on the last day of a month other than December. An entity's tax year need not coincide with its fiscal year for purposes of financial accounting. Extensive rules govern the selection of tax years other than calendar years by C corporations, S corporations, LLCs, partnerships, and trusts.

What is the current U.S. federal income tax rate structure?

Corporate tax rates are 34 percent for businesses with taxable income of up to $10 million, and 35 percent for larger companies (plus a surtax on taxable income of more than $15 million). Generally, ordinary income and capital gains are taxed at the same rate under corporate tax law.[14]

Is the distinction between capital gains and ordinary income still relevant in tax planning?

Yes. In its most recent tax bills, Congress retained the myriad rules and complexities in the tax code pertaining to capital gains and losses. More important for tax planning is that the IRC retains various limitations on the use of

capital losses to offset ordinary income. So M/A/B planners must still pay attention to the characterization of income or losses as capital or ordinary.

What is the significance of the relationship between the corporate and individual tax rates?

Corporations can be used to accumulate profits when the tax rate on the income of corporations is less than the tax rate on the income of individuals. (Offsetting this benefit is the double tax on corporate earnings—paid once by the company and then by the stockholders receiving the company's dividends.[15]) Conversely, noncorporate pass-through entities can be used to store profits when the tax rate on the income of corporations is greater than the tax rate on the income of individuals.

How does capital gains tax fit in?

A shareholder's tax on the sale or liquidation of interest in the corporation is determined at preferential capital gains rates.

Is the tax treatment different for debt versus equity?

Yes. Debt interest is deductible for tax purposes. However, dividends paid on common stock are not deductible in calculating income for tax purposes.

How does the double tax on corporate earnings work?

The IRC sets forth a dual system of taxation with respect to the earnings of corporations. Under this system, a corporation is taxed as a separate entity, unaffected by the tax characteristics of its shareholders. The corporation's shareholders are subject to tax on their income from the corporation if and when corporate earnings are distributed to them in any form.

What are the practical consequences of the dual system of corporate taxation?

The primary consequence of the dual system of taxation is that corporate earnings are generally taxed twice—first at the corporate level and again at the

shareholder level. The shareholder-level tax may be deferred but not eliminated when the corporation retains its earnings rather than paying it out in dividends. If the earnings and profits rules of the IRC are violated, the shareholders will pay a second level of tax when they sell their interests in the corporation.

How can leverage reduce the effects of double taxation?

A leveraged company's capital structure is tilted toward debt instead of equity. Leverage reduces or eliminates the negative effect of double taxation of corporations in two ways. First, unlike dividend payments to shareholders, which are generally taxable, debt repayments to lenders are not generally taxable to the recipient.[16] Second, in most cases, interest payments are tax deductible to the corporation making them.[17]

It is very important to remember, however, that the IRS might take the position that a purported debt is actually equity, thus eliminating the benefit of leverage. While a thorough discussion of the circumstances under which the IRS might take this position are outside the scope of this book, a key consideration is whether the leveraged company has enough equity underpinning the debt to adequately support it (i.e., thinly capitalized). While there is no bright line test, a debt-equity ratio of greater than 7:1 might raise serious IRS scrutiny. If the debt is reclassified as equity, interest and repayment of principal might be taxable as dividends. A corporation can minimize the likelihood of IRS scrutiny by (1) adequately documenting the debt instrument, (2) structuring reasonable debt terms, such as a market interest rate and a definite maturity rate, (3) adhering to the debt repayment schedule, (4) not structuring payments that are contingent on earnings, and (5) as previously noted, maintaining a prudent debt-equity ratio. Other red flags to consider are if shareholders hold similar pro rata positions of debt and equity, or if the use of funds is for start-up operations.

What is the alternative minimum tax, or AMT?

The alternative minimum tax was enacted in 1969 to curb exploitation of deductions and preferences by certain high-income individuals and corporations. In later tax legislation, Congress amended the minimum tax provisions and created a rather severe regime of alternative minimum tax, particularly for corporations. The *alternative minimum tax* (AMT) for both individuals and corporations is determined by computing taxable income under the regular

method (with certain adjustments), and adding back certain deductions or "preferences" to obtain AMT income. To this amount is applied the AMT rate for individuals or for corporations. The taxpayer is required to pay the greater of the regular tax or the AMT. (Recent legislation has exempted middle-income individuals from paying an AMT.) Small businesses are exempt from AMT.[18] Currently under this law, a small business is a corporation that has revenues of less than $7.5 million.[19]

What is (or was) the General Utilities rule?

Under the dual system of taxation, corporate earnings from the sale of appreciated property are taxed twice, first to the corporation when the sale occurs, and then to the shareholders upon the distribution of the net proceeds. A long-standing exception to this system was the so-called *General Utilities rule.* Named after a 1935 Supreme Court decision, this rule permitted nonrecognition of gain to the corporation upon certain distributions to shareholders of appreciated property.

The breadth of the General Utilities rule was narrowed over the years, both statutorily and judicially. In the Tax Reform Act of 1986, Congress repealed the rule entirely, with certain temporary exceptions (now expired) for small corporations. The repeal of the General Utilities rule increased the tax costs, or reduced the tax benefits allowed under prior law, of acquiring and disposing of appreciated corporate assets. Specifically, the change in law substantially narrowed the circumstances in which an acquisition or divestiture will be structured as an asset purchase, and increased the prevalence of stock transactions. Additionally, the repeal of the General Utilities rule placed greater emphasis on the use of pass-through entities wherever possible.

Basic Tax Structure: Taxable Transactions

How does an asset acquisition for tax purposes differ from a stock acquisition for tax purposes?

The basis a purchaser takes in the assets acquired is the primary distinction between an *asset acquisition* and a *stock acquisition* for tax purposes. When a purchaser directly acquires the assets of another corporation, and the acquired company is subject to tax on the sale or exchange of the assets, the basis of the

assets to the purchaser is their cost. This is called *cost* or *stepped-up basis*. When a purchaser indirectly acquires the assets of another corporation through the acquisition of stock, the basis of the assets in the possession of the corporation is generally not affected. This is called *carryover basis* because the basis of an asset in the acquired corporation carries over on the change of stock ownership.

With the exception of a stock acquisition governed by the provisions of Section 338 of the IRC, the acquisition of all or part of the stock of a corporation does not alter the bases of the assets owned by the corporation. (In a Section 338 transaction—which is an indirect asset acquisition—the acquisition's cost basis in each asset is generally its fair market value.) With the exception of an asset acquisition governed by the IRC's tax-free reorganization provisions, the acquisition of the assets of a corporation will produce a cost basis to the purchaser.

A cost basis transaction is, therefore, often referred to as an *asset acquisition for tax purposes* (or as an *asset acquisition* for short), and a carryover basis transaction is often referred to as a *stock acquisition for tax purposes* (or a *stock acquisition* for short). Neither of these terms necessarily reflects the actual, legal structure of the transaction.

What types of transactions are carryover basis, or stock, transactions?

As a general rule, a carryover basis, or stock, acquisition includes any transaction where the stock or assets of the acquired corporation are acquired by the purchaser, and the bases of the assets of the acquired company are not increased or decreased on the change of ownership. There are several types of stock or carryover basis transactions. The direct purchase of the acquired corporation stock in exchange for cash and debt is the most straightforward stock acquisition. Another transaction that is treated as a sale of stock for tax purposes is the merger of the acquiring corporation into the acquired corporation—a reverse merger—where the shareholders of the acquired corporation relinquish their shares in exchange for cash or debt in a fully taxable transaction. Another common stock transaction is the purchase of the stock or assets of the acquired corporation in a transaction free of tax to its exchanging shareholders.

What types of transactions are cost basis, or asset, transactions?

As a general rule, a cost basis, or asset, acquisition includes any transaction where the pre-acquisition gains and losses inherent in the assets acquired are

triggered and recognized by the acquired corporation. There are several types of cost basis transactions. The direct purchase of the assets from the acquired corporation in exchange for cash or indebtedness is the quintessential asset acquisition. Another common asset transaction is the statutory merger of the acquired corporation into an acquiring corporation—a forward cash merger—where the shareholders of the acquired corporation exchange their shares for cash or other property in a fully taxable transaction. In certain circumstances, a corporation may acquire the stock of another corporation and elect under Section 338 of the IRC to treat the stock acquisition, for tax purposes, as an asset acquisition.

What is the significance to the purchaser of the basis of the assets in the acquired corporation?

The basis of the assets in an acquired corporation may have a significant and continuing effect on the tax liabilities and, therefore, the cash flow of either the purchaser or the acquired corporation. The basis of an asset represents the extent to which the asset may be depreciated or amortized (if at all), thereby generating noncash reductions of taxable income. Basis also represents the extent to which the consideration received in a taxable sale or exchange of an asset may be received by the seller free of tax.

What is the prospective cost basis of an asset to the purchaser?

The *prospective cost basis* of an asset to the purchaser is the price that it will pay for the asset, directly or indirectly, which is presumed to be its fair market value.

What is the prospective carryover basis of an asset to the purchaser?

The prospective carryover basis of an asset to the purchaser is simply the adjusted basis of the asset in the possession of the acquired corporation prior to its acquisition. As explained previously, the adjusted basis of an asset is generally its historical or initial cost, reduced or adjusted by subsequent depreciation or amortization deductions.

What is meant by stepped-up basis?

Where the basis of an asset is increased from the acquired corporation's lower initial basis (or adjusted basis, if different) to a basis determined by a

purchaser's cost or fair market value, the basis of the asset is said to have been *stepped up.* The term may refer, however, to any transaction in which the basis of an asset is increased. In most asset, or cost basis, transactions, the basis of the assets of the acquired corporation is stepped up to the purchaser's cost. An acquisition in which the basis of the assets of the target corporation is increased is referred to as a step-up transaction.

Who benefits from a cost (stepped-up) basis?

Generally, the buyer. High tax basis in an asset is always more beneficial to its owner than low basis. The higher the basis, the greater the depreciation or amortization deductions (if allowable), and the less the gain (or the greater the loss) on the subsequent disposition of the asset. An increase in these deductions and losses will reduce the tax liabilities of the purchaser or the acquired corporation during the holding period of the assets, thereby increasing after-tax cash flow. For the same reasons, a high basis in the acquired corporation's assets will enhance their value to a potential carryover basis purchaser.

The purchase of another company should generally be structured to maximize the basis of the assets of the acquired corporation. If a purchaser's prospective cost basis in the assets of the acquired corporation exceeds its prospective carryover basis, an asset acquisition or step-up transaction is generally more beneficial to the purchaser than a stock acquisition. If a purchaser's prospective carryover basis exceeds its prospective cost basis in the assets of the acquired corporation, a stock acquisition is generally more beneficial to the purchaser than an asset, or cost basis, acquisition.

The primary exceptions to this general rule are the situations where (1) the purchaser would acquire beneficial tax attributes—NOLs, tax credits, or accounting methods—in a carryover basis transaction that would be lost in a step-up transaction, and (2) the value of such tax attributes to the purchaser exceeds the value of the stepped-up basis in the acquired corporation's assets that it would have obtained in a cost basis transaction.

Will a purchaser's cost basis in an asset generally be greater than its carryover basis?

Yes. Where an asset has appreciated in value, or where the economic depreciation of an asset is less than the depreciation or amortization deductions allowed for tax purposes, a purchaser's prospective cost basis in the asset will exceed its prospective carryover basis. The depreciation and amortization deductions allowed for tax purposes for most types of property are designed to

exceed the actual economic depreciation of the property. As a result, the fair market value of most assets, which represents the prospective cost basis of the asset to a purchaser, generally exceeds adjusted tax basis. The aggregate difference between the purchaser's prospective cost and carryover bases of the acquired corporation's assets is often substantial.

Will a purchaser generally receive greater tax benefits by acquiring another corporation through a cost basis transaction than through a carryover basis transaction?

Yes. A purchaser will generally acquire a higher basis in the assets of the acquired corporation through a cost basis transaction than through a carryover basis transaction because the cost or fair market value of the assets acquired is generally greater than the adjusted basis of the assets prior to the transaction. In that circumstance, a cost basis transaction will step up the basis of the assets of the acquired corporation. The amount of the increase in basis—the excess of cost basis over carryover basis—is referred to as the *step-up amount.*

Do all asset, or cost basis, transactions step up the bases of the acquired corporation's assets?

No. Where the purchase price of the assets of the acquired corporation, which is presumed to equal their fair market value, is less than the carryover basis of the assets, a cost basis, or asset, transaction will result in a net reduction of basis. In such cases, the transaction should generally be structured as a carryover basis, or stock, acquisition.

In what circumstances are carryover basis transactions more beneficial to a purchaser, from a tax standpoint, than cost basis transactions?

There are two situations where a carryover basis, or stock, transaction may be more beneficial to the purchaser than a cost basis, or asset, acquisition. The first is where the carryover basis of the acquired corporation's assets to the purchaser exceeds their cost basis. This excess represents potential tax benefits to the purchaser—noncash depreciation deductions or taxable losses—without a corresponding economic loss. That is, the tax deductions or losses

from owning the assets may exceed the price paid for such assets. The second is where the acquired corporation possesses valuable tax attributes—net operating loss carryovers, business tax credit carryovers, or accounting methods, for example—that would inure to the benefit of the purchaser. Situations where carryover basis transactions are preferable to the purchaser over cost basis transactions, however, are more the exception than the rule.

What is Section 338 of the IRC?

Section 338 of the IRC applies to taxable acquisitions. The provision enables an acquirer to treat a purchase of stock as a purchase of assets for tax purposes. This election can be attractive to the acquirer because the buyer obtains a stepped-up basis in the selling company's assets. This step-up, in turn, provides the acquirer with a higher depreciable tax base in the assets and generates higher tax deductions in future years.

After a Section 338 acquisition, must the purchaser retain the acquired company as a subsidiary?

The purchasing corporation is permitted to liquidate the company in a tax-free liquidation as soon after the qualified stock purchase as it wishes. Such a liquidation may be structured as a statutory merger.

What are loss carryovers and carrybacks?

If a corporate taxpayer has an excess of tax deductions over its taxable income in a given year, this excess becomes an NOL of that taxpayer. Section 172 of the IRC allows that taxpayer to use its NOL to offset taxable income in subsequent years (a carryover or carryforward) or to offset taxable income in earlier years (a carryback). For most taxpayers, an NOL may be carried back for up to two taxable years and may be carried forward for up to 20 years.

Under other provisions of the IRC, certain tax losses or tax credits that are unusable in a given year may be carried forward or carried back to other tax years. Examples of such deductions or credits are capital losses, excess foreign tax credits, and investment credits. Generally, IRC provisions for a company's ability to use NOL carryovers apply as well to these other items. For purposes of simplicity, all of these items tend to be grouped together with loss carryovers. This is a practice that we will follow in the discussion here.

One other important limitation applies to NOLs under federal tax law. For NOLs arising in taxable years ending before December 31, 2001, the NOL may be used to offset AMT income by up to 90 percent. In the special legislation briefly mentioned, Congress increased this to 100 percent of AMT income for taxpayers with NOL carryforwards, effective for tax years beginning after December 31, 2001. In addition, Congress increased the limit to 100 percent for deductions for NOLs attributable to carrybacks arising in tax years ending in 2001 and 2002, as well as NOL carryforwards in 2001 and 2002.

Generally speaking, each state has its own NOL carryback and carryforward rules, which might not necessarily match the federal rules. Therefore, an acquired corporation might have different amounts of available federal and state NOLs.[20]

What role do loss carryovers play in mergers and acquisitions?

As stated previously, a potential advantage in carryover basis acquisitions (both taxable stock purchases and tax-free reorganizations) is the carryover of basis and of favorable tax attributes in the hands of the buyer. To the extent that a buyer can purchase an acquired corporation and retain favorable NOL carryovers, it can increase the after-tax cash flow generated by the activities of the acquired corporation and, to some extent, utilize those losses to offset tax liability generated by the buyer's own operations.

Over the course of many years, Congress and the IRS have imposed various limitations on the use of loss carryovers by persons other than those who owned the entity at the time that the loss was generated. For example, after a substantial ownership change, an acquiring corporation can deduct the NOLs of the acquired corporation only up to a certain limit, called a *Section 382 limitation,* and must meet a *continuity of business enterprise* requirement. Continuity of business enterprise means the continuation of a significant business of the acquired corporation's business assets. These rules have achieved a level of complexity that is extreme even by the standard of the tax laws generally.

What happens when corporations having loss carryovers acquire other corporations that generate taxable gains?

The IRC covers this in Section 384, which limits a company's ability to offset its losses against taxable gains recognized by the subsidiaries that it

acquires (and with which it files a consolidated tax return). Loss carryovers of the acquiring corporation include unrealized built-in losses.

How do accounting authorities treat net operating losses? Is there some flexibility here?

Statement 109 mandates recognition of the tax consequences of a transaction or an event in the same period that the transaction or event is recognized in the enterprise's financial statements (called the *one-event approach*). The crucial event for recognition purposes is the event that gives rise to the deductible temporary difference or tax credit or NOL carryforward. Once that event occurs, those tax benefits should be recognized subject to an impairment challenge.

Under Statement 109:

- Deferred tax liabilities are recognized for future taxable amounts, deferred tax assets are recognized for future deductions and operating loss and tax credit carryforwards, and the liabilities and assets are then measured using the applicable tax rate.
- A valuation allowance is recognized to reduce deferred tax assets to the amounts that are more likely than not to be realized, and the amount of the allowance is based on available evidence about the future.
- Deferred tax expense or benefit is computed as the difference between beginning and ending balance of the net deferred tax asset or liability for the period.
- Generally, deferred tax assets and liabilities are classified as current or noncurrent in accordance with the classification of the related asset or liability for financial reporting purposes.
- The effects of changes in rates or laws are recognized at the date of enactment.

These requirements, like all tax accounting requirements, continue to go through refinement—most recently as part of a project on "Uncertain Tax Positions (Recognition of Tax Benefits)." In mid-2006, the FASB decided that the measurement attribute for the amount of recognized tax benefit should be the "maximum amount which is more likely than not to be realized."[21]

There are two particularly important issues to consider upon application of Statement 109:

- *Operating loss and tax credit carryforwards and carrybacks.* Enterprises must identify the availability of NOL and tax credit carryforwards, their expiration dates, and limitations on their use, for each taxing jurisdiction. Statement 109 presumes that the enterprise will be able to use these benefits, subject to an impairment challenge. Under either of the predecessor standards, tax credit carryforwards that could not be used to reduce recorded deferred tax liabilities were not recognized but were disclosed in the notes to the financial statements.
- *Valuation allowance.* A key concept underlying the measurement of net deferred assets is that the amount to be recognized is the amount of deferred benefit to be realized. In its deliberation, the FASB considered how high the recognition threshold should be. The FASB concluded that if it allowed asset recognition only when realization was ensured beyond a reasonable doubt, some assets would not be recognized even though they were expected to be realized. This led to the conclusion that a lower threshold—recognition if realization is more likely than not—would be preferable.

Realization of tax benefits is dependent on whether there will be sufficient future taxable income of the appropriate character in the period during which deductible temporary differences reverse, or within the carryforward period established under the tax law. If, on the basis of available evidence, it is more likely than not that all or a portion of the deferred tax asset will not be realized, the asset must be reduced by a valuation allowance.

What are the tax consequences of a cost basis, or asset, acquisition to the acquired corporation?

The general rule is that the basis of an asset in the possession of an acquired corporation may not be stepped up to cost or fair market value without the recognition of taxable gain to the corporation. In a cost basis transaction, the acquired corporation will generally be subject to an immediate tax on an amount equal to the aggregate step-up in the bases of the assets. In addition, the

sale or exchange of an asset may trigger the recapture of investment or business tax credits previously taken by the acquired corporation on the acquisition of the asset.

What are the tax consequences of a cost basis, or asset, acquisition to the shareholders of the acquired corporation?

The shareholders of the acquired corporation will be subject to tax upon the receipt of the asset sales proceeds (net of the corporate-level tax) from the acquired corporation, whether the proceeds are distributed in the form of a dividend, in redemption of the shareholders' acquired corporation stock, or in complete liquidation of the acquired corporation. If the asset sale's proceeds are retained by the acquired corporation, then the value of those proceeds is indirectly taxed to the shareholders upon the sale or exchange of the stock of the acquired corporation.

In what circumstances will an acquired corporation and its shareholders be subject to double tax on a cost basis, or asset, acquisition?

The acquired corporation and its shareholders will typically be subject to double tax where (1) the acquired corporation sells, or is deemed for tax purposes to sell, its assets to the purchaser in a taxable transaction; (2) the shareholders of the acquired corporation will ultimately receive the proceeds of the sale, either directly or indirectly through the sale of their stock in the acquired corporation; and (3) the receipt of the proceeds by the shareholders of the acquired corporation will be taxable to them. The cost basis transaction in these circumstances causes the proceeds of the sale to be taxed twice, first to the acquired corporation and again to its shareholders. There are several significant exceptions to this general rule.

The most common exception is those situations where a selling shareholder of the acquired corporation stock is a C corporation: the proceeds from the sale of the acquired corporation's stock by a corporate shareholder will likely be taxed again upon their ultimate distribution to noncorporate shareholders.

On balance, which type of structure is preferable: an asset or stock acquisition?

Generally, a stock acquisition is preferable to an asset acquisition because of the adverse tax consequences to the seller. The immediate tax cost to the acquired corporation and its shareholders on the basis step-up amount of asset acquisition is generally greater than the present value of the tax benefits to the purchaser.

What are the circumstances in which a cost basis, or asset, acquisition transaction is justifiable for tax purposes?

An asset, or cost basis, transaction is generally advisable for tax purposes in situations where the double-tax burden to the seller can be partially or wholly avoided and in situations where double tax is inevitable regardless of the structure. For instance, the seller may be able to avoid the double-tax burden where tax losses from other corporate activities can offset the taxable gains that arise from the sale of assets. Alternatively, where the sales price of the assets is less than the seller's tax basis in those assets, the seller may actually generate a tax benefit from structuring the deal as an asset sale rather than as a stock sale.

Previously you said that a pass-through entity isn't subject to double taxation like a C corporation is. Can a seller avoid the double tax by converting the acquired corporation to a pass-through entity immediately prior to a sale?

No. In general, a corporation can convert to a pass-through entity only by first undergoing a taxable liquidation. The companion book to this series, *The Art of M&A Structuring: Techniques for Mitigating Financial, Tax, and Legal Risk,* discusses taxable liquidations in more detail. For all practical purposes, such liquidations are taxed the same as an asset sale. Where an acquired C corporation converts to an S corporation, a special corporate-level tax will be imposed on the sale or exchange of the assets of the acquired corporation to the extent of the built-in gain in its assets as of the time of the conversion.

How can a seller reduce tax costs?

The simplest way to reduce the seller's tax bill is to postpone the recognition of gain. This may be accomplished in a tax-free or partially tax-free acquisition or via the installment sale route.

What are installment sales and how can they help in structuring a merger, acquisition, or buyout?

An installment sale is a disposition of property (by a person who is not a dealer in such property) in which at least one payment is to be received after the close of the taxable year in which the sale occurs. Basically, an installment sale is a sale or exchange for a promissory note or other debt instrument of the buyer. In the case of an installment sale, the gain on the sale is recognized, pro rata, whenever principal payments on the note are received, or if earlier, upon a disposition of the installment obligation. For example, if A sells property to B for a note with a principal amount of $100 and A's basis in the property was $60, A realizes a gain of $40. Because the ratio of the gain recognized ($40) to the total amount realized ($100) is 40 percent, this percentage of each principal payment received by A will be treated as taxable gain. The other $60 will be treated as a nontaxable return of capital.

Installment sale treatment is available only with respect to a debt obligation of the buyer itself, as opposed to a related third-party issuer. An obligation of the buyer will not qualify if it is payable on demand, or, generally, if it is in registered form and/or designed to be publicly traded. Note, however, that an installment obligation may be guaranteed by a third party and may even be secured by a standby letter of credit. In contrast, installment obligations secured by cash or cash equivalents, such as certificates of deposit or U.S. Treasury instruments, do not qualify.

What kinds of transactions are eligible for installment sale treatment?

The installment method is generally available for sales of any property other than installment obligations held by a seller, and other than inventory and property sold by dealers in the subject property. Subject to certain exceptions, installment treatment is generally available to shareholders who sell their stock or to corporations or other entities that sell their assets. Installment treatment is not available for sales of stock or securities that are traded on an established securities market.

Basic Tax Structure: Tax-Deferred Transactions

What exactly is a tax-deferred transaction and how does it differ from a tax-free transaction?

The term *tax-free* in its purest sense means that no tax is ever paid on the transaction, while the term *tax-deferred* means that the tax is paid later. Colloquially, many professionals use the terms interchangeably. Technically *tax-deferred* is more accurate for all transactions. Also, most tax-deferred transactions take the form of reorganizations—this is because, for tax purposes, the IRC views such transactions as a mere reshuffling of assets.

Could you give an example of a so-called tax-free reorganization that in reality only defers taxes?

In the classic tax-free acquisition, Al Smith (Smith) owns all of the stock of Mom and Pop Grocery, Inc. (Grocery), which is acquired by Supermarkets, Inc. (Supermarkets). In the transaction, Smith surrenders to Supermarkets all of his stock in Grocery solely in exchange for voting stock of Supermarkets. This is a so-called tax-free transaction known as a Type B reorganization, in which Smith recognizes no immediate gain or loss.

In other words, Smith obtains a basis in his Supermarkets stock equal to his basis in the Grocery stock surrendered (substituted basis) and continues his old holding period in the stock. Similarly, Supermarkets takes a basis in the Grocery stock acquired equal to Smith's basis (carryover basis) and also picks up Smith's holding period. Because the seller will have a basis in the buyer's stock that is the same as the seller's old basis in the acquired corporation's stock (a substituted basis), *tax is only deferred until the acquired corporation's stock is ultimately sold.*

Nonetheless, because this type of transaction is widely called tax-free, we will refer to it as that.

What are the advantages of tax-free transactions to sellers and buyers in this sense?

By participating in this type of transaction, the seller is provided the opportunity to exchange stock in the acquired corporation for stock of the buyer without the immediate recognition of gain. Where the acquired corporation is

closely held and the buyer is publicly held, the seller may obtain greatly enhanced liquidity without a current tax.

Additionally, although death and taxes are both said to be inevitable, a seller participating in a tax-free transaction may use the former to avoid the latter. Under a long-standing but controversial IRC rule, an individual's estate and beneficiaries may take a new, fair market value basis in the decedent's properties upon death. Thus, a seller may avoid the payment of any tax on the buyer's stock received in exchange for the old acquired corporation stock by holding this new stock until the seller's death.

For the buyer, there are two principal advantages to a tax-free acquisition. First, if the buyer can use stock in the transaction, significant acquisition-related debt may not be incurred (although debt might be assumed on the balance sheet of the acquired corporation at the time the deal closes). If the buyer wants equity financing anyway (as opposed to debt financing or internal growth), a business acquisition is a good way to get it. Second, the acquired corporation's tax attributes (including NOL carryovers) will remain usable after the acquisition (subject to some limitations).

What kinds of transactions may qualify for tax-free treatment?

Every transaction involving an exchange of property is taxable unless otherwise specified in the IRC. Thus, corporate acquisitions are generally taxable to the seller of stock or assets. However, several types of acquisition transactions may be tax-free to the seller, but only to the extent that the seller receives stock in the acquiring corporation (or in certain corporations closely affiliated with the acquiring corporation).

In general, tax-free acquisitions fall into three categories:

- Statutory mergers
- Exchanges of stock for stock
- Exchanges of assets for stock

All of the available tax-free acquisition transactions (except for the Section 351 transaction) are provided under Section 368 of the IRC. In all, considering the various permutations of its provisions, Section 368 ultimately sets forth more than a dozen different varieties of acquisition reorganizations. The most commonly used forms of reorganizations are the Type A, B, C, and D reorganizations. (Others are F and G reorganizations, and various hybrids.)

How does a transaction qualify as tax-free under Section 368?

To qualify as tax-free reorganizations under Section 368, all acquisitive reorganizations must meet three nonstatutory requirements:

- First, the reorganization must have a *business purpose.* That is, a transaction must be motivated by a legitimate business purpose other than tax avoidance. This requirement arises most frequently in the context of divisive reorganizations.
- The second, probably the most burdensome, is the *continuity of proprietary interest* requirement.
- Third, the acquiring corporation must satisfy the *continuity of business enterprise* requirement.

What is continuity of proprietary interest?

Continuity of proprietary interest is a legal doctrine that frequently arises in applying the IRC's tax-free reorganization rules to a specific transaction. The general reasoning behind the continuity of interest doctrine is that a reorganization is the amalgamation of two corporate enterprises. Accordingly, the equity owners of both enterprises must continue to be owners following the transaction. This rule is intended to prevent transactions that aren't really sales from being accorded tax-free treatment. Stock typically maintains a shareholder's continuity of proprietary interest in a business, while debt and cash do not.

What is continuity of business enterprise?

Continuity of business enterprise is a second legal doctrine that frequently arises in applying the IRC's tax-free reorganization rules to a specific transaction. Generally, the doctrine requires that the acquirer either (1) continue the acquired corporation's "historic business" or (2) use a "significant portion" of the acquired corporation's "historic business assets" in a business. The term *significant portion* takes a relative meaning—that is, the portion of assets that are considered significant are relative to their importance in the operation of the acquired corporation's business. However, all other facts and circumstances, such as the net fair market value of those assets, are also considered. If the acquired corporation has more than one line of business, the acquirer is only required to continue one of the selling company's lines, although the transaction is still subject to the significant portion requirement. Alternatively,

the IRC generally permits the acquirer to use the selling company's assets in *any* business—not just the acquired corporation's historic business.

What are some examples of the continuity of business enterprise requirement?

Treasury Regulation Section 1.368-2 provides a handful of examples. In one example, the acquirer (A) manufactures computers, and the target (T) manufactures components for computers. T sells all of its output to A. On January 1, 2006, A decides to buy imported components only. On March 1, 2006, T merges into A. A continues buying imported components but retains T's equipment as a backup source of supply. The use of the equipment as a backup constitutes use of a significant portion of T's historic business assets, thus establishing continuity of business enterprise. A is not required to physically continue T's business in this illustration.

In a second example, the target (T) is a manufacturer of boys' and men's trousers. On January 1, 2003, as part of a plan of reorganization, T sells all of its assets to a third party for cash and purchases a highly diversified portfolio of stock and bonds. As part of the plan, T operates an investment business until July 1, 2006. On that date, the plan of reorganization culminates in a transfer by T of all its assets to an acquirer (A), a regulated investment company, solely in exchange for A voting stock. The continuity of business interest requirement is not met. T's investment activity is not its historic business, and the stocks and bonds are not T's historic business assets.

What is a Type A reorganization?

A *Type A reorganization* (named after its alphabetic place in Section 368 of the IRC) is very simply "a statutory merger or consolidation."[22] This type of reorganization has other, more complex names—such as a *reorganization not solely for voting stock,* as distinct from a *B reorganization,* which *is* solely for voting stock. It is also referred to as a *tax-free forward merger,* as opposed to the taxable forward merger and taxable reverse merger forms discussed previously (there is no tax-free reverse merger). To qualify for a Type A, the most important consideration is whether the shareholders of the selling corporation (dubbed the target, or T, in this chapter) maintain continuity of proprietary interest by owning stock in the acquiring corporation (called the acquirer, or A, in this chapter). In order to satisfy the IRS's advance ruling requirements, the parties generally should structure the transaction so that the

acquirer pays at least 50 percent of the transaction consideration in the form of A stock—which can be either voting or nonvoting stock, and may be common or preferred shares. The rest of the consideration (up to 50 percent) can be in the form of cash, debt, or property (commonly referred to as *boot* in tax law nomenclature).

If the acquirer is a subsidiary of another corporation, may it use its parent's stock as transaction consideration in a Type A reorganization?

Yes. In the event the acquirer is a controlled subsidiary of another corporation (the acquirer's parent or, in tax parlance, a "controlling corporation"), target shareholders can receive parent stock for their shares if (1) no acquirer (i.e., subsidiary) stock is used in the transaction, and (2) the transaction would have otherwise qualified as a Type A reorganization if acquirer stock had been used instead of parent stock. This alternative is particularly attractive if the parent is publicly traded but the acquirer-subsidiary is not. In addition, if the parent is a holding company of other subsidiaries, the parent company stock may offer more diversification to the sellers.

How long must the target shareholders hold their new shares under a Type A reorganization?

The IRC generally permits the target's shareholders to sell or otherwise dispose of their shares after the transaction, although the IRS may collapse all the transactions (i.e., view all steps of a transaction as a single, integrated transaction) in applying the continuity of interest test. In particular, the IRS must consider whether a subsequent disposal of shares is part of the overall plan (e.g., whether, prior to the transaction, the target's shareholders entered into a binding agreement to sell their shares after the closing). In situations in which the IRS finds the subsequent disposal to be part of the overall transaction plan, the agency will treat the reorganization and disposal as one integrated transaction and will apply the continuity of interest test to the integrated transaction. This process is also known as the *step transaction doctrine,* and is a fact-based test not subject to mechanical application of the IRC. (It is important to note here, however, that the lack of a binding commitment might not be sufficient to overcome this test.)

Does the step transaction doctrine always work against the taxpayer's interest?

No, the step transaction doctrine can also work in the taxpayer's favor. This was highlighted in a relatively recent revenue ruling (2001-46) in which the IRS collapsed a two-step reorganization involving a reverse triangular merger (which has a 20 percent boot limitation) into a Type A reorganization (which has a more relaxed 50 percent limitation). In the ruling, the IRS addressed the situation where, in the first step, an acquirer (A) formed a new merger subsidiary (S) and merged S into a target corporation (T), which was the surviving corporation. (This structure is generally known as a *reverse triangular merger.*) The T shareholders exchanged all of their stock for a mix of consideration involving 70 percent A voting stock and 30 percent cash. In the second step, T was merged into A as part of the same overall plan. An advantage of this structure, which is illustrated in Figure 5-2, is that A does not need to obtain shareholder approval for the transaction. But if T merged into A directly (and without the interim transaction with S), A's shareholders may have a right to approve the transaction.

If the two steps were viewed individually, the first step would fail to qualify as a tax-free reverse triangular merger because, based on the requirements described in more detail later in this chapter, the fact that 30 percent of S's consideration to T shareholders was in the form of cash meant S acquired only 70 percent and not the requisite 80 percent control of T in a single transaction using A voting stock. In that scenario, the first step of the transaction would be treated as a qualified stock purchase under Section 338 and the second step would be treated as a Section 332 liquidation. The implication to the constituent corporations could be that the acquisition is a taxable event.

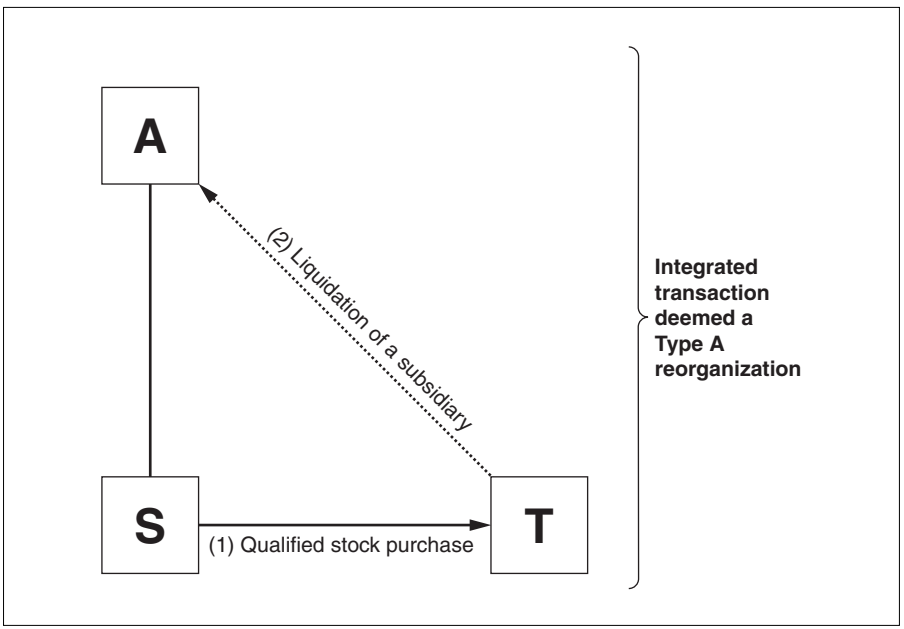
However, in Revenue Ruling 2001-46, the IRS determined that the step transaction doctrine should apply in this situation. As a result, the IRS collapsed the qualified stock purchase and subsequent merger into a statutory merger of T into A rather than a qualified stock purchase followed by a liquidation. This permitted the transaction to qualify as a Type A reorganization, which permits up to 50 percent boot.

What is a creeping transaction?

A *creeping transaction* (sometimes also referred to as *creeping control*) is generally defined as two or more purchases by the acquirer of target stock as

FIGURE 5-2

Integrated Transaction Illustration



part of the same overall plan (i.e., to which the step transaction doctrine applies). Without the creeping transaction doctrine, the parties to a Type A reorganization could easily circumvent the spirit of the IRC's reorganization rules. For example, the acquirer could structure a two-step transaction in which (1) Step 1 involved a taxable purchase of an otherwise prohibited percentage of target stock, say 75 percent, and (2) Step 2 involved a statutory merger that would otherwise qualify under the Type A reorganization rules. Where the two-step transaction is used as an overall plan, the IRS will evaluate the continuity of propriety interest requirement as if the transactions all occurred at the same time. In cases in which multiple transactions are not part of the same overall plan, however, the IRS will treat the prior purchases as "old and cold" (in tax parlance) and apply the continuity of propriety interest test to only the relevant transaction(s). As with the step transaction doctrine, the IRS makes a fact-based determination in evaluating a potential creeping transaction.

What is a drop down, and does it preclude a transaction from qualifying under the Type A rules?

In a *drop down,* the acquirer transfers all or part of the recently acquired assets of the target to a subsidiary that the acquirer controls. The IRC permits a drop down in a transaction that otherwise qualifies as a Type A reorganization.

Must all target shareholders in a Type A reorganization receive the same mix of consideration?

No. The tax rules analyze whether the target's shareholders as a group—not individually—maintain continuity of propriety interest. As a result, the acquirer may pay some target shareholders in cash or debt, but others in stock, so long as the minimum percentage is met overall. This point adds a degree of flexibility to the potential transaction structure and can allow the acquirer to meet the objectives of differing shareholder classes. It should be noted, however, that shareholders receiving cash or other forms of boot will be taxed on a pro rata portion of their shares. The taxation of boot consideration is discussed later in this chapter.

May the acquirer sell a portion of the target's historic operating assets following a Type A reorganization?

Generally, yes. According to Revenue Ruling 2001-25 and Revenue Ruling 88-48, a transaction will still qualify as a Type A reorganization notwithstanding the sale of a portion of the target's assets after the merger and as part of a plan that includes the merger, where the proceeds from the sale continue to be held by the surviving corporation.

Does federal tax law ever permit the acquirer to pay less than 50 percent of the transaction consideration in stock and still qualify as a Type A reorganization?

In some older tax case law, courts have permitted acquirers to pay less than 50 percent of the transaction consideration in stock. In a 1938 Supreme Court

decision, for example, the Court permitted Type A treatment to a transaction that involved 38 percent of the consideration paid in preferred stock. But, as noted previously, this lower threshold generally would not qualify for the IRS's advance ruling purposes and could potentially result in a lengthier and costlier transaction process. It is highly unadvisable to push the 50 percent threshold limit without the advice of competent tax legal counsel. If the transaction is found to not qualify as a Type A reorganization, all of the transaction consideration will be taxable to the target's shareholders. This can create a tax-inefficient scenario for the sellers, and the acquirer would lose the target's tax characteristics (NOLs, high earnings and profits, etc.).

How is nonstock consideration taxed in a Type A reorganization?

To the extent that the T shareholders receive boot (i.e., consideration other than stock, such as cash or debt), such shareholders must recognize realized gain on the nonstock consideration. The pro rata portion of the transaction that involves boot is generally treated as a taxable asset acquisition discussed previously in this chapter.

What is a Type B reorganization?

A *Type B reorganization* is a stock-for-stock exchange in which one company buys the stock of another company using only ("solely") its own stock. Under a Type B reorganization, the target becomes a subsidiary of the acquirer, which must control the target immediately after the transaction. Under Section 368(a)(1)(B) of the IRC, the term *control* is defined as ownership of 80 percent or more of the target's voting power and 80 percent or more of each class of the target's voting stock.

Must the acquirer purchase 80 percent of the target's voting power and stock in one transaction?

No. The Type B reorganization rules do not require a purchase of 80 percent or more of the target's voting power and stock all at once, but rather only require that the acquirer control the target immediately following the deal. If the acquirer uses only voting stock as the transaction consideration, the acquirer may purchase target stock in one or more traunches (i.e., a creeping

transaction, as discussed in the context of Type A reorganizations). If more than one purchase is made, only the transaction that pushes the acquirer over the control threshold (80 percent) can qualify for tax-deferred treatment under the Type B reorganization rules. In the event the acquirer made one or more previous purchases of target stock using transaction consideration other than voting stock (i.e., cash, debt, or nonvoting stock), these previous purchases will disqualify the creeping transaction from Type B reorganization treatment unless the prior purchases are deemed "old and cold." There is no bright line test, but Treasury Regulation Section 1.368-2(c) includes examples that suggest purchases separated by 12 months or less would probably not qualify, but that transactions separated by several years probably would.

What kind of stock may the acquirer use in a Type B reorganization?

The acquirer may use only voting stock in a Type B reorganization, and generally even the smallest amount of nonvoting stock will disqualify Type B treatment altogether. The voting rights associated with these shares cannot be restricted to just extraordinary corporate events such as merger, but extend unconditionally to votes on routine corporate matters.

Can the target or the target's selling shareholders receive cash under any circumstances in a Type B reorganization?

Yes, in some instances. There are three principal scenarios in which the IRC permits the target or the target's shareholders to receive cash in a Type B reorganization: (1) the redemption of fractional shares by the acquirer; (2) payment of the target's transaction expenses (but not the target shareholders' transaction expenses), such as accounting, legal, and other reorganization costs; and (3) buyouts of dissenting minority shareholders that object to the transaction. Under this third exception, only the target or other target shareholders may purchase the dissenting shareholders' stock—not the acquirer—nor may the acquirer indirectly provide the funds for these purchases. To the extent that the T shareholders receive boot, such shareholders must recognize realized gain on the nonstock consideration. The pro rata portion of the transaction that involves boot is generally treated as a taxable stock acquisition discussed previously in this chapter.

What about earnouts, holdbacks, or other forms of contingent consideration? Are those permitted under a Type B reorganization?

Generally speaking, the IRC permits contingent consideration in Type B reorganizations assuming, of course, that the contingent consideration is paid only in voting stock. In an *earnout,* the selling shareholders are entitled to additional consideration if the target meets certain financial milestones post-closing. In a *holdback,* the selling shareholders are entitled to additional consideration, assuming that a certain representation made at the time of closing is later confirmed to be accurate.

Does the step transaction doctrine apply to a Type B reorganization?

Yes. Accordingly, if the acquirer redeems a selling shareholder's shares for cash after the reorganization, the redemption may disqualify the entire transaction from Type B treatment if the acquirer agreed to redeem the target shareholder's shares as part of the broader transaction.

Are drop downs permitted in a Type B reorganization?

Assuming the transaction otherwise qualifies as a Type B reorganization, the acquirer is permitted to transfer the target's assets to a controlled subsidiary after the reorganization.

If the acquirer is a subsidiary of another corporation, may it use its parent's stock as transaction consideration in a Type B reorganization?

Yes. Similar to a Type A reorganization, the acquirer may exchange the voting stock of a controlling corporation (i.e., the acquirer's parent) for target stock, assuming (1) no acquirer stock is used in the transaction, and (2) the transaction would have otherwise qualified as a Type B reorganization if acquirer stock had been used instead of parent stock.

What is a Type C reorganization?

A *Type C reorganization* is a transaction in which one company buys substantially all of the assets of another company using its own voting stock, and the target corporation subsequently liquidates. The IRS defines *substantially all* as either (1) 90 percent of the target's net assets (i.e., assets less liabilities—the book value of the assets acquired), or (2) 70 percent of the target's gross assets (measured at fair market value). In some situations, courts have approved Type C reorganizations that involved asset percentages below these thresholds, particularly where the target retains liquid assets such as cash in order to pay creditors. However, if the target redeems stock held by dissenting shareholders for assets, the IRS will count such assets toward the "substantially all" test (assuming the redemptions are part of the overall reorganization). A Type C reorganization is also sometimes referred to as a *practical merger* because, although the transaction consideration flows into the target (and not directly to the target's shareholders), the IRC requires the target to liquidate following the reorganization and distribute the acquirer stock and the target's remaining assets and liabilities to the target's shareholders.

Must the target corporation always liquidate following a Type C reorganization?

In rare cases, the IRS has waived this requirement. These have generally been limited to rare situations in which (1) the selling company's shareholders all intend to reincorporate the target's remaining assets, and (2) the new corporation's shares would be held in exactly the same ownership percentages as the target, but (3) it is generally impractical for the target's shareholders to do so. However, even in these cases, the IRS will tax the target corporation and its shareholders as if the target had liquidated the remaining assets and the shareholders had subsequently contributed them to form a new corporation. So from a practical perspective, there is probably little difference.

Can the target receive any consideration other than voting stock of the acquirer under any circumstances in a Type C reorganization?

While the acquirer generally must use voting stock to compensate the target, there are a number of exceptions (sometimes referred to as *boot relaxation rules*) in which the acquirer may use consideration other than voting stock. First, the acquirer can assume liabilities of the target without violating the

"solely for voting stock" requirement. Second, the acquirer can use stock of its parent as transaction consideration. Third and finally, the acquirer may use cash or other non-voting-stock consideration if the transaction involves assets with at least 80 percent of the fair market value of the target's total assets. In the case of this third exception, the dollar value of any liabilities assumed by the acquiring corporation, and the dollar value of any liability to which any asset acquired by the acquiring corporation is subject, shall be treated as cash paid to the target corporation.

Treasury Regulation Section 1.368-2(d)(2) provides an example of the third exception. Assume, for instance, that Corporation T has assets with a fair market value of $100,000 and liabilities of $10,000. In exchange for these assets, Corporation A transfers $82,000 worth of its own voting stock, assumes the $10,000 liabilities, and pays $8,000 in cash to Corporation T, which subsequently liquidates. The transaction qualifies as a Type C reorganization even though Corporation A pays cash for a portion of Corporation T's assets (either directly or indirectly by assuming liabilities). The dollar value of Corporation T's liabilities plus the deemed cash involved (or $18,000 combined) is less than 20 percent of the fair market value of its assets (or $100,000).

On the other hand, if the assets of Corporation T worth $100,000 were subject to $50,000 in liabilities, an acquisition of all the assets, subject to the liabilities, for any consideration other than solely voting stock of Corporation A would not qualify as a Type C reorganization; the liabilities of Corporation T (or $50,000) are in excess of 20 percent of the fair market value of its assets (or $100,000). However, if Corporation A was interested in acquiring all of Corporation T's assets, the parties might consider a Type A reorganization instead.

To the extent that the T shareholders receive boot, such shareholders must recognize realized gain on the nonstock consideration. The pro rata portion of the transaction that involves boot is generally treated as a taxable asset acquisition discussed previously in this chapter.

Can creeping acquisitions arise in a Type C reorganization?

Yes, though the area is not well settled from a legal perspective. While a Type C reorganization is by definition a stock-for-assets exchange, a creeping acquisition can occur in two scenarios. First, a creeping acquisition may arise where the acquirer purchases more than 20 percent of the target's assets for non-voting-stock consideration, and then subsequently acquires some or all of the remaining assets solely for voting stock. In this case, the best advice is to follow the step transaction doctrine—if both the first and second transactions

were part of the overall same plan, the IRS would probably disqualify the second transaction for Type C reorganization treatment.

Second, a creeping acquisition may arise in certain historical transactions where the acquirer already owns more than 20 percent or more of the target's stock, acquires all of the target's assets solely for voting stock, and the target subsequently liquidates and distributes the acquirer stock to the target's shareholders. In the only adjudicated example of note, the federal Court of Appeals for the Second Circuit held in a 1958 case that this transaction structure violates the Type C reorganization rules because the acquirer purchased more than 20 percent of the target's assets in the liquidation of the target in exchange for the target stock the acquirer previously owned.[23] However, the IRS subsequently promulgated Treasury Regulation Section 1.368-2(d)(4)(i), which states that the prior acquisition of a target corporation's stock by an acquiring corporation generally will not by itself prevent the "solely for voting stock" requirement in a Type C reorganization from being satisfied for transactions occurring after December 31, 1999. Even under this newly created exception, however, the step doctrine still applies.

This creeping acquisition problem likely would not arise where the acquirer previously owned less than 20 percent of the target's stock because the boot relation rules would create an exemption. Nor would this problem likely arise where the acquirer previously owned more than 80 percent of the target, as the transaction would probably qualify as a tax-free liquidation of a subsidiary under Sections 332 and 337 of the IRC.

Are drop downs permitted in a Type C reorganization?

Assuming that the transaction otherwise qualifies as a Type C reorganization, the acquirer is permitted to transfer the target's assets to a controlled subsidiary after the reorganization.

If the acquirer is a subsidiary of another corporation, may it use its parent's stock as transaction consideration in a Type C reorganization?

Yes. Similar to Types A and B reorganizations, the acquirer may exchange the voting stock of a controlling corporation (i.e., parent) for target stock, assuming (1) no acquirer stock is used in the transaction, and (2) the transaction

would have otherwise qualified as a Type C reorganization if acquirer stock had been used instead of parent stock.

Previously, you mentioned a nondivisive, nonacquisitive reorganization. What exactly is this?

A nondivisive, nonacquisitive reorganization is a transaction in which a company transfers its assets down into a subsidiary. This kind of transaction is known as a *Type D reorganization,* and would disqualify a company from meeting the requirements of Section 355 (spin-offs). There are, however, still some complicated loopholes here. Type D reorganizations are generally outside the scope of this book.

What is a forward triangular merger, and when might an acquirer consider using the structure?

A *forward, or direct, triangular merger* (also known as a *forward, or direct, subsidiary merger*) is a form of tax-free reorganization. The structure generally involves the acquirer (A) creating a new, wholly owned acquisition subsidiary (S) into which the A contributes A stock tax-free under Section 351 of the IRC. The target (T) is then merged into S under state law (and dissolves), with the former T shareholders receiving A stock in exchange for their T stock. S is the surviving corporation after the reorganization and remains a wholly owned subsidiary of A.

An acquirer might structure a forward triangular merger if it wishes to keep the target corporation's liabilities segregated in a separate subsidiary, as even using a drop-down structure can potentially open up the acquirer to legal liability beyond the target's book value. In addition, A's shareholders are not required to vote on the deal because A is technically not a party to the deal. Because A is the only shareholder of S, the structure can streamline the shareholder approval process and cut down on considerable time and expense—particularly if A is a widely held corporation.

What are the requirements to qualify for a forward triangular merger?

A forward triangular merger functions like a hybrid of Types A and C reorganizations (acquiring 90 percent of net assets or 70 percent of gross

assets), so it might not come as a surprise that the requirements are similar. In order to qualify for tax-free treatment, the transaction must meet the following requirements:

- S must acquire substantially all of the assets of T, with *substantially all* being defined in the context of a Type C reorganization.
- The reorganization would have qualified as a Type A, but for the fact that T is merged into S instead of its controlling corporation A.
- S may not use its own stock, only that of A, as consideration in the transaction. Consistent with the Type A reorganization requirements, S may generally use its own debt securities, cash, or other property for up to 50 percent of the consideration. To the extent that the T shareholders receive boot (i.e., consideration other than stock, including cash or debt) such shareholders must recognize realized gain on the nonstock consideration. The pro rata portion of the transaction that involves boot is generally treated as a taxable asset acquisition discussed previously in this chapter.

What is a Section 351 transaction?

Building on the previous discussion, Section 351 of the IRC provides nonrecognition treatment on the transfer of property to a corporation by one or more parties in exchange for stock or stock and securities of the transferee corporation, provided the transferors possess 80 percent control of the transferee corporation immediately after the transaction. Although designed for the initial incorporation of a previously unincorporated business, Section 351 can be used as an alternative to the reorganization provisions in order to allow nonrecognition of gain to some of the acquired corporation shareholders.

What is a National Starch transaction?

A so-called *National Starch transaction* (named after an acquisition technique first employed by that company) is a type of Section 351 transaction. (This should not be confused with the later *National Starch* case discussed at the end of this chapter.) Under this structure, the buyer contributes cash, and the target's shareholders contribute target-company stock to a newly formed corporation under Section 351, in exchange for acquired corporation common and preferred stock, respectively. The new corporation then utilizes the cash to purchase the remaining acquired corporation stock in the company being acquired.

Because the initial transfer of acquired corporation stock and cash to the new entity qualifies under Section 351, no gain is recognized to the acquired corporation shareholders on the receipt of the new company's preferred stock. A diagram of this transaction appears at the end of this chapter.

What is the difference between a Section 351 transaction and a recapitalization?

In a recapitalization, the acquired corporation's stockholders end up holding minority interests in the target itself (sometimes called an *equity rollover*), whereas in the Section 351 transaction, a newly formed holding company that makes the acquisition issues the preferred stock or minority stock to the target's shareholders.

What is a tax-free spin-off?

A *spin-off* is a wholly or partly tax-free division of a single corporation into two or more corporations. The division typically involves converting a preexisting company division into a wholly owned subsidiary and distributing the stock in the subsidiary pro rata to all shareholders in the original company. By contrast, an ordinary divestiture or sell-off is the sale (often taxable) of the stock or assets of a business unit to another company or to an investment group. Assuming the transaction qualifies under Section 355(e) of the IRC, a spin-off is tax-free to both the issuer and its shareholders. The companion book in this series, *The Art of M&A Structuring: Techniques for Mitigating Financial, Tax, and Legal Risk,* describes spin-offs in greater detail.

Choice of Entity

What types of entities may operate the business of an acquired company?

Choosing the appropriate legal form for operating the business of the acquired company depends on the unique circumstances of the constituent parties, and is important for tax, liability, financing, and other purposes. Though an exhaustive discussion is outside the scope of this chapter, the business may generally take the legal form of nearly any business entity, such as (1) a C corporation, (2) an S corporation, (3) a partnership, either general or limited,

or (4) an LLC. An LLC is a more recent kind of hybrid entity, authorized in 1988 by the IRS. It offers the legal insulation of a corporation and the preferred tax treatment of a partnership. Today, all 50 states and the District of Columbia permit LLCs.

What are the primary differences among the four types of business entities?

A regular, or C, corporation is a separate taxpaying entity. Therefore, the corporation pays taxes on its earnings, and shareholders pay taxes on their dividends. Partnerships, S corporations, and LLCs, in contrast, are generally not separate taxpaying entities.

Because S corporations, partnerships, and LLCs are generally exempt from tax (but rather pass the tax liability with respect to such earnings directly through to their owners) these entities are commonly referred to as pass-through entities. The earnings of pass-through entities are taxed directly at the partner or shareholder level, whether or not distributed or otherwise made available to such persons. Moreover, pass-through entities may generally distribute their earnings to the equity owners free of tax.

What are pass-through entities?

Pass-through entities are structures that permit one level—rather than two levels—of taxation. There are four types of pass-through entities: (1) a partnership, both general and limited, (2) an LLC, (3) an S corporation, and (4) a C corporation that files a consolidated income tax return with its corporate parent. The earnings of all C corporations are subject to double taxation, but the consolidated return provisions generally permit the earnings of subsidiary members of the consolidated return group to be taxed to the ultimate parent only. The earnings of an S corporation, with certain exceptions, are subject to taxation only at the shareholder level. The earnings of a partnership are also subject to a single tax, but only to the extent that such earnings are allocated to noncorporate partners (unless the partner is an S corporation). Partnership earnings that are allocated to corporate partners are subject to double taxation, just as though the income were earned directly by the corporations.

What is a C corporation?

The IRC defines a *C corporation* as any corporation that is not an S corporation. The term C corporation as used in this chapter, however, excludes

corporations granted special tax status under the IRC, such as life insurance corporations, regulated investment companies (mutual funds), or corporations qualifying as real estate investment trusts (REITs).

What is an S corporation?

An *S corporation* is simply a regular corporation that meets certain requirements and elects to be taxed under Subchapter S of the IRC. Originally called a *small business corporation,* the S corporation was designed to permit small, closely held businesses to be conducted in corporate form, while continuing to be taxed generally as if operated as a partnership or an aggregation of individuals. As it happens, the eligibility requirements under Subchapter S, keyed to the criterion of simplicity, impose no limitation on the actual size of the business enterprise.

Briefly, an S corporation may not (1) have more than 75 shareholders, (2) have as a shareholder any person (other than an estate and a very limited class of trust) who is not an individual (i.e., a corporation cannot be a shareholder of an S corporation), (3) have a nonresident alien as a shareholder, (4) have more than one class of stock, (5) be a member of an affiliated group with other corporations, or (6) be a bank, a thrift, an insurance company, or certain other types of business entities.

It should be noted that not all states recognize the S corporation. For those that do not, the corporation pays state income taxes as if it were a C corporation. For those states that do recognize S corporations, both resident and nonresident shareholders of the state where the corporation does business must file returns and pay taxes to that state. In such cases, a shareholder's state of residence will usually (but not always) provide a credit against its own tax.

What is a partnership for tax purposes?

Except under rare circumstances, a *partnership for tax purposes* must be a bona fide general or limited partnership under applicable state law. With certain exceptions, LLCs and S corporations are treated as partnerships for tax purposes, meaning that they have many of the tax benefits available under current tax law.

What considerations are key to choosing the appropriate legal form of the operating entity?

Where there are many considerations the parties need to keep in mind, there are four key points that often drive the choice of legal form for the operating entity:

- *Limitations on liability.* Frequently, the most important consideration in choosing a business entity is the limitation of investors' liability. Where the owners select a limited liability entity, their risk of capital loss is capped at the amount of capital actually invested into the entity (with limited exceptions, as briefly discussed in the following). Where the owners select a different entity, their liability may be unlimited.

  Business entities that afford the owners limited liability include corporations (both C corporations and S corporations), limited liability companies, limited liability partnerships, and, to some degree, limited partnerships.[24] The principal entity that does not offer limited liability protection is a general partnership. However, under principle of general corporate law, owners of limited liability entities can in rare circumstances be held personally liable for the actions and/or obligations of their businesses. These circumstances are known as *piercing the corporate veil.*
- *Financing alternatives.* The financing plans of the owners of the operating entity may preclude certain entities from consideration. In particular, an S corporation election usually offers the shareholders the least amount of flexibility regarding financing alternatives. For example, an S corporation would not be an appropriate choice if one of the potential shareholders is a corporation, due to legal restrictions that generally limit shareholders to individuals only. Similarly, an S corporation would not be an efficient choice if the parties plan to take the operating entity public in the foreseeable future—S corporations cannot qualify for publicly traded status because, among other reasons, the number of S corporation shareholders is limited to 75. More important, the entity would potentially be subject to a tax penalty upon conversion to a C corporation. Finally, S corporations cannot have more than one class of stock. As a result, the choice of entity does not accommodate a preferred stock structure.

  For these reasons and others, partnerships and LLCs are frequently the entity of choice for operating the acquired company. An LLC, for example, allows multiple classes of stock, which facilitates institutional shareholdings. In addition, both partnerships and LLCs offer tremendous flexibility in structuring creative profits allocation among the partners (see the following). They also allow corporations as a partner or as a member (in the case of an LLC),

and generally are not subject to a tax penalty upon conversion to a C corporation.

- *Taxation.* The owners of the operating entity must consider the tax implications of forming, operating, and exiting the operating entity. As discussed previously, forming a new business entity is usually (although not always) considered a nontaxable event. The choice of entity and precise structure of the operating entity can impact whether a partner's exit from the entity is nontaxable, tax deferred, or taxable at ordinary income rates or capital gains rates.

  For example, business entities classified as partnerships for tax purposes are usually considered pass-through entities and are usually subject to only one level of federal taxation. (Some state and local tax regimes might still apply to partnerships. New York City, for instance, imposes an 8.85 percent tax on the unincorporated business taxable income of a partnership allocable to New York City.) Income and/or losses are taxable to partners as the business entity earns income, regardless of whether the operating entity makes any distributions, and such income or losses retain their character (e.g., depreciation, charitable contributions, capital gains, etc.). Undistributed income from the operating entity generally increases the basis of each partner's interest in the operating entity. This minimizes the likelihood of double taxation of the partner's interest if the partner subsequently sells the ownership position. When distributions are made, the payments are not taxable to the extent the partner has sufficient adjusted basis in the partnership interest. (After the partner works down the adjusted basis, subsequent distributions are usually considered a nontaxable return of capital and capital gains.) Tax law usually requires a partnership to adopt a calendar tax year rather than a noncalendar, fiscal tax year.

  In contrast, business entities structured as C corporations usually isolate tax consequences related to the operating entity to the entity level rather than passing them through to the owner level. However, C corporations are subject to two levels of taxation: one at the operating entity level as the entity generates income, and one at the shareholder level as the entity pays out dividends. The dividends-received deduction generally allows a corporate shareholder to deduct 70 percent of dividends received from other domestic corporations. What's more, corporate shareholders may deduct

100 percent of dividends received. Unless the operating entity is required to file a consolidated return, taxable income does not flow from the JV entity and to the shareholders until the shareholders are actually paid out. The taxable income loses its character and is taxable entirely as ordinary income to the extent the business entity has earnings and profits (a term of art in tax law). (The distinction between ordinary income and capital gains income is, to a large degree, moot if the shareholders to the operating entity are C corporations because, unlike individuals, such corporations are not taxed at different rates for the two income streams.) Above that, distributions are treated as a return of capital to the extent of the shareholder's adjusted basis, and capital gains thereafter. To the extent the operating entity has undistributed losses, a business entity structured as a partnership for tax purposes will result in the partner's basis in the entity declining, which will increase its taxes upon a subsequent sale. This would not occur if the operating entity were a C corporation. Finally, unlike a partnership, a C corporation is usually permitted substantial flexibility in adopting a fiscal tax year that does not end on December 31.

- *Financial allocation and governance provisions.* Some entities such as partnerships and LLCs offer substantially more flexibility than corporate structures (both C corporations and S corporations) regarding allocation, distribution, and governance provisions.

In most cases, a form of partnership (either general or limited) or an LLC structure is the preferable legal form, given the relative flexibility of these structures.

When should an S corporation be considered?

Typically, an S corporation should be considered where the acquired corporation is, or will be, a freestanding domestic operating corporation owned by 75 or fewer U.S. individual shareholders. There is no limit on the size of the business that may be conducted in an S corporation. Assuming the business entity has at least one individual shareholder, the corporate parties to the operating entity have a variety of alternatives to stay under the 75 limit. For example, the operating entity could issue the nonindividual warrants, other options, or convertible debt. These must be carefully constructed to avoid the appearance or reality of de facto corporate entity holders.

Nonetheless, just because a large company can use an S corporation does not mean it should. The S corporation requirements intentionally encourage simple structures; they are not inherently user-friendly vehicles for larger, complex operations. With the emergence of LLCs, and other business entities with both limited liability and partnership tax treatment, it is frequently not worthwhile pursuing the S corporation alternative.

When should a partnership be considered?

The partnership is an alternative to the S corporation, with several notable advantages. First, it is always available without restriction as to the structure or composition of the acquired corporation's ownership; therefore, it can be used when the S corporation is unavailable for technical reasons. In addition, the partnership is unique in enabling the partners to receive distributions of loan proceeds free of tax. Finally, if the acquired corporation is expected to generate tax losses, a partnership is better suited than an S corporation to pass these losses through to the owners (unless they do not wish to recognize such losses). The last two advantages result from the fact that partners, unlike S corporation shareholders, may generally include liabilities of the partnership in their basis in the partnership.

In addition to the choice of entity, what major structural issue should be considered?

From a tax standpoint, probably the most important issue is whether the buyer should seek to obtain a cost basis or a carryover basis in the assets of the acquired corporation. Because of the potential for obtaining either of these results regardless of whether assets or stock are actually acquired, the determinations of the tax goal and the actual structure may initially be made on a separate basis.

What are the mechanics of achieving a cost or carryover basis?

In a taxable acquisition, carryover basis can be achieved only through a stock acquisition. For federal tax purposes, however, stock may be acquired in two ways: first, through a direct purchase of seller's stock, and second, through a reverse cash merger.

As indicated previously, a cost basis can be achieved by purchasing either assets or stock from the seller. As in the case of a stock purchase, the tax

law permits an asset purchase to be effected in two ways: first, through a direct purchase of the seller's assets, and second, through a forward cash merger. In the context of a stock acquisition, a cost basis can be achieved by making an election under Section 338 of the IRC.

Is it possible to obtain a cost basis in some of the assets of the acquired company and a carryover basis in other assets?

Some acquirers have wanted to pick and choose their tax treatment, seeking a cost basis for some assets and a carryover basis for others. Congress and the IRS want to prevent this, so Section 338 of the IRC provides that when a buyer makes a qualified stock purchase of more than one corporation affiliated with the company being acquired ("affiliate"), it may not make a Section 338 election with respect to one of those corporations without automatically making a Section 338 election with respect to all of them. This rule is commonly called the *stock consistency rule* under Section 338.

Are there any complications involving the sale of stock between related parties?

Section 304 of the IRC addresses a tax avoidance technique involving the sale of stock in one related corporation to another related corporation. Under the prohibited structure, a common shareholder could withdraw cash or property from his corporations while retaining undiminished ownership. The classic case involves Individual A, who owns all of the stock of corporations X and Y, and who sells some or all of the X stock to Y for cash. In such a case, Section 304 recharacterizes the transaction and treats it as a dividend from Y accompanied by a nontaxable contribution of X stock to Y, instead of merely a sale of X stock that would qualify as capital gain.

The reach of Section 304 goes far beyond this example, however. It encompasses any situation in which there is direct or indirect control by the selling shareholders of the stock of both the acquiring corporation and the corporation being acquired. *Control* is defined here as 50 percent of the voting power or 50 percent of the value of a corporation's stock (including pure preferred). Control of the buyer acquired in the transaction itself is included.

Section 304 transactions became popular during the LBO era of the late 1980s, discussed in Chapter 4. When a company is acquired in an LBO, and the value of the common stock of both the acquired company and the newly formed purchasing corporation, on a book value basis, is

fairly negligible, even a relatively small amount of preferred stock in the purchasing corporation issued to the seller may cause its ownership of the buyer to exceed the 50 percent mark in terms of value. In such a case, Section 304 would come into play.

How may preferred stock be issued to the seller without falling under Section 304?

One way of avoiding these problems is to issue the seller a subordinated debenture or other long-term debt instrument rather than stock. In such a case, unless the debt has peculiar features involving a high risk of recharacterization as equity, Section 304 and the 80 percent affiliation problems can be clearly avoided.

When the structure of a transaction requires that the seller receive equity rather than debt, an alternative approach might be in order. In such a case, it might be worthwhile to seek out a third-party preferred stock investor, whose interest could be superior to that of the seller. By thus increasing the amount of stock value not held by the seller, this approach avoids Section 304. Here is where Section 351 comes in.

How can Section 351 prevent a qualified stock purchase?

Section 351 of the IRC is designed to provide nonrecognition treatment to one or more persons who transfer property (including cash) to a corporation in exchange for substantially all of the corporation's stock. Where the purchasing corporation is a newly formed entity, there is some risk that everyone who receives stock in the entity in connection with transactions that were firmly contemplated at the time of its incorporation will be treated as a transferor receiving nonrecognition treatment under Section 351.

The facts in this regard can vary significantly. On the one hand, where a group of investors forms a corporation to negotiate for and ultimately acquire another corporation, and the purchasing corporation has been fully capitalized prior to the commencement of negotiations with the selling company and its shareholders, any stock ultimately received by the selling company's shareholders should probably not be treated in connection with the initial incorporation of the purchaser. On the other hand, where a group of individuals contemplating an acquisition negotiates with the shareholders of the selling company prior to the incorporation or even the capitalization of the purchasing corporation, the risk that stock in the purchaser ultimately issued to the selling company's shareholders will be treated under Section 351 is very high.

As was the case with Section 304, where more than 20 percent of the stock of the acquired company is received, or is treated as received, by the purchasing corporation in a Section 351 transaction, the qualified stock purchase under Section 338 will fail.

How are purchase price allocations made for tax purposes?

Although businesses are usually bought and sold on a lump-sum basis, for tax purposes each such transaction is broken down into a purchase and sale of the individual assets, both tangible and intangible. There is no specific requirement under the tax laws that a buyer and seller allocate the lump-sum purchase price in the same manner. Because each party has tended to take positions most favorable to it, and because the IRS has an interest in maintaining consistent principles in this domain, the IRS has litigated reallocation issues fairly often over the years. At the same time, courts and, to a lesser extent, the IRS have tended to defer to allocations of purchase price agreed upon in writing between a buyer and seller in an arm's-length transaction.

Are there any rules governing the allocation of purchase price?

Yes. If the seller transfers assets constituting a business and determines its basis as the consideration (e.g., purchase price) paid for the assets, then this transfer is considered a Section 1060(c) *applicable asset* acquisition. Both buyer and seller in such a transaction must use the *residual method* to allocate the purchase price received in determining the buyer's basis or the seller's gain or loss. This method, which is also used for a stock purchase, requires that the price of the assets acquired be reduced by cash and cashlike items; the balance must be allocated to tangible assets, followed by intangibles, and finally by goodwill and going-concern value. IRS regulations state that both buyer and seller are bound by the allocations set forth in the acquisition agreement.

What about amortization of intangibles following an acquisition?

Section 197 of the IRC sets a uniform standard of 15 years for amortization of intangibles at a rate of 100 percent. Exceptions include the following:

- Land
- Financial interests

- Certain computer software
- Certain interests or rights acquired separately
- Interests under leases and debt instruments
- Sports franchises
- Mortgage services
- Transaction costs

These exceptions are treated with either longer periods (e.g., land) or shorter periods (e.g., computer software). In general, Section 197 benefits acquirers of companies that have intangibles with a long life that normally would have to be amortized over a longer period. In general, businesses like to write off intangibles as quickly as possible, as this creates cash in hand from tax savings and rids the company of a drag on profits.

When allocating the purchase price to certain tangibles, the buyer might feel tempted to allocate more of the purchase price to an intangible with a life of less than 15 years (i.e., the tax life of goodwill). A price example would be allocating more value to a five-year noncompete (assuming, of course, the seller agrees to this allocation, which generally would have adverse tax consequences due to the ordinary income it generates). Buyer beware! The IRS has successfully challenged this structure. For an example, see *Bemidji Distributing Co., Inc. v. Commissioner,* T.C. Memo 2001-260.

Tax Consequences in Structuring Acquisition Debt Financing

What are the principal tax issues that arise in structuring acquisition debt financing?

While clearly not an exhaustive list, some of the issues to consider are: (1) whether the IRS might recharacterize the debt as equity; (2) if the target will be part of an affiliated group filing a consolidated return post-transaction; and (3) whether the acquirer risks maxing out its interest deductions, or otherwise is not in a position to fully use the benefits of debt financing.

What is straight debt financing?

Straight debt (1) is an unconditional obligation to repay principal and interest, (2) has a fixed maturity date not too far removed, (3) is not convertible, and (4) has not attached warrants, options, or stock. A straight debt

instrument ordinarily does not include interest that is contingent on profits or other factors, but it may provide for a variable interest rate. It will not have a principal that is subject to contingencies. In short, straight debt is an instrument without significant equity features.

What tax issues should be analyzed in structuring straight debt financing?

Straight debt instruments are generally classified as debt for tax purposes. Accrued interest on a straight debt instrument is deductible by the borrower and taxable to the lender. As a practical matter, the only tax issue in straight debt financing is the computation of the accrued interest.

The IRC and proposed regulations contain an extremely complex set of comprehensive rules regarding interest accruals. These rules generally require that interest must accrue whether or not a payment of interest is made. Thus, interest may be taxed, or deducted, before or after interest is paid.

How is debt distinguished from equity for tax purposes?

As noted, it is important to remember that the IRS may take the position that a purported debt instrument is actually equity, thereby disallowing the interest deduction on the debt. While a thorough discussion of the circumstances under which the IRS might take this position is outside the scope of this book, a key consideration is whether the leveraged company has enough equity underpinning the debt to adequately support it (i.e., thinly capitalized). While there is no bright-line test, a debt-equity ratio of greater than 7:1 might raise serious IRS scrutiny. If the debt is reclassified as equity, interest and payment of principal may be taxable as dividends. A corporation can minimize the likelihood of IRS scrutiny by (1) adequately documenting the debt instrument, (2) structuring reasonable debt terms, such as a market interest rate and a definite maturity date, (3) adhering to the debt repayment schedule, (4) not structuring payments that are contingent on earnings, and (5) as noted, maintaining a prudent debt-equity ratio. Other red flags to consider are if shareholders hold similar pro rata positions of debt and equity, or if the use of funds is for start-up operations.

What does the debt-equity issue boil down to then?

A few useful generalizations can be made. Virtually all of the litigation and activity by the IRS has been in the recharacterization of purported debt as

equity, and not the other way around. Therefore, it is quite safe to say that recharacterization is not a problem when one is dealing with a purported equity instrument.

In examining a purported debt instrument, the courts look for evidence that the parties intended a true debtor-creditor relationship. In particular, they have placed great weight on whether the instrument represents an unconditional promise to pay a certain sum at a definite time. Other significant factors that are considered include whether the loan was made by shareholders of the borrower, the borrower's debt-equity ratio, whether the loan is subordinated to third-party creditors, and whether it has a market rate of interest.

What about debt issued to third-party investors?

Until the IRS signals a newly aggressive stance, the view of most tax advisors is that debt issued to third-party investors for cash is not likely to be recharacterized as equity, even though the debt may be subordinated to senior debt, convertible into common stock, or part of a capital structure involving a high ratio of debt to equity. This will at least be true where the instrument contains the common indicia of indebtedness—that is, a certain maturity date that is neither unduly remote nor contingent, a reasonable interest rate, and creditors' rights upon default. Note, however, that even if these criteria are met, the IRS is likely to argue for equity characterization if the conversion features of the instrument are such as to make it economically inevitable from inception that the instrument will be converted into stock.

What are the tax consequences if debt with equity features is recharacterized as equity?

The tax consequences of recharacterization of purported debt into equity may be quite severe.

First, interest payments with respect to recharacterized debt will be treated not as interest but as distributions to a shareholder and, therefore, will not be deductible. Repayment of debt principal is tax-free to the debt holder, but if treated as a redemption of stock, it may be taxed as a dividend.[25]

Second, the recharacterization may destroy the pass-through status of the issuer. When debt is recharacterized as equity, it is ordinarily expected to be treated as a kind of preferred stock. Because an S corporation may not have two classes of stock, a recharacterization of debt into equity can create a second class of stock, invalidating the S election and causing a corporate-level tax. If the issuer is a member of a consolidated group, the recharacterized debt

will most likely be treated as preferred stock that is not pure preferred stock. As such, the company may be disaffiliated from the consolidated group if, after taking into account the newly recharacterized stock, the members of the consolidated group own less than 80 percent of the company's stock.[26]

Third, a recharacterization of debt into equity may completely change the structure of the deal. For example, the recharacterization may invalidate an election to have a stock transaction treated as an asset transaction under Section 338 of the IRC. For a valid Section 338 election, the buyer and the acquired company must be affiliated at the time of the election. If the recharacterization of a purported debt into equity disaffiliates the two companies, the election is invalid. In the case of purchase money notes, the conversion of debt into stock consideration may convert a taxable acquisition into a tax-free reorganization.

What if the acquired company's operations are to be held in an affiliated group of corporations filing a consolidated federal income tax return? How is post-acquisition debt treated then?

In such a case, the acquisition debt will often be issued by the parent. Therefore, for federal income tax purposes, the group is treated as a single taxpayer, in which the parent's interest deductions offset the operating income of the subsidiaries. From the point of view of the various states in which the subsidiaries do business, there is no consolidation with the parent; therefore, the parent's interest payments, even though funded by cash flow from the subsidiary, will not reduce the subsidiary's state income tax liability.

In such cases, deal planners should consider, where feasible, passing the parent's interest deductions to the subsidiaries by having them assume portions of the parent's indebtedness directly, or indirectly via bona fide intercorporate indebtedness owed to the parent by the respective subsidiaries. The parent must exercise great care to avoid adverse tax treatment under federal law—or under state law (in its own state of residency)—as a result of such restructuring.

Is the interest paid on debt tax-deductible?

Not entirely. Section 279 of the IRC disallows interest deductions in excess of $5 million a year on debt that is used to finance an acquisition, to the extent that the company's interest deductions are attributable to "corporate

acquisition indebtedness." Because its effects are direct and harsh, Section 279 must be considered in evaluating any debt instrument used in connection with a corporate acquisition, or a refunding of such a debt instrument.[27]

When might corporate acquisition indebtedness be characterized as Section 279 debt?

Corporate acquisition indebtedness is a type of debt incurred by a corporation to acquire either stock in another corporation or at least two-thirds of the assets of another corporation. To avoid being characterized as Section 279 debt, it must meet certain specific subordination tests and must not be convertible into stock or issued as part of an investment unit. The issuing corporation must have a low debt-equity ratio as specifically set forth in the statute and regulations.

Section 279 is difficult to bypass. For this reason, corporate counsel to issuers, lenders, and underwriters must be sure that tax counsel is consulted as to even seemingly minor changes in acquisition structure or financing.

Does the IRC place any restrictions on allowable interest rates?

Yes. Under Section 163(e)(5) of the IRC, interest payments on loans may not be deducted if the debt bears a rate of interest higher than the federal rate plus five percentage points, among other features. Section 163(j) disallows deductions on interest payments made to nonprofits.

From a tax standpoint, when might preferred stock be more advantageous than subordinated debt?

When an issuer does not need additional interest deductions (for example, when it expects to generate or otherwise have available NOLs), it might have no reason to use debt, and preferred stock might be a sensible alternative.

The most common tax reason for using preferred stock over debt is to enable an acquisition to qualify as a tax-free reorganization. As discussed previously, shareholders can obtain tax-free treatment on the receipt of nonvoting, redeemable preferred stock, and such stock will qualify in satisfying the continuity of interest requirement.

More generally, preferred stock can be used to provide tax-free treatment to an acquired company's shareholders, while still effectively converting their

interest to that of a passive investor or lender. Although preferred stock dividends are not deductible to the issuer, the corporate holder may exclude from its taxable income 70 percent of the dividends received, called the *dividends-received deduction* (DRD). This is a tax benefit that the wise dealmaker will not want to ignore.[28]

What role can special-class, or alphabet, stock play in tax planning?

Special-class, or *alphabet, stock financing* is a device that tax planners have thought about a good deal in the past few years but have rarely acted upon. The stock is typically tied to a specific subsidiary of a corporation (similar to a tracking stock) and has different voting rights from the parent company's stock. In addition, the special-class stock typically pays a dividend tied to the operating performance of the particular subsidiary. The device became known as "alphabet stock" because the name of each class of stock typically followed alphabetical order—that is, a corporation may have three classes of stock (class A, class B, and class C) tied to three separate divisions or subsidiaries.

Special-class stock is a variation upon series-class stocks that have been used by mutual funds for many years, but was first used for a standard business organization when General Motors (GM) acquired Electronic Data Systems Corporation in 1984. GM again used the device a year later when it acquired Hughes Aircraft Company (subsequently sold to Raytheon in 1998). In those two acquisitions GM issued a new class E and class H stock, respectively. Holders of these stocks had the same basic rights under state and federal law as common shareholders, but they received dividends that are more sensitive to the fortunes of their unit. Because these stocks were listed in an exchange and actively traded, they could be valued for tax purposes.

Can an ESOP be used to provide favorable financing in a leveraged buyout?

An employee stock ownership plan (ESOP) is a type of qualified employee benefit plan that invests primarily in stock of the employer. In order to encourage the use of ESOPs, Congress has provided a variety of special tax benefits both to stockholders who sell their stock to an ESOP and to lenders providing financing for so-called leveraged ESOPs. Shareholders who sell their stock to an ESOP may qualify for tax-free rollover treatment under Section 1042 of the IRC. That section permits the share-

holder to defer the payment of a capital gain tax upon the sale of stock, provided the shareholder reinvests the sale proceeds in stock of another active business corporation within one year after the sale. Additionally, where the selling shareholder is an estate, or other entity holding the employer's stock at the time of the decedent's death, as much as one-half of the proceeds of the sale of the stock to an ESOP may be deducted from the gross estate for federal estate tax purposes.

There are two tax benefits provided to a company that sets up a leveraged ESOP. First, all payments of both interest and principal on loans incurred by an ESOP to purchase employer stock are deductible to the company. Additionally, qualified lenders on ESOP loans are permitted to exclude 50 percent of the interest received on such loans. Such a tax exclusion for the lender may be expected to provide a strong incentive to make loans available for ESOP financing on favorable terms.

With such clear tax incentives, the ESOP should be considered in many contexts in mergers and acquisitions. Provided an investor group is willing to share the ultimate economic benefits of an acquired company with the employees, at least to the extent required by the tax laws, the leveraged ESOP may be a viable alternative to other means of financing a leveraged buyout.

Management Buyout Tax Basics

What is a management buyout?

A *management buyout* (MBO) is a transaction in which a company, or subsidiary or division, is acquired by a new company in which management of the acquired business holds a significant, if not controlling, equity stake. The purchaser is typically privately held and has not been an operating company or a subsidiary of one. Its funds typically consist of borrowed money, so most MBOs are also LBOs.[29]

How is an MBO typically structured?

In brief, management, together with any financial partner, forms a new company to acquire the target business. The acquiring company might purchase either all the assets or stock of the target, or it may merge with the target. Often, management forms a holding company and engages in a forward or reverse merger with the selling company. If management owns stock, it can

either have the acquiring company repurchase its existing shares or contribute its equity in the target business to the acquiring company. These methods have different tax consequences.

How should an MBO be structured?

MBOs are usually structured as either tender offers or as mergers. In the first case, managers buy company stock using cash or stock. In the second case, they do the same thing but then merge the purchased entity into another company. Each structure—the tender offer versus the merger—has its disadvantages.

A stock purchase via a tender offer is the fastest method to purchase a majority of any public company's stock. A tender offer can be made in cash or stock, and timing is about the same.[30] Under current rules, exchange offers can start upon filing, which enables bidders to solicit the tender of stock from security holders.[31] This so-called *fast-track review* allows exchange offers to compete with their cash counterparts.

However, tender offers have certain disadvantages. Tender offers can force buyers to spend money prior to gaining access to the target company's cash flow, and without any assurance of ever tapping it. The margin rules of the Federal Reserve Board (Regulations G and U) restrict a purchaser from borrowing more than half of the purchase price against the pledge of publicly traded securities. Because the margin rules complicate financing, acquisitions of public companies are often done as mergers or use unsecured financing.

The merger form for an MBO usually requires approval of the stockholders. In noncash transactions approvals are needed from the shareholders of both entities. In cash transactions, approval must come from the shareholders of the nonsurviving corporation. A merger transaction involving a public company will require the filing of proxy materials with the SEC and a registration statement complying with federal and state securities laws where securities are to be issued. A stock purchase can be done where ownership of the target's shares is concentrated in the hands of a few persons, but it typically must be consummated contemporaneously with a merger to obtain the required financing.

Can an MBO involve management employees as owners?

Yes, it can be structured as an ESOP. In an ESOP buyout, the ESOP is the sole or a principal purchaser of its company's stock. Senior management can own stock in addition to the stock owned through the ESOP.

The ESOP purchase of the stock is financed by a loan, either directly to the ESOP or through the company. The loan is almost always backed by the company's assets. Interest payments to the ESOP lender are given favorable tax treatment and therefore can be obtained at below-market rates, lowering the company's interest expense. Loan repayments are treated for tax purposes as contributions to a pension plan and are deductible in full, in effect making principal repayments deductible as well as interest. Thus, the ESOP is a powerful and efficient financing tool. However, because the ESOP is a tax-qualified pension plan subject to ERISA and the IRC, there are limits on the size of the ESOP and the extent to which it may benefit senior management.

What special tax issues ordinarily arise in an MBO?

For the most part, an MBO raises the same tax issues as any other LBO. In addition, there are a few categories of issues that pertain specifically to acquisitions with equity participation by management. These issues relate primarily to the manner in which management's investment will be paid for or financed and generally involve questions of whether significant amounts of compensation income will be deemed to be received by management. Where members of management already own stock or stock rights in a selling company, special care must be taken in structuring the transaction to allow a tax-free conversion of these existing equity rights.

A discussion of management equity participation in a buyout inevitably leads to a broader discussion of executive compensation. Here, we focus primarily on management's direct equity participation in an acquisition. It is worth noting, however, that to the extent management does obtain a direct ownership interest in the company, many of the conventional devices employed by large companies to motivate and reward management, such as bonus plans and stock option plans, may become less important.

An MBO will likely require a greater cash investment than most of the management participants will have available from personal resources. Unless the management pays for the stock, in cash, at fair market value, there may be taxable income to the employee when stock is obtained. The employee and the corporation will have some control over when the taxable income is treated as being received. Their interests may differ. The tax consequences of the alternative ways of making this investment are governed by the basic rules under Section 83 of the IRC.

What is the basic rule for taxation of an employee who receives or purchases stock in an MBO?

As a general rule, under Section 83 an employee receives taxable compensation to the extent that the value of any property received from the employer exceeds the amount the employee pays for that property. To the extent that the employee has taxable income, the employer is entitled to a deduction and is required to withhold tax on the same basis as if regular salary were paid. These rules apply whether the employee is receiving stock or other kinds of property. If an employee has not paid full value for the stock and is thus taxed on the receipt of the stock, the employee will obtain a basis in the stock equal to the amount actually paid for it, plus the amount of taxable income recognized. If an employee has paid full value for the stock, the employee will have a basis in the stock equal to the cost and will have no compensation income. In either case, when the employee later sells the stock, the employee will have capital gain or loss measured by the difference between the sale proceeds and the basis in the stock.

There is an important exception to the general rule. If the stock is not substantially vested in the employee, there is no tax to the employee and no deduction to the employer until such time as the stock does become substantially vested. Stock is substantially vested if it either is not subject to a "substantial risk of forfeiture" or is transferable by the employee. When the risk of forfeiture or the restriction on transferability lapses, rendering the property substantially vested, the employee will be required to pay tax on the excess of the stock's value at the time the property vests over the amount paid for the stock. This rule will apply even if the employee originally paid full value for the stock, and cannot be avoided unless the employee otherwise elects under Section 83(b).

Here is how it works. Assume that a management employee will acquire 100 shares of company stock in the MBO. The employee buys the stock for $100, which is the full fair market value of the stock. If the stock is then fully vested and transferable, the employee recognizes no taxable income. If, two years later, the stock is worth $150, there will be no impact on the employee; only if the stock is actually sold for $150 will the employee have $50 in long-term capital gain. The company will have no deduction. But if the employee acquires the stock subject to a substantial risk of forfeiture that does not lapse for a two-year period, the result is different. There is still no income at the outset. Two years later, when the stock is worth $150, the risk of forfeiture lapses. The employee must then recognize taxable income of $50 (which is the difference between the $150 fair market value of the stock at that time and the $100 paid for the stock two years earlier), even if the employee has not

sold the stock and has no cash proceeds to pay the tax. At that time, the company is entitled to a $50 deduction.

Are there circumstances that might impel an employee to forfeit stock?

Yes. Many typical "golden handcuff" techniques create a substantial risk of forfeiture and can therefore undermine the tax plans. The receipt of stock may be subject to forfeiture if the employee will be required to return the stock upon the occurrence of a particular event, or the failure to satisfy some condition. The typical example of a provision creating a substantial risk of forfeiture is one requiring that the employee return the stock to the company in the event that the employee terminates employment with the company within a certain period after the receipt of the stock. A requirement that the employee return the stock unless certain earnings goals are met also creates a substantial risk of forfeiture.

There is not, however, a substantial risk of forfeiture where the company is required to pay the employee full value for the stock upon a termination of employment. Also, where the event that will produce a forfeiture is peculiarly within the control of the employee, such as dismissal for cause or taking a job with a competitor of the company, there will not be a substantial risk of forfeiture. A special rule applies if the sale of the stock could subject the employee to litigation alleging violation of Section 16(b). This is the so-called *short-swing* rule—under Section 16(b) of the Securities Exchange Act of 1934, which makes profits on sales in a six-month period illegal. In such a case, the employee's rights in the property could be subject to a substantial risk of forfeiture. Consequently, when the six-month period ends, the employee's interest vests and the employee becomes subject to tax on any increase in value of the stock over what was paid for it.

If the employee sells the stock before the risk of forfeiture lapses, the employee will have taxable income equal to the excess of the amount realized on the sale over the amount paid for the stock. The employer can take a deduction in this amount.

Will receipt of stock by a management investor always be treated as receipt of stock by an employee?

Technically, Section 83 applies to the receipt of stock or other property by an employee only if it was received in connection with the performance of

services. This includes past, present, and future services. In some circumstances, a reasonably strong case can be made that the employees are not receiving stock in connection with the performance of services but are receiving stock on the same basis and in the same context as other members of an investor group. In spite of this commonsense analysis, most tax advisors recommend that planning in this area proceed on the assumption that the IRS will apply Section 83 in determining the tax consequences to members of an investor group who are employees of the company.

May employees elect to recognize any taxable income currently?

If an employee receives stock that is substantially nonvested, the employee may elect under Section 83(b) to take any gain into income at the time of receipt of the stock. The employee will recognize compensation income in the amount of the excess, if any, of the stock's value over the amount paid for it. The employer receives a deduction at that time, equal to any compensation income recognized. The election must be made, no later than 30 days after the receipt of the stock, by filing a form with the IRS service center at which the employee files tax returns. The employee must also file a copy of the election with her tax return. The IRS is quite strict in applying the 30-day filing deadline, and one should not expect any flexibility on this point. Additionally, once such an election is made, it may not be revoked.

Note that a Section 83(b) election may be made even where the effect of making the election will be to recognize no income because at the time the stock was issued there was no spread between its value and the amount paid. Thus, such an election can be useful for an employee who does pay full value at a time when the prospects for subsequent appreciation in the stock are significant. The employee described previously, with $100 in forfeitable stock, could have filed an 83(b) election, recognized a gain of zero, and avoided the $50 gain when the risk of forfeiture lapsed.

Where management is purchasing stock in an acquiring entity or in a selling company that is the subject of a leveraged buyout at or before the acquisition closing and at the same price as other investors, it can usually be comfortably argued that the amount paid for the stock at the inception of the transaction is equal to its fair market value. In such a case, there will be no compensation income to the management participants under Section 83, provided that either the stock is substantially vested or the management participants file Section 83(b) elections.[32]

If the employee's stock purchase is financed with a note, is Section 83 income avoided?

Management rarely has enough cash to buy as large an equity interest as it would like. The stock acquisition of management is usually financed by the company, the investor partner, or a third party. A promissory note from the employee will be treated as a bona fide payment for the stock in an amount equal to the face amount of the note, provided it meets two important requirements. First, the note should provide for adequate stated interest at least equal to the applicable federal rate. Second, the note should be with recourse to the employee.

When should the employee be treated as receiving income?

The employee's principal objective is to make sure that whatever event will trigger income to the employee will also cause the employee to have converted the stock investment into cash. Suppose an employee buys 100 shares of company stock for $100, which is its fair market value at that time. To ensure that the employee will not later be taxed on appreciation in the stock on the basis of a claim that the interest has not yet vested, she files a Section 83(b) election. Thereafter, the employee sells the stock for $500. Traditionally, the main planning goal would be to ensure that the $400 of appreciation would be taxed at favorable capital gains rates. If the employee is in the 20 percent tax bracket, however, she will be largely indifferent as to whether the $400 gain is taxed as capital gain or as ordinary compensation income, so long as the employee is not taxed until she sells the stock. It appears that the employee's objective has been achieved.

On the other hand, the company's tax planning objectives may not have been well served. There is no benefit to the company as a result of the employee's recognition of $400 of capital gain upon the sale of the stock. Where, however, the employee is able to defer the triggering of Section 83 until she sells the stock, the company will obtain a deduction in the amount of $400. The value of this deduction will be very significant for any company that is a C corporation. The employee is taxed at the capital gains tax rate (currently 20 percent); the employer deducts at the corporate income tax rate (currently 34 percent or higher).

In some cases, the tax problem can be solved by a company commitment to pay the employee a bonus sufficient to cover the employee's tax. The bonus is deductible to the company, of course, at rates currently higher than

those paid by the employee. The combination of tax bonus plus Section 83 deduction may be better for the employer than making an 83(b) election, and the employee will be indifferent, since the tax is paid by the employer.

Are there additional adverse consequences to an employee who purchases stock with a nonrecourse note when the employer is an S corporation or a partnership?

As explained, where the employee purchases stock with a nonrecourse note secured solely by the stock, he will be treated as holding only a nonqualified option to buy stock. As such, the employee is not treated as owning any of the stock for tax purposes. This will have a dramatic effect where the company is a pass-through entity, either an S corporation or a partnership. For each tax year before the note is paid, all of the income or loss of the entity will be passed through to all other shareholders or partners, excluding the employee. The resulting distortions will be permanent and will almost always work to the disadvantage of the employee.

Assume that an employee has purchased with a note and is therefore treated as having an option to purchase 10 percent of the stock of an S corporation for $100. In each of the next two years, the company generates aggregate taxable income of $1,000 and distributes $350 to the shareholders (including the employee) to reimburse them for federal and state income taxes. At the end of year 2, the employee completes the purchase and sells the stock for $300. Because the employee's basis is $100, he recognizes a short-term capital gain of $200. If the employee had been treated as a stockholder in the company, his basis in the company stock would have been increased by $65 (10 percent of the company's undistributed taxable income) for each taxable year in which the company stock was held. Upon the sale of the company stock for $300 after year 2, the employee would have recognized only $70 long-term capital gain, that is, $300 proceeds realized, less $230 basis. This adverse consequence is somewhat offset by the fact that the employee was not taxed on the company income during prior years.

What happens when management borrows from third-party investors rather than from the company itself?

Where stock of the company or a nonrecourse loan to buy stock in the company is made available to an employee from a party that is a shareholder in

the company, the Section 83 rules make it clear that the employee will suffer the identical income tax results as if the stock or loan were made available directly from the company itself. As to the shareholder who makes the stock or loan available to the employee, any value transferred to the employee thereby is treated as having been contributed to the company by the shareholder on a tax-free basis. The only benefit obtained by the shareholder will be an increase in the basis in her stock of the company.

Can some of the employee's assets be protected from the recourse loan?

Typically, even in the most highly leveraged transactions, the amount of money required for management to purchase its shares cannot be repaid if the buyout does not succeed, without having a fairly severe impact on the lifestyle of the employee. Given a high level of confidence in the venture, and a relatively low stock purchase price, a management participant should be willing to risk his capital in a meaningful way, albeit not with personal bankruptcy as the consequence. In such cases, it might be worthwhile to consider a loan that gives the lender recourse to the borrowing employee, but specifically excludes recourse with respect to certain assets—for example, a house.

Although there is no authority on this question, one would have to stretch the Section 83 regulations substantially to treat such partially nonrecourse loans as nonqualified options. As long as the debt, and the personal liability of the employee thereon, is bona fide and real, it should probably be respected as such for tax purposes.

What other techniques provide management with full equity rights at a lower cost than the cost to third-party investors?

The most direct and effective means of reducing the cost of management stock relative to that purchased by other investors is through some multiclass arrangement. There are numerous variations on this theme. Here is an example of the most straightforward: Assume that a leveraged buyout is to be capitalized with $5 million in common equity, and that third-party investors are willing to put up this entire sum. The third-party investors could be given a preferred stock with a liquidation preference of $5 million and some reasonable preferred dividend rights. For a relatively nominal sum, both the third-party investors and management would purchase all of the common shares of the company.

By providing the third-party investors with preferential rights equal to virtually the entire shareholders' equity of the corporation, the book value, and arguably the fair market value of the common stock, will be nominal.

There are two problems with this arrangement. First, the IRS can argue that the preferred stock was in fact worth less than $5 million and that in any event the common stock was worth more than the nominal value ascribed to it because of the very low risk-reward ratio of the investment. Second, having more than one class of stock will prevent the company from electing to be an S corporation. Where S corporation status is desired, the purchase price of the common stock can be reduced by having third-party investors purchase deeply subordinated debt instruments in addition to their common stock.

If management already owns stock, how can management convert its existing stock ownership into stock in the buyer on a tax-free basis?

There are several tax-free ways in which management (as well as other shareholders) of a selling company may exchange existing equity in the target for a participating interest in the acquiring company in a leveraged buyout. Depending upon the other structural goals and requirements, a tax-free rollover may occur in the context of a recapitalization of the acquired company, some other tax-free reorganization, or a Section 351 National Starch transaction.

Achieving a tax-free rollover of management's equity can adversely affect other aspects of the tax structuring of the transaction. Most notably, if the management buyout is intended to be treated for tax purposes as a cost basis asset acquisition, overlapping ownership between the selling company and the buyer may thwart such a characterization.

If cash is received as part of the exchange, how is it treated?

Because LBOs involve a significant reduction in the value of the target's equity through increased debt financing, a target shareholder who wishes to retain an equity interest will either realize a significant increase in her percentage ownership of the outstanding stock or receive cash or other nonequity consideration in addition to the stock. In the latter case, management's tax advisors must analyze the facts to ensure that the receipt of nonstock consideration will be treated as capital gain rather than a dividend

to the participant. One key difference between a dividend and capital gain is that under the latter characterization the shareholder will be permitted to reduce taxable income by her basis in the stock.

Do the same rules apply where management owns nonqualified options or substantially nonvested stock?

No. In the case of both nonqualified options and restricted stock subject to a substantial risk of forfeiture for which a Section 83(b) election has not been made, the exchange of the option or stock for stock in the buyer that is not subject to a substantial risk of forfeiture will give rise to compensation income under Section 83 in an amount equal to the value of the target stock involved. If the employee holds restricted stock for which he has made a Section 83(b) election, the employee will be eligible for tax-free treatment.

Post-Acquisition Tax Issues

What is the principal tax planning goal in postdeal asset dispositions?

Postdeal asset disposition, if structured properly, can reduce or eliminate taxable gain.

It will be helpful to illustrate this point with a simple scenario. Purchaser corporation P wishes to acquire target corporation T from selling corporation S in an LBO for $100. The operations of T consist of two divisions, T1 and T2. The purchase price for the T stock has been financed largely through borrowed funds. S has a tax basis in its T stock of $20, and T has a tax basis in the T1 and T2 assets of $0. To pay down acquisition debt, P must dispose of the T2 division to a third party shortly after the acquisition of T. Although the two divisions of T are of approximately equal value, P believes that it will be able to sell the T2 division alone for $60.

Proposition: If P has purchased all of T for $100, it should be able to dispose of all of T immediately thereafter for $100 and recognize no taxable gain. What should follow is that if P disposes of the T2 division, constituting one-half of the value of T, for $50, then no gain should be recognized there as well.

As a general matter, whether or not this proposition will be true depends upon whether P has purchased the assets of T or the stock of T. As explained

earlier, where P, directly or through a subsidiary, purchases the assets of T for $100 or makes a Section 338 election, it will obtain a cost basis in all of the T assets and will recognize no gain if it disposes of some or all of those assets for an amount equal to their cost. However, where P purchases the stock of T and no Section 338 election is made, T retains a carryover basis in its assets and P will have to incur a tax on T's $50 of built-in gain upon a disposition of the T2 division.

The general rule is that the assets of T may not be disposed of by T without the recognition of a tax on the appreciation in those assets, notwithstanding that a buyer may have obtained a cost basis in the stock of T. The most direct and sure means of eliminating a second tax on built-in gain inside a target is to obtain a cost basis in the target's assets through a direct asset acquisition, forward cash merger, or Section 338 transaction.

Must unwanted assets always be removed after the acquisition of a target?

As a general matter, where a spin-off is followed by a sale by the shareholder of the stock of either the distributing corporation or the spun-off subsidiary, the spin-off is likely to violate the requirements of Section 355. One important exception to this rule is that a target corporation is permitted to spin off a subsidiary to the target's shareholders prior to an acquisition of the target in a Section 368 tax-free reorganization. Where the shareholder of the target is a corporation, it is probable that the IRS would permit a significant amount of cash to be issued in the transaction along with qualifying stock consideration. Where the shareholders of the target are individuals, one should expect not to be permitted to utilize much cash in the transaction.

Other Tax Issues

What role do state and local taxes play in structuring mergers, acquisitions, and buyouts?

State and local taxes generally play a secondary role in planning M/A/B transactions. First, most state income tax systems are based largely on the federal system, particularly in terms of what is taxable, to whom, when, and in what amount. Second, when the company being acquired operates in a number of states, it can be inordinately difficult to assess the interaction of

the various state tax systems. On the other hand, tax planners cannot afford to ignore a transaction's state tax consequences. Although a detailed discussion of state income tax consequences deserves a book of its own, several extremely important state tax issues will be mentioned throughout the following discussion.

First and foremost, there are income taxes. These vary from state to state and may affect companies located outside the state.[33] Beyond income taxes, there are numerous taxes imposed by states and localities that may affect an acquisition. Although these rarely amount to structural prohibitions or incentives, they often increase costs. For example, when real estate is being transferred, there will often be unavoidable real property gain, transfer, or deed recordation taxes.

Purchases of assets might not be exempt from a state's sales tax. Many states offer exemptions, but this should not be taken for granted. Check it out.

Certain types of state and local taxes not directly associated with an acquisition can be significantly affected by an acquisition or by the particular structure of the acquisition. For example, a state's real property and personal property taxes are based on an assessment of the value of the property owned by a taxpayer. Often, a transfer of ownership of the property will trigger a reassessment of the value of the property.

Are takeover expenses tax-deductible? What is the leading legal precedent?

Sometimes no, sometimes yes, as two 1992 cases illustrate. In 1992, the Supreme Court decided a case involving the deduction or capitalization of expenses incurred by a company (National Starch) in connection with a friendly takeover by another company (Indopco).[34] The expenses included investment banking fees, legal fees, and other acquisition-related expenses.

The Court affirmed the decision of the U.S. Court of Appeals for the Third Circuit in holding that the expenses do not qualify as current deductions since deductions are exceptions to the norm of capitalization, and they are allowed only if there is clear provision for them in the tax code. The burden of proof is on the taxpayer to show a right to the current deduction, and this burden was not met in the *National Starch* case.

The *National Starch* Court specifically rejected the taxpayer's interpretation of a previous Supreme Court decision that the expenditure had to be capitalized only if it created or enhanced a separate or distinct asset. An important factor in determining whether the appropriate tax treatment is immediate deduction or capitalization of the expenditures is the taxpayer's expectation of

benefits beyond the year in which the expenditures are incurred. The Court found that those future benefits did in fact exist and, consequently, that capitalization was appropriate.

On the other hand, in a 1992 bankruptcy court case involving the unsuccessful effort by Federated Department Stores and Allied Stores to prevent being taken over by Campeau, fees paid by Federated and Allied to potential white knights (Edward DeBartolo and Macy's) were held to be deductible.[35] Testimony elicited at the hearing indicated that such fees are ordinary and customary provisions demanded by potential white knights as compensation for all the cost and expenses they have incurred in a hostile takeover situation.

The bankruptcy court in *Federated* had little difficulty distinguishing this case from *National Starch.* It pointed out that both the courts and the IRS had historically allowed deductions for costs related to abandoned business transactions. The bankruptcy court noted that in this case, unlike *National Starch,* the merger expenditures of the abandoned white knight conferred no possible benefits to the corporations taken over because the outcome resulted in the exact opposite of any possible long-term future benefit.

What is pro forma financial information?

Pro forma financial information reflects the impact on historical financial statements of a particular business combination and its financing as if the transaction had been consummated at an earlier date. Pro forma information ordinarily includes (1) a description of the transaction, the entities involved, and the periods for which the pro forma information is presented, and (2) a columnar presentation of historical condensed balance sheet and income statements, pro forma adjustments, and pro forma results.

The demise of Enron in 2002, following positive pro forma reports, gave pro formas a bad name. The SEC published a warning about pro forma statements, as follows:

1. The antifraud provisions of the federal securities laws apply to a company issuing pro forma financial information. Because pro forma information is information derived by selective editing of financial information compiled in accordance with GAAP, companies should be particularly mindful of their obligation not to mislead investors when using this information.
2. If companies present financial results focused on a limited feature of a company's overall financial results (for example, earnings before interest, taxes, depreciation, and amortization), or

estimating financial results on a basis other than GAAP, they need to describe accurately the controlling principles involved.

3. Companies must pay attention to the materiality of the information that is omitted from a pro forma presentation.
4. If a financial report deviates from GAAP the company should explain in plain English, in the same public statement, how it has deviated from GAAP and the amounts of each of those deviations.
5. Investors should compare any summary or pro forma financial presentation with the results reported on GAAP-based financials by the same company. "Read before you invest; understand before you commit."[36]

Pro forma adjustments to the income statement are computed assuming that the transaction was consummated at the beginning of the fiscal year and include adjustments that give effect to events that are (1) directly attributable to the transaction, (2) expected to have a continuing impact on the registrant, and (3) factually supportable.

Pro forma financial information might appear in both the private M&A and public M&A contexts. In the private M&A context, a seller might show how the selling company's financial results would have been reported if the company were controlled by a different shareholder. A typical adjustment in this case might include above-market compensation to a CEO or controlling shareholder. A selling company might present such information to prospective buyers in order to maximize the perceived earnings power and, hence, acquisition price of the target.

In the public M&A context, the acquiring corporation frequently might be required by GAAP to publish pro forma financial data in its 10-Q to reflect the acquisition. The most common adjustments to the acquiring corporation's actual results would include any adjustments under purchase accounting, as well as interest expense on acquisition or assumed debt, for the full reportable period, rather than just the period during which the target was part of the acquirer's actual results.

How should the fair value or carrying amount of preferred stock issued in business combinations be determined?

The distinctive attributes of preferred stock make some preferred issues similar to debt securities, whereas others are more similar to common stock, with many variations between the extremes. Determining the appropriate carrying

value to assign to preferred stock issued in a business combination will be affected by its characteristics.

Even though the principle of recording the fair value of consideration received for stock issued applies to all equity securities, preferred as well as common, the carrying value of preferred securities may be determined in practice on the same basis as debt securities. For example, the carrying value of a nonvoting, nonconvertible preferred stock that lacks characteristics of common stock may be determined by comparing the specified dividend and redemption terms to debt securities with similar terms and market risks.

What is pushdown accounting?

Pushdown accounting refers to the establishment of a new accounting and reporting basis in an acquired company's separate financial statements, resulting from the purchase and substantial change of ownership of its outstanding voting equity securities. The buyer's purchase price is "pushed down" to the target and used to restate the carrying value of its assets and liabilities. For example, if all of a target's voting equity securities are purchased, the assets and liabilities of the acquired company are restated using fair market values so that the excess of the restated amounts of the assets over the restated amounts of the liabilities equals the buyer's purchase price.

In what circumstances should pushdown accounting be applied?

The SEC requires the use of pushdown accounting by public enterprises with respect to target corporations that are substantially or wholly owned. The SEC stated that when the form of ownership is within the control of the buyer, the basis of accounting for purchased assets and liabilities should be the same regardless of whether the entity continues to exist or is merged into the buyer. The SEC recognized, however, that the existence of outstanding public debt, preferred stock, or a significant minority interest in a subsidiary might affect the buyer's ability to control the form of ownership. As a result, the SEC, although encouraging its use, generally does not insist on the application of pushdown accounting in these circumstances. Pushdown accounting is optional for the separate financial statements of a nonpublic target.

CONCLUDING COMMENTS

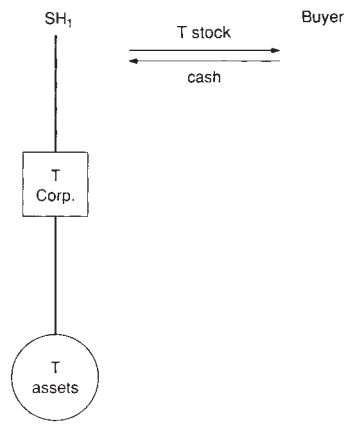
Deal structuring is not for the faint of heart. It requires current, professional-grade knowledge of accounting standards, securities law, and tax law. Dealmakers should call on expert advisors with current M&A experience. At the same time, dealmakers should not shy away from structuring. Instead, they should familiarize themselves with the general concepts and vocabulary in this area. That way they can be sure that the transaction they are handling remains linked to the other aspects of their deal—including due diligence, the subject of the next chapter.

TRANSACTION DIAGRAMS

Figures 5-3 to 5-13 illustrate graphically many of the transactions discussed in this book. In each diagram, an SH represents a shareholder, a square is a corporation, and a circle represents corporate assets. Vertical and diagonal lines indicate the ownership of stock or assets, and arrows represent the flow of cash, assets, stock, and so on.

FIGURE 5-3

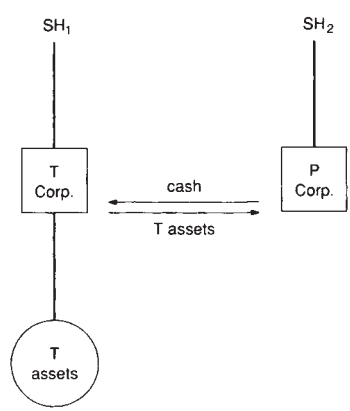
Stock Purchase



1. SH_1 owns 100% of the stock of T.
2. Buyer purchases 100% of the stock of T in exchange for cash.

FIGURE 5-4

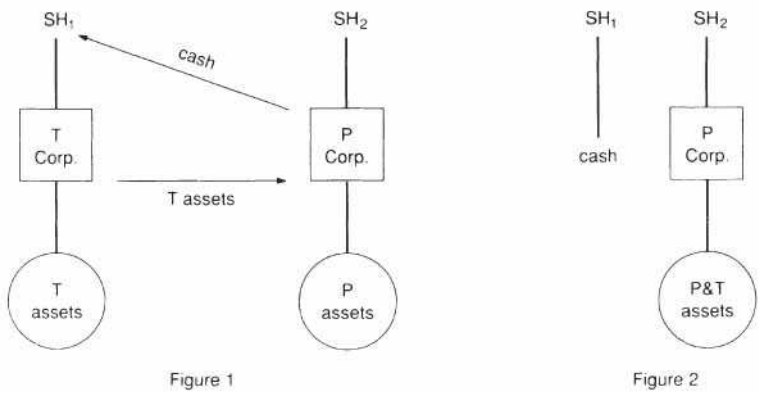
Asset Purchase



1. SH_1 owns 100% of the stock of T; SH_2 owns 100% of the stock of P.
2. P purchases all assets of T in exchange for cash.

FIGURE 5-5

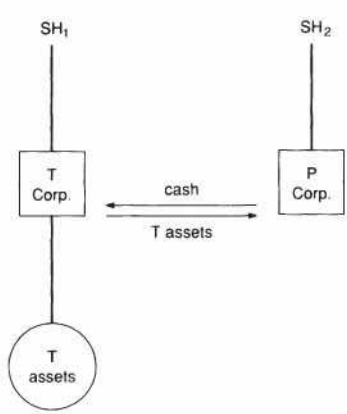
Taxable Forward Merger



1. SH_1 owns 100% of the stock of T; SH_2 owns 100% of the stock of P.
2. T is merged into P. T's assets are transferred to P, the stock of T is canceled, and the existence of T is terminated.
3. P transfers cash to SH_1.

FIGURE 5-6

Taxable Reverse Merger



1. SH_1 owns 100% of the stock of T; SH_2 owns 100% of the stock of P.
2. P purchases all assets of T in exchange for cash.

FIGURE 5-7

Taxable Forward Subsidiary Merger

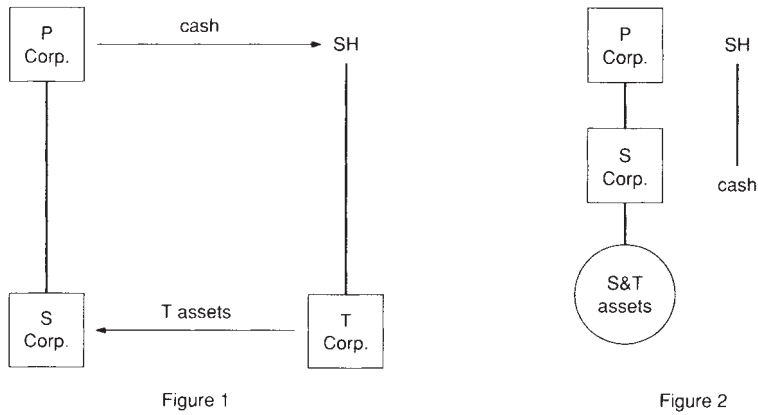


Figure 1 Figure 2

1. Corporation P owns 100% of the stock of S; SH owns 100% of the stock of T.
2. T is merged into S by the terms of the merger agreement, T's assets are transferred to P, the stock of T is canceled, and P transfers cash to SH.

FIGURE 5-8

Tax-Free Forwardf Merger (A Reorganization)

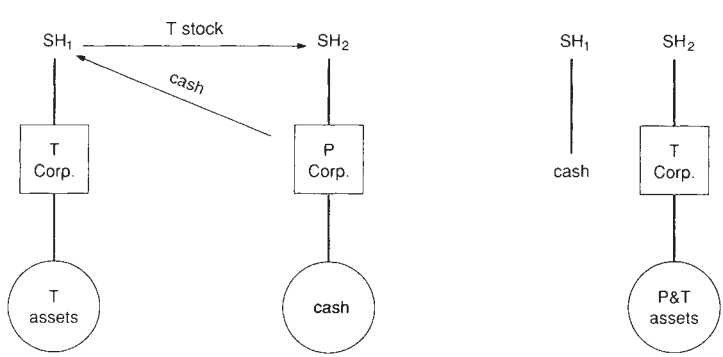


Figure 1 Figure 2

1. SH_1 owns 100% of the stock of T; SH_2 owns 100% of the stock of P.
2. P is merged into T: The stock of P is canceled, and the corporate existence of P is terminated.
3. By the terms of the merger agreement, SH_1 receives cash of P, and SH_2 receives the stock of T.

FIGURE 5-9

Tax-Free Forward Triangular Merger
[Hybrid A Reorganization–Section 368 (a)(2)(D)]

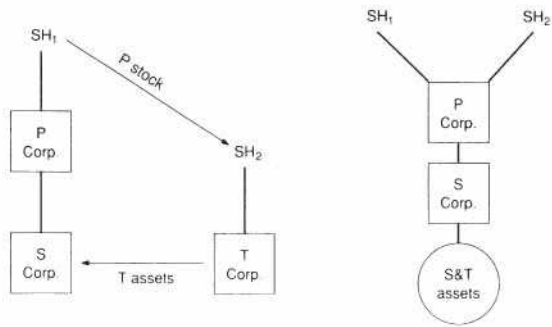


Figure 1 Figure 2

1. SH_1 owns 100% of the stock of P; P owns 100% of the stock of S.
2. SH_2 owns 100% of the stock of T.
3. T merges into S. T's assets are transferred to S and the stock of T is canceled.
4. SH_1 transfers a portion of the stock of P to SH_2.

FIGURE 5-10

Tax-Free Acquisition of Stock for Voting Stock
(B Reorganization)

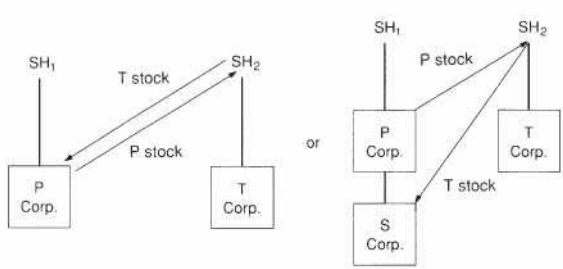


Figure 1 Figure 2

"B" Reorganization (Figure 1)
1. SH_1 owns 100% of the stock of P; SH_2 owns 100% of the stock of T.
2. SH_2 transfers all the stock of T to P.
3. In exchange for its stock of T, SH_2 receives shares of the stock of P.

Triangular "B" Reorganization (Figure 2)
1. In a triangular "B" reorganization, P owns 100% of the stock of S.
2. SH_2 transfers all the stock of T to S.
3. In exchange for its stock of T, SH_2 receives shares of the stock of P.

FIGURE 5-11

Acquisition of Property for Voting Stock
(C Reorganization)

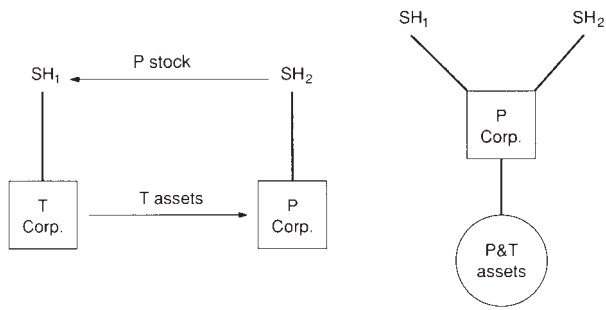


Figure 1 Figure 2

1. SH_1 owns 100% of the stock of T.
2. SH_2 owns 100% of the stock of P.
3. T transfers its assets to P.
4. SH_2 transfers a portion of the stock of P to SH_1 and T is liquidated.

FIGURE 5-12

Acquisition of Property for Voting Stock
(D Reorganization)

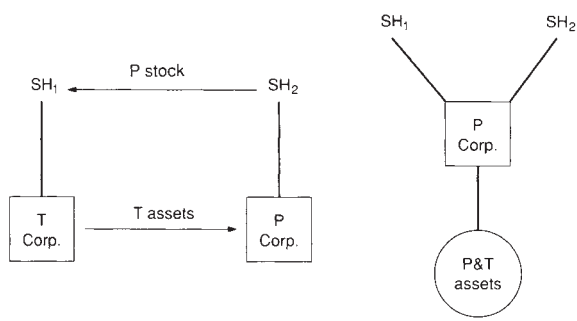
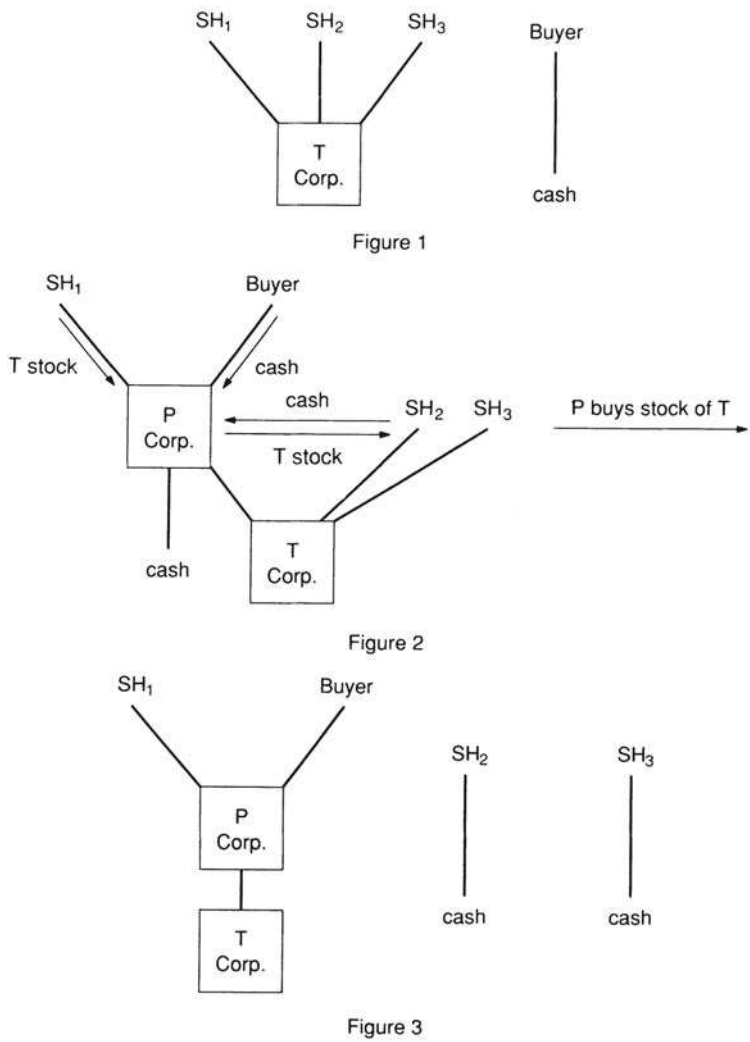


Figure 1 Figure 2

1. The value of T is greater than the value of P.
2. SH_1 owns 100% of the stock of T.
3. SH_2 owns 100% of the stock of P.
4. T transfers its assets to P, and T is liquidated.
5. SH_2 transfers a portion (more than 50%) of the P stock to SH_1.

FIGURE 5-13

National Starch Transaction (Section 351 Acquisition)



1. SH_1, SH_2, and SH_3 together own 100% of the stock of T.
2. Buyer and SH_1 incorporate P: Buyer transfers cash to P; SH_1 transfers its stock of T. Buyer and SH_1 receive the stock of P.
3. P buys the stock of T from SH_2 and SH_3 in exchange for cash.

NOTES

1. See Alexandra R. Lajoux and H. Peter Nesvold, *The Art of M&A Structuring: Techniques for Mitigating Financial, Tax, and Legal Risk* (New York: McGraw-Hill, 2004).
2. A principal exception exists when an acquirer is purchasing assets out of bankruptcy.
3. For example, in January 2006, the senate of the state of Indiana introduced a bill 0286, to repeal the state's bulk sales law. "Synopsis: Repeal of uniform bulk sales law. Repeals the uniform law concerning the documentation and regulation of bulk sales. Makes conforming amendments." See www.in.gov/legislative/bills/2006/IN/IN0286.1.html. As we go to press, this bill is still pending.
4. As of January 2006, some 20 percent of public companies require a supermajority vote to approve mergers. For a guide to the use of bylaws for supermajority provisions and other defensive provisions, see Lyle G. Ganske and Lisa K. Kunkle, "Corporate Bylaws: The Building Blocks of a Corporation—and a Bulwark of Defense," *Director's Monthly,* January 2002, pp. 5–9.
5. In January 2003 (Announcement 2003–2), the IRS announced new Form 8883, Asset Allocation Statement Under Section 338. This form is used to report information about transactions involving the deemed sale of corporate assets under Section 338 of IRC. For instructions posted February 2006, see www.irs.gov/instructions/i8883/ar01.html.
6. Twenty percent seems to be a common threshold for dilution. In parallel fashion, the New York Stock Exchange Listed Company Manual, Rule 312.03, states:
   (c) Shareholder approval is required prior to the issuance of common stock, or of securities convertible into or exercisable for common stock, in any transaction or series of related transactions if:
   - **(1)** the common stock has, or will have upon issuance, voting power equal to or in excess of 20 percent of the voting power outstanding before the issuance of such stock or of securities convertible into or exercisable for common stock; or
   - **(2)** the number of shares of common stock to be issued is, or will be upon issuance, equal to or in excess of 20 percent of the number of shares of common stock outstanding before the issuance of the common stock or of securities convertible into or exercisable for common stock.

   (d) Shareholder approval is required prior to an issuance that will result in a change of control of the issuer.
7. For a recent (2006) interpretation, see www.sec.gov/divisions/corpfin/cf-noaction/gasnatural030206.htm.

8. Rule 145 of the Securities Act of 1933, concerning "Reclassification of Securities, Mergers, Consolidations and Acquisition of Assets," defines transactions within the rule as including "an 'offer,' 'offer to sell,' 'offer for sale,' or 'sale.' " These fall under the rule when "there is submitted for the vote or consent of such security-holders a plan or agreement for: reclassifications . . . mergers or consolidations . . . or transfers of assets." *Securities Act Rules, Volume 1, Rules 100 through 236; General Rules and Regulations under the Securities Act of 1933,* March 15, 2006 (New York: Bowne & Co., 1997).
9. The authors are grateful to Pat McConnell, Janet Pegg, and other members of Bear Stearns' accounting and tax policy research team, whose Statement 141–142 reports proved invaluable.
10. In some situations, an acquirer under the old rules could use stock as acquisition currency, yet still receive purchase accounting treatment for the transaction.
11. The authors are grateful to Deloitte & Touche publications for the substance of this discussion.
12. For an IRC publication on how to depreciate intangible property under Section 179 of the IRC, see www.irs.gov/publications/p946/ch01.html#d0e1264.
13. The Government Accounting Standards Board is working on applying this standard to its own accounting. For a report as of mid-2006, see www.gasb.org/project_pages/intangible_assets.html.
14. The Jobs and Growth Tax Relief Reconciliation Act of 2003 accelerated the reduction in marginal income-tax rates to 25 percent (from 27 percent), 28 percent (from 30 percent), 31 percent (from 33 percent), and 33 percent (from 35 percent). It also reduced the capital gains tax rate from 20 percent to 15 percent (from 10 percent to 5 percent for taxpayers in the 10 percent and 15 percent brackets) effective after May 5, 2003, and through December 31, 2008, with steeper reductions for lower tax brackets. The act applies the reduced capital gains tax rates to dividends in certain circumstances. Where eligible, taxpayers in tax brackets above 15 percent pay 15 percent on dividends paid between January 1, 2003, and December 31, 2008. Source: Valic Financial Advisors, Inc., of the American International Group, Inc. Note: The Tax Increase Prevention and Reconciliation Act of 2006 includes a two-year extension of the 15 percent maximum capital gains tax rate.
15. The double tax that the corporate shareholders face got reduced under The Jobs and Growth Tax Relief Reconciliation Act of 2003. Under this act, qualified dividends received by individuals are taxed at the same rate that applies to net long-term capital gains, depending on the individual's marginal income tax bracket.
16. Ordinary dividends are taxable as ordinary income unless they are qualified dividends. Qualified dividends are ordinary dividends that meet

the requirements to be taxed at the same maximum rates as net capital gains.

17. Under current law, an issuer of debt can deduct the interest that it pays, but an issuer of equity may not deduct dividend payments it makes. Complications arise under a new definition of equity securities that includes equity futures. See "Amendment to Definition of 'Equity Security' " www.sec.gov/rules/final/33-8091.htm.

18. See Section 401 of the Taxpayer Relief Act of 1997, effective for years beginning after December 31, 1997, and for property placed in service after December 31, 1998.

19. The actual wording is as follows: "The tentative minimum tax for a corporation shall be zero for any taxable year if—(A) such corporation met the $5,000,000 gross receipts text . . . for its first taxable year beginning after December 31, 1996, and (B) such corporation would meet such test for the taxable year and all prior taxable years beginning after such first taxable year if such test were applied by substituting '$7,500,000' for '$5,000,000.' "

20. In 2006, two states (Pennsylvania and New Hampshire) prohibit companies from carrying forward the full extent of their net operating losses to offset future income. According to critics, this "penalizes start-up technology firms and cyclical companies by significantly increasing their tax rates." See www.pghtech.org/membership/net.asp. Of the 47 states that permit net operating loss carryforward provisions, only Pennsylvania and New Hampshire limit the amount of loss that can be used to offset income in each future tax year. California had temporarily capped the use of losses but recently returned to the position of letting all losses be used in a future tax year. New Jersey temporarily suspended and then restricted net operating loss carryforward provisions.

21. See www.fasb.org/project/uncertain_tax_positions.shtml#summary, last updated April 21, 2006.

22. IRC § 368(a)(1)(A). According to Treasury Regulation Section 1-368-2(b)(1), the regulation specifies that the merger or consolidation must be "effected pursuant to the corporation laws of the United States or a State or Territory or the District of Columbia."

23. See *Bausch & Lomb Optical Co. v. Comm'r,* 267 F.2d 75 (2d Cir. 1959), *cert. denied,* 361 U.S. 835 (1959).

24. Parties to a limited partnership are limited partners (LPs) and one or more general partner (GP). LPs enjoy limited liability status but GPs do not.

25. A *corporate distribution* means an actual or constructive transfer of cash or other property (with certain exceptions) by a corporation to a shareholder acting in the capacity of a shareholder. For tax purposes, a transfer of property to a shareholder acting in the capacity of an employee or lender, for example, is not a corporate distribution.

26. A recharacterization of debt into equity raises a somewhat different concern in the case of the debt of a partnership. Debts of a limited partnership for which no general or limited partner is personally liable (nonrecourse debts) increase the basis of the limited partners in the partnership. A recharacterization will not convert a partnership into a taxpaying entity. Rather, the lender will become a partner, and the entire amount of the recharacterized debt will be allocated to increase the lender's basis. Other partners' bases will shrink, causing them to encounter unexpected tax results. For example, cash distributions in excess of their recharacterized bases will produce income, and, if the partnership generates a taxable loss, some or all of the loss may have to be allocated to the lender-partner.

27. For the most recent revisions to this IRC section, see code of Federal Regulations, Title 26, Volume 3, revised as of April 1, 2005, from the U.S. Government Printing Office. 26 CFR 1.279-5, pp. 668–674.

28. See IRC Title 26, Subtitle A, Chapter 1, Subchapter B, Part VII, Section 264A, for the full text.

29. Conflicts of interest have become a common theme in court-ordered studies of bankrupt MBOs. See H. Peter Nesvold, "Going Private or Going for Gold: The Professional Responsibilities of the In-House Counsel During a Management Buyout," 11 *Georgetown Journal of Legal Ethics* (1998). Some say that independent corporate directors should retain counsel to ensure that they are not accused of conflict of interest—a theme in cases such as *Kahn v. Tremont Corp.,* 694 A.2d 422 (Del. 1997). This is refuted in E. Norman Veasy, "Separate and Continuing Counsel for Independent Directors: An Idea Whose Time Has Not Come as a General Practice," *The Business Lawyer* (Vol. 59, No. 4), August 2004. Judge Veasey, retired chief justice of the Delaware Supreme Court, is a partner with Weil, Gotshal & Manges LLP.

The issue of parent company liability arises frequently in litigation following leveraged buyouts. In August 1992, bankruptcy court judge Alexander Pashay cleared such a post-LBO case for trial. In this decision, *In re: Hillsborough Holdings Corp. et al. U.S. Bankruptcy Court, Tampa, Florida, Division 89-9715-8p1,* Judge Pashay questioned whether certain post-buyout divestitures by Walter Industries (which themselves were structured as buyouts) "were done for legitimate business purposes or . . . solely for the purpose of denuding [the target] Celotex of assets."

30. Clifford E. Neimeth, "Inconsistent Application of the SEC's 'All Holders-Best Price' Rule Continues to Chill Tender Offers," *Journal of Investment Compliance,* Winter 2002/2003.

31. Final Rule: Regulation of Takeovers and Security Holder Communications, Securities and Exchange Commission 17 CFR Parts 200, 229, 230, 232, 239, and 240; Release No. 33-7760; 34-42055; IC-24107; File No. S7-28-98.

32. For a fairly recent case in this regard, see B. Jannell Grier Esq., "Section 83

Case Splits the Circuits," 2003, re *Robinson v. United States,* 52 Fed. Cl. 725, 729 (2002).

33. One of the laws limiting the reach of state income taxes was broadened in 1992 when the U.S. Supreme Court declared a "de minimis" exception to a 1959 law establishing a federal limitation on state income taxes. This exception, set forth in *Wisconsin Department of Revenue v. William Wrigley, Jr., Co.,* found that certain activities were "not entirely ancillary to requests for purchases" and therefore not exempt from state income tax.

34. 503 U.S. 79 (1992), aff'g *National Starch and Chem. Corp. v. Commissioner,* 918 F.2d 426, 90-2 U.S.T.C. ¶50,571 (3d Cir. 1990), aff'g 93 T.C. 67 (1989). For a thoughtful commentary that remains relevant today, see Harvey Coustan, "What does the future hold for Indopco?" *Insight,* December 2000–January 2001.

35. In re Federated Dept. Stores, Inc., 92-1 U.S.T.C. ¶50,097 (Bankr. S.D. Ohio 1992), aff'd 94-2 U.S.T.C. ¶50,430 (S.D. Ohio 1994).

36. See Release Nos. 33-8039, 34-45124, FR-59, Securities and Exchange Commission, Cautionary Advice Regarding the Use of "Pro Forma" Financial Information in Earnings Releases, December 4, 2001. For a recent (2006) example of a company following these guidelines, see www.sybase.com/content/1040264/Q106ReconciliationtoProFormaStatement042506.pdf.

CHAPTER 6

The Due Diligence Inquiry

INTRODUCTION

The basic function of *due diligence,* in any merger or acquisition, is to assess the potential risks of a proposed transaction by inquiring into all relevant aspects of the past, present, and predictable future of the business to be purchased. The term is also used in securities law to describe the duty of care and review to be exercised by officers, directors, underwriters, and others in connection with public offerings of securities.

Although the term *due diligence* is applied in *securities law*—statutory law set by legislatures—the term itself originated in so-called *common law,* also known as *case law*—the law that develops through decisions of judges in settling actual disputes. The common law system arose in medieval England after the Norman Conquest, and is still in use there as well as in the United States, among other countries. In this type of law, as opposed to law passed by legislatures, judges use the precedents of previous case decisions in order to render their own decisions. Much of U.S. common law has been codified in the statutes of individual states, and in a broadly used document called the U.S. Commercial Code.

The due diligence effort in a merger transaction should include basic activities to meet diligence standards of common law and best practices. These activities include the following:

- *Financial statements review*—to confirm the existence of assets, liabilities, and equity in the balance sheet, and to determine the financial health of the company based on the income statement.

- *Management and operations review*—to determine quality and reliability of financial statements, and to gain a sense of contingencies beyond the financial statements. (Recent regulatory and accounting reforms in the United States, in the aftermath of the 2002 law known as Sarbanes-Oxley, make this review somewhat easier, because now corporate leaders have greater accountability for the oversight of internal accounting controls.)
- *Legal compliance review*—to check for potential future legal problems stemming from the target's past.
- *Document and transaction review*—to ensure that the paperwork of the deal is in order and that the structure of the transaction is appropriate.

Careful scrutiny in all these areas can prevent problems after the transaction is over and the new company's life begins. So let's get started!

GETTING STARTED

When does due diligence begin?

The due diligence process begins from the moment a buyer senses a possible acquisition opportunity. The buyer then starts to examine the information that is readily available at this early time about the company. For public companies, this information is usually derived from public documents—including press reports, filings with securities regulators, and any debt or equity offering memorandums the company or its bankers might have prepared for potential buyers.

This initial stage of due diligence review based on public documents usually starts during the search-and-screen, valuation, and financing processes, described in the previous chapters. During these phases, the acquirer has asked and answered three opening questions:

- Is it in our stockholders' long-term interests to own and operate this company?
- How much is it worth?
- Can we afford it?

When the parties are ready to go forward and to set a tentative price for the deal, the buyer should engage attorneys and accountants to conduct a more thorough study of the company to be acquired. This "dirty linen" phase

of the due diligence inquiry—discovering what's wrong with the company—can never start too early. Buyers often neglect this phase, because they do not want to offend sellers, but they must proceed. Buyers need to ask and answer the tougher questions such as:

- Do the firm's financial statements reveal any signs of insolvency or fraud?
- Do the firm's operations show any signs of weak internal controls?
- Does the firm run the risk of any major postmerger litigation by the government or others?

Two milestones marking the official onset of due diligence are the signing of a *confidentiality agreement* and a *letter of intent* to buy the company. Formal due diligence usually does not begin until these two documents are signed. More details are specified in the *acquisition agreement.* (For a sample confidentiality agreement, see Appendix 6A at the end of this chapter. For a sample letter of intent and acquisition agreement, see Chapter 7.)

What does the acquisition agreement typically say about due diligence?

Among other items, the acquisition agreement should:

- State the time available for due diligence
- Promise the buyer access to the selling company's personnel, sites, and files

Here is sample language about due diligence from an acquisition agreement:

> ***Investigation by Buyer.*** The Seller and Target shall, and the Target shall cause its Subsidiaries to, afford to the officers and authorized representatives of the Buyer free and full access, during normal business hours and upon reasonable prior notice, to the offices, plants, properties, books, and records of the Target and its Subsidiaries in order that the Buyer may have full opportunity to make such **investigations** of the business, operations, assets, properties, and legal and financial condition of the Target and its Subsidiaries as the Buyer deems reasonably necessary or desirable; and the officers of the Seller, the Target, and its Subsidiaries shall furnish the Buyer with such additional financial and operating data and other information relating to the business operations, assets, properties, and legal and financial condition of the Target and its Subsidiaries as the Buyer shall from time to time reasonably request.

> Prior to the Closing Date, or at all times if this Agreement shall be terminated, the Buyer shall, except as may be otherwise required by applicable law, hold confidential all information obtained pursuant to this Section 6.6 with respect to the Target and its Subsidiaries and, if this Agreement shall be terminated, shall return to the Target and its Subsidiaries all such information as shall be in documentary form and shall not use any information obtained pursuant to this Section 6.6 in any manner that would have a material adverse consequence to the Target or its Subsidiaries.
>
> The representations, warranties, and agreements of the Seller, the Target, and its Subsidiaries set forth in this Agreement shall be effective regardless of any investigation that the Buyer has undertaken or failed to undertake.

The first paragraph of this clause is called an *investigation covenant.* It ensures that the seller will cooperate with the buyer by granting access and logistical support for the buyer's due diligence review of the seller and its subsidiaries. This is one of the most valuable parts of any acquisition agreement.

The second paragraph, sometimes nicknamed a *burn or return* provision, may help allay the seller's fears about confidentiality. Note, however, that the seller will often require the prospective buyer to enter into a separate confidentiality agreement.

The third paragraph makes a statement that removes the burden of perfect investigation from the acquirer. Without such a statement, the seller can avoid liability following a breach of contract. The seller can disclaim responsibility for representations, arguing that the buyer could have discovered the breach during the investigation of the seller's company.

Who conducts due diligence?

Typically outside counsel to the acquirer directs the due diligence review, with help from a team of professionals employed or retained by the acquirer. As mentioned, the review has both financial and legal aspects. Each of these parts can benefit from specialized attention. The financial and legal sides each have separate and distinct responsibilities, although they may, and indeed should, communicate with one another.

The financial statement review requires attention from the acquirer's financial and accounting personnel, such as the chief financial officer and, if the company has one, the chief internal auditor. The legal compliance review requires external and, if available, internal counsel. The acquirer may also bring in economic consultants, engineers, environmental experts, and a host of other professional talent during the review.

The party directing the review should be clear from any conflicts of interest. Any party paid a contingency for the completion of the transaction—for example, an investor banker having such an arrangement—has a conflict of interest and should not direct the review. Also, if a firm has a consulting engagement with the company it is studying, it may also have a conflict of interest with respect to the transaction. This would include any audit firm that also performs management consulting for the company. (Fortunately, such a dual role for auditors occurs only rarely now. Sarbanes-Oxley prohibits it for audits of public companies, and professional standard setters such as the American Institute of Certified Public Accountants (AICPA) discourage it for audits of private companies.[1])

How can the professionals conducting due diligence keep the process on track?

It is helpful for investigators to have a due diligence checklist. The checklist should be drafted first, and should undergo constant revision as the acquirer discovers important points. The acquisition agreement, which is drafted after the checklist, will express the most important elements on the checklist.

A typical checklist will include key assets, both tangible and intangible. In parallel, the acquisition agreement will often indicate which of these assets will be appraised. (For a sample due diligence checklist, see Appendix 6B.) Take for example Section 4.8 of the sample acquisition agreement at the end of Chapter 7, which states:

> ***Section 4.8. Most Recent Inventory.*** The inventories of the Target and the Subsidiaries on a consolidated basis as reflected on the Most Recent Balance sheet consist only of items in good condition and salable or usable in the ordinary course of business, except to the extent of the inventory reserve included on the Most Recent Balance sheet, which reserve is adequate for such purpose. Such inventories are valued on the Most Recent Balance Sheet *at the lower of cost or market* in accordance with GAAP.

As noted in the annotations to this section, it is important for the buyer to know whether the valuation of inventory on the financial statements reflects its actual value. In some cases, the buyer may include a representation that a particular dollar amount is the minimum value of the target's inventories—a representation that is more common in an asset purchase. To find this dollar amount, the services of an appraiser can be helpful.

- The first priority will be to appraise any assets *used in the business* that are *independently marketable,* such as machinery, real property,

or inventories. This kind of appraisal is mandatory for lenders, who base the amount of their loans on the market value of the assets available as security.

- It is also advisable (but not mandatory) to appraise *other assets* (i.e., those not used in the business and/or that cannot be marketed independently). These include unused real property, marketable securities, excess raw material, investments in nonintegrated subsidiary operations, and reserves in the extracting industries.
- Finally, the acquirer can appraise the company's *operations* and *intangibles* such as patents or trademarks that support an earnings stream.

To ensure that all appraisals and other assurances get accomplished, a checklist can help. The checklist should be used as a reminder rather than a sequential road map. Investigators should focus their investigation on the particular issues as they arise. Due diligence will often unfold as a series of independent mini-investigations with respect to the key issues.

What should be in the due diligence checklist?

A due diligence checklist will often parallel the structure of the representations and warranties that the seller makes in the acquisition agreement. These are essentially written assurances from the seller that things are as they seem—for example, the buyer must require that the seller state that the consolidated financial statements of the target fairly represent the financial condition of the target in accordance with GAAP.

In drafting a workable checklist, acquirers should concentrate on areas of relevance to the transaction at hand. For example, inquiries regarding the frequency and extent of customer complaints and returned goods would be most relevant to a consumer goods retail business, while questions regarding environmental violations would be most appropriate in a manufacturing firm.

Depending on the size of the acquisition, the checklist may or may not reflect a threshold of materiality. For example, a checklist may include only capital expenditures above $50,000, or will set a limit of five years back for certain documents. Acquirers should agree to limits of this kind carefully, bearing in mind that any ground given at this point is likely to limit the scope of the seller's representations and warranties in the acquisition agreement.

Some items on the checklist will require the seller to provide documentation. For this there can be a separate checklist. (See Appendix 6C.) Not everything has to be a document from the seller. Most sellers will not

welcome requests for information that require creating new documentation, so whenever possible the buyer should attempt to obtain data through interviews with the seller's officers or other key employees. This information can be captured in the acquisition agreement signed by buyer and seller.

DURATION OF DUE DILIGENCE

How long should the due diligence process take?

The due diligence process occurs throughout the acquisition process, which lasts from a few weeks to a year or more. Surprisingly, the due diligence process does not slow the pace of the acquisition negotiation in most cases; sometimes, the buyer accelerates the process by doing extensive investigation before making the first offer. At the other extreme, management buyers, who believe they know their own company, may willingly dispense with extensive due diligence inquiry, sometimes to their regret. If the parties are eager to deal, they may substitute extensive warranties for the due diligence process.

When buyers do initiate a formal, organized due diligence investigation, they should put it on a fast track. Speedy due diligence ensures minimal disruption to ongoing business activities and the minimization of out-of-pocket costs to both parties. Another benefit can be smoother relations between the parties.

The most valuable result of fast-track due diligence is timely information to the buyer, who can quickly determine whether the acquisition is of interest and, if so, on what terms and conditions. The buyer can then focus attention on determining the appropriate structure for the transaction; the basis for calculation of the purchase price; what representations, warranties, and covenants should be negotiated into the final acquisition agreement; and what conditions to closing need to be imposed. (In fact, the earlier the draft of the schedule "Conditions Precedent to Closing" is generated, the better. Somehow, with that document on the table and under constant revision as the due diligence proceeds, the probability that the deal will close seems to improve.)

DUE DILIGENCE LEVELS

How thorough must due diligence be?

The due diligence conducted must be reasonable, but it need not be perfect. Companies are complex entities operating in a complex world; no investigation

can uncover all the potential risks of an acquisition. Even if an expert can later find fault, the expert's ability to poke holes in the diligence of investigators does not automatically create liability.[2]

In court decisions, diligence and negligence are opposite qualities; the presence of one proves the absence of the other. (Later in this chapter, we will go into more depth on the subject of due diligence as a defense against charges of negligence during a transaction.)

The level of due diligence necessary in any given transaction depends on the companies involved. Due diligence in public companies is far more complex than in private companies. Manufacturers have greater legal exposure than many service companies. The due diligence work in the acquisition of large, diversified, global companies looms larger than the work necessary for small, single-product domestic firms. Finally, transaction type can limit the due diligence effort, since stock purchases trigger more due diligence responsibilities than do asset purchases.

How far a buyer wishes to go in the due diligence process depends in part on how much time and money the buyer has to investigate the enterprise. This will depend to some extent on the status of the enterprise in the community, the years it has been in business, whether it has been audited by a major firm for some years, whether executive turnover is low, and other factors that would establish the basic stability of the firm, such as long-term customer retention.

The thoroughness of due diligence also depends to some extent on what information the seller is willing to give in the form of representations and warranties to be included in the purchase agreement. Beware the seller who resists making any representations or warranties. Such deals are high-risk transactions and are rarely the bargains they appear to be. If stockholders' money is involved, the business judgment rule may not protect the quick-dealer on either side if things go wrong later. Many sellers discourage heavy due diligence effort. In negotiating reductions in the representations and warranties, they will insist that the buyer visit the plant. By all means, buyers, do so, but do not let such eyeballing and tire-kicking relieve the seller of any possibility of misrepresentation.

Even if buyers decide to rely on the sellers' representations and warranties, they must nevertheless still conduct at least enough due diligence to be assured that there will be a solvent company and/or seller to back the representations and warranties. If there is any doubt, acquirers must establish cash reserves.

Due diligence is also greatly affected by whether or not the acquisition

candidate is a publicly reporting company. If it has outstanding 10-Ks and 10-Qs on file with the SEC, the buyer not only should obtain copies, but should examine in detail the agreements, contracts, and other significant company documents that may be filed with them as exhibits.

What do securities laws say about due diligence?

The two fundamental federal securities laws are the Securities Act of 1933 and the Securities Exchange Act of 1934. Both mandate a certain level of diligence with respect to securities, although neither mentions the term *due diligence* per se.

How does the Securities Act of 1933 mandate due diligence?

The *Securities Act of 1933* applies primarily to disclosures made when registering securities (debt or equity) for sale to the public, but it has broader implications. Some concepts in the 1933 act, and in rules promulgated under it, have had far-reaching influence in court decisions. Therefore, mastering the disclosure principles in the Securities Act can help companies, both public and private, maintain good business practices.

Directors who are sued for violation of the Securities Act can use proof of their due diligence as a legal defense. Section 11 of the law requires accurate and complete disclosure of material facts in a securities offering registration statement. If a registration document contains misstatements or omissions of material facts, shareholders can sue the underwriters, accountants, and/or directors—and may prevail even without any proof of intentional wrongdoing.[3] Defendants must show that in approving the statements, they relied on experts to a reasonable degree.[4]

Section 11 is the single greatest source of liability for directors of public companies, and must be regarded with a great deal of attention—particularly the so-called *expertised portions* of the statement. In the language of a report from a commission chaired by the former Delaware Supreme Court Chief Justice Norman Veasey, "When evaluating the reliability of the parts of the registration statement (or other disclosures) based on expert authority, directors should be satisfied that the expert is qualified and fully informed, and should remain alert for any red flags that would raise doubts about the reliability of those experts' authority."[5]

How does the Securities Exchange Act of 1934 mandate due diligence?

The *Securities Exchange Act of 1934* is the sequel to the 1933 act. Whereas the 1933 act covers the registration of securities, the 1934 act covers their exchange. Since many mergers involve the exchange of securities, the so-called *due diligence portions* of this law are particularly important for acquirers to master.

Like the 1933 act, the 1934 act does not use the term *due diligence* anywhere, but individuals accused of violating certain parts of the 1934 act can use due diligence as a defense. In particular, a due diligence defense may be useful in defending against charges Section 10(b) of the 1934 act, particularly Rule 10b-5.

Rule 10b-5 forbids certain practices deemed to constitute intentional fraud in connection with the purchase or sale of a security. The fraudulent behavior must be engaged in knowingly (or in legal Latin, there must be *scienter*). Legal complaints can come from any buyer or seller of a security who claims to be harmed by such a fraud—not just from the government.

The text of 10b-5, as amended, reads as follows:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange:
>
> **(a)** To employ any device, scheme, or artifice to defraud,
>
> **(b)** To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> **(c)** To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.[6]

The due diligence defense cannot be used in all 10b-5 cases. If the fraud came from a conscious intent to deceive, the due diligence defense does not apply. It applies only in cases where the plaintiff alleges that the fraud in question stemmed from extreme negligence or recklessness. (As mentioned earlier, diligence is the opposite of negligence.)

Recent court cases do seem to include recklessness as a type of *scienter* fraud, thus making 10b-5 suits a threat to acquirers who have insufficient due diligence in the conduct of acquisitions involving public companies. Unless and until the courts reject recklessness as a type of *scienter* requirement,

plaintiffs can cite a breakdown in due diligence as evidence in suing under 10b-5 or other private securities litigation.[7] One of the best ways to ensure strong due diligence is to obtain independent verification of facts.

What does independent verification of facts entail?

In conducting a due diligence investigation, attorneys (or others) need to obtain independent verification of facts wherever reasonable. Reasonable, independent verification, based on accepted wisdom concerning due diligence in securities offerings, usually means referencing information sources outside, as well as inside, the company.

The famed case of *Escott v. Barchris Construction Co.* (1968) stated that it is "not sufficient to ask questions, to obtain which, if true, would be thought satisfactory, and to let it go at that, without seeking to ascertain from the records whether the answers in fact are true and complete."[8]

The final investigative reports in the bankruptcies of Enron and WorldCom (in late 2001 and mid-2002, respectively) faulted the board members and advisors who allegedly did not pay adequate attention to warning signs of financial troubles.[9] These findings contributed to the directors' decision to settle out of court, even though amounts requested were very large. The large settlements in these cases suggest the increased importance of due diligence.

In favoring underwriters accused of negligence (lack of diligence), courts have been impressed with underwriters' *direct contacts* with the issuing firm's:

- Accountants
- Bankers
- Customers
- Distributors
- Lenders
- Licensees
- Suppliers

- *On-site visits* to the facilities of a company can prove diligence.
- Furthermore, verification can be achieved by *examining documents to check officers' statements.*
- More generally, reviewing *press reports* about the company and its industry.

- Use of one's *own economic models* to test those offered by the company.
- Verification may also mean *cross-checking statements made by insiders*—for example, speaking with lower-level employees to verify statements of upper-level management.

Clearly, all of these due diligence efforts are applicable to M&A due diligence, when an acquirer is looking to buy the shares or the assets of another company.

Could you say more about cross-checking in the context of due diligence?

The courts are favorably impressed by efforts to cross-check representations. For example, if two division presidents both submit reports about the purpose and results of a joint project, do the reports match up? Cross-checking is particularly important when one finds questionable information or red flags. This is a hot area of due diligence in offering statements. It is a recurring theme in government reports and judicial decisions judging actions of board members.[10]

What are some red flags in a due diligence investigation?

Acquirers should be alert to certain warning signs in each of the due diligence areas previously listed (from financial due diligence to liability due diligence). All of these are warning signs that need to be investigated to some degree.

- *Financial red flags* include resignation of external or internal auditors, change in accounting methods, sales of stock by insiders, and unusual ratios. These may indicate fraud and/or insolvency.
- *Operational red flags* include very high or very low turnover and poor or inadequate reporting of important nonfinancial programs (quality, compliance). These may indicate unstable operations.
- *Liability/compliance red flags* include potential exposure to litigation from regulators, consumers, employees, and stockholders.
- *Transactional red flags* include conflicting accounting and tax goals. These need to be resolved as early as possible.

RELATIONS WITH SELLER

How can a buyer obtain seller cooperation?

The seller is more likely to cooperate when the buyer (or the buyer's counsel) conveys the important message that full exploration of facts and risks benefits everyone—and can help protect against the risk of an even more adversarial process via cross-examination in court, if either the seller or buyer is sued after the transaction closes. For example, just as a buyer can be sued for paying too much money for an acquisition, a seller may be sued for accepting too little money.

The buyers can invite sellers to conduct their own due diligence. All sellers need to conduct some kind of due diligence in connection with the legal opinions to be given. The seller will need to conduct due diligence of the buyer when the buyer is paying in stock. Finally, it is in the interests of sellers to investigate the buyer if the sellers' ownership and/or employment will continue after the sale of the business.

By conducting its own due diligence, the seller is more likely to develop an appreciation for what the acquirer is doing in a due diligence investigation.

Suppose the seller refuses to produce the requested documentation but offers access to its files?

Then the buyer must organize an on-site document review effort. This will typically entail traveling to the entity's corporate headquarters. If the company has multiple sites, there may be travel to those places, as well. Investigators will be using the previously mentioned acquisition checklist. The seller should be willing to direct the buyer to employees with knowledge of each subject of inquiry detailed on the checklist or, at least, to the relevant files.

As mentioned, the acquisition agreement should include the seller's representation (promise) to the buyer that the buyer will have access to all relevant files for requested information. The buyer should also ask the seller to provide sufficient personnel and photocopying facilities to make copies of all significant documents produced by the review effort. This may also be specified in the acquisition agreement. If the seller refuses to cooperate, the buyer may have to rent photocopying machines and hire temporary help. This is not of grave consequence, but the seller should be urged to cooperate. A refusal to support due diligence could look bad if the acquisition ever had to undergo judicial review for any reason.

As a courtesy to the seller and to avoid confusion between or among documents, which can vary in format from company to company, the buyer should make two copies of each document—one for itself, and one for the seller. In any event, some identification system involving numbering should be devised to keep track of the documents produced, especially of those that are copied.

Throughout the process, the buyer should be sensitive to the stress on its own personnel and on its relationship with the seller. The due diligence effort is a disruption of the ordinary business routine and may be viewed by the seller as a sign of unwarranted suspicion by the buyer and disregard for the seller's interests. The seller may fear adverse consequences for the conduct of its business and its future sale to others if the contemplated deal does not close. Indeed, many potential transactions do fall through because of the rigors of the due diligence process, which alienates the seller, the buyer, or both.

Thorough due diligence can substantially increase pre-transaction costs and can absorb the attention of key employees who have other jobs to do. Nonetheless, it is unavoidable. The key is to make the process thorough, yet reasonable.

LOCATION OF DUE DILIGENCE RESEARCH

Where should due diligence take place?

The buyer's examination of the seller's assets occurs both on-site (tire-kicking) and off-site (record-hunting). On-site inquiries may involve discussions with officers and employees as well as inspections of real property, machinery, equipment, and inventory. In conducting interviews with key executives and employees, the investigator seeks to fill in the gaps in the documentation and to ascertain whether there may be areas of potential concern or liability (or definable assets) not identified in the due diligence checklist.

Good interview notes will include the following:

- Time and place of the interview
- Name and title of the person interviewed
- Scope of the interview
- Significant disclosures made during the interview

Depending on the size and structure of the transaction and the importance of the specific assets, the buyer may wish to use a real estate appraiser to value any owned real property involved, an engineer to inspect plant and equipment, and an accounting team to review inventory. The accountants should also review the seller's financial statements with respect to these items.

Off-site investigations may include the search of public records about the company and discussions with parties with whom the acquisition target has significant relationships. These include customers and suppliers, private lenders, and former key employees including directors and officers. Key people to interview are those who have won major suits against the target—especially former employees and stockholders.

What are some potential problem areas when talking about a company with third parties?

This is a very sensitive area. Discussions with third parties may, if correctly conducted, be the source of valuable information. But they can also give rise to tensions between buyer and seller if the seller believes that the discussions may be impairing its ability to carry on its business or the buyer will use the information when and if it buys a competitor. Discussions with the buyer's lenders may be particularly sensitive in this regard. Guidelines for third-party discussions should be covered in the confidentiality agreement (see the end of this chapter) and the letter of intent (see the end of Chapter 7).

Another delicate area is that of *standing agreements.* The buyer should begin fairly early to negotiate with parties to existing supplier or customer agreements, requiring that they be assigned to the buyer when and if it acquires the business. If the supplier or customer refuses, this may be the basis for a claim that there has been a material adverse change (or material adverse impact) in the affairs of the business between the execution of the acquisition agreement and the closing.

What public records should be checked?

The first concern to be satisfied in the due diligence search is basic: the buyer must confirm that the corporation was legally formed and continues to exist. To do so, the buyer will establish the jurisdiction of the company's incorporation and document the company's organization by finding and examining the articles of incorporation, including any amendments such as name changes.

Articles of incorporation are public documents that may be obtained (in the form of certified copies) from the secretary of state of the jurisdiction of incorporation. There should also be obtained, from the same office, evidence of the corporation's continuing status in good standing in the eyes of the state of incorporation. It is also necessary to review carefully the relevant state statutes and corporate minute books to establish that the articles and amendments have been properly adopted and that no action has been taken to dissolve the corporation. An examination of the minute book should also

ascertain that it is up-to-date and that the election or appointment of the corporation's directors and officers is duly reflected therein.

Having established that the corporation was indeed duly formed, the buyer's due diligence then examines the company's qualifications to do business in jurisdictions other than its state of incorporation—in other words, in whatever other states or countries it may conduct business. To be thorough in wrapping up this initial due diligence stage, the buyer must seek out good standing certificates and tax certificates from each of the states and foreign jurisdictions in which the seller operates.

Once corporate formation, qualification, and good standing are established, a search should be made for liens, encumbrances, and judgments that may exist against the company or any of its assets. Sources to be searched in uncovering liens, encumbrances, and judgments include the following:

- The offices of the secretary of state of the state where the company's principal office is located and of other relevant states and, sometimes, county clerk offices where filings are made to disclose creditors' interests in assets under the UCC
- All relevant recorder of deeds offices
- All relevant courts, including federal, state, and local
- Any special filing jurisdictions for
  Bankruptcy
  Maritime/aviation assets
  Patents, trademarks, and copyrights

With respect to the last item, check out the present and previous corporate names and all trade names, service marks, and trade dress registrations. If you are buying a company because of its trademarks, be sure the company in fact owns them. (The famous Bell Telephone mark, due to a fluke, was not registered by its original owner.)

EVALUATING ASSETS

How much information can a buyer get about a target that is a corporate subsidiary or division?

It depends on whether the company is private or public, and, if public, what percentage of its revenues comes from the subsidiary.

Private corporations may not have to make any public disclosure of subsidiary or divisional performance, depending on their states of incorporation (some states do require the filing of such data). Public corporations must

make such disclosure (as *line of business* reports) for units generating 5 percent or more of corporate revenues.

Some companies, private and public, make voluntary public disclosure of all subsidiary and divisional financials, however, and all well-managed companies report such results on an internal basis.

LITIGATION ANALYSIS

How should a buyer analyze existing or potential litigation against an acquisition candidate?

Litigation analysis of acquisition candidates requires a special procedure, usually conducted by trained litigation analysts. Management or its counsel can ask an attorney who specializes in commercial or corporate litigation and is familiar with the seller's industry to determine the validity of and exposure on existing claims.

The individual primarily responsible for the litigation risk review must first determine the parameters of the review and identify the litigation or administrative actions that warrant particular scrutiny. The primary reviewer must obtain a schedule of all litigation, pending and threatened, and must arrange to receive copies of all relevant pleadings.

Before reviewing specific cases, the primary reviewer should ascertain what cases the seller believes are covered by liability insurance and then determine what cases, if any, are in fact covered. Because the two do not always coincide, it is critical to review all insurance policies.

The individual responsible for the litigation analysis must have a working knowledge of both the structure of the transaction—for example, whether it is to be a stock or asset purchase—and the corporate and tort law rules concerning successor liability for debts and torts, especially with regard to compensatory and punitive damages. These are then applied case by case. Any reviewer should have at hand the latest trends on director and officer (D&O) litigation. A leading source for this information is Tillinghast-Towers Perrin.[11]

Who might be suing (or planning to sue) a company, and what are some of the issues that give rise to lawsuits against companies?

Customers—as well as competitors, suppliers, and other contractors—might sue over:

- Contract disputes
- Cost, quality, and safety of product or service[12]
- Debt collection, including foreclosure
- Deceptive trade practices
- Dishonesty or fraud
- Extension or refusal of credit
- Lender liability
- Other customer and client issues
- Restraint of trade

Employees—including current, past, or prospective employees or unions—might sue over:

- Breach of employment contract
- Defamation
- Discrimination
- Employment conditions
- Harassment or humiliation
- Pension, welfare, or other employee benefits[13]
- Wrongful termination

Regulators might sue over:

- Antitrust (in suits brought by government)
- Environmental law
- Health and safety law

Shareholders might sue over:

- Contract disputes (with shareholders)
- Divestitures or spin-offs
- Dividend declaration or change
- Duties to minority shareholders
- Executive compensation (such as golden parachutes)
- Financial performance or bankruptcy
- Financial transactions (such as derivatives)
- Fraudulent conveyance
- General breach of fiduciary duty
- Inadequate disclosure
- Insider trading

- Investment or loan decisions
- M&A scenarios (target, bidder)
- Proxy contents
- Recapitalization
- Share repurchase
- Stock offerings

Suppliers might sue over:

- Antitrust (in lawsuits brought by suppliers)
- Business interference
- Contract disputes
- Copyright or patent infringement
- Deceptive trade practices

What general rules govern the buyer's potential liability for the target's debts and torts?

The traditional rule is that where one company sells or otherwise transfers all its assets to another company, the successor is not liable for the debts and tort liabilities of the predecessor. The successor may be liable, however, under the following circumstances:

- If it has expressly or implicitly agreed to assume liability
- If the transaction is a merger or consolidation
- If the successor is a mere continuation of the predecessor
- If the transaction was fraudulently designed to escape liability

A further exception exists for labor contracts. If the successor buys the predecessor's assets and keeps its employees, the successor will probably also be bound to recognize and bargain with unions recognized by the predecessor, and to maintain existing employment terms. Existing contracts may also create successorship problems. State law may vary with respect to assumption of debts and liabilities, so the reviewer must be cognizant of the specific statutory or case law that will govern the transaction.

Courts are increasingly likely to find successor liability, particularly with respect to product liability claims, under the "continuity of product line" or "continuity of enterprise" exceptions to the general rule of nonliability. The first of these exceptions applies where the successor acquires a manufacturer

in the same product line. The second exception applies where the successor continues the predecessor's business.

Faced with an increasingly aggressive plaintiffs bar in search of ever-deeper pockets, with the public and the courts searching for *someone* to blame, *someone* to shoulder the costs of injury to plaintiffs with no other course for recovery, the courts are exacting from corporate successors product liability damage awards, including in some instances punitive damages. This trend is particularly egregious in the case of asbestos manufacturers, whose decade-long struggle to achieve a class settlement continues to this day. Accordingly, the due diligence reviewer must be aware of the current state of the law concerning successor liability for both compensatory and punitive damages.

(Fortunately there is a ray of hope in the Class Action Fairness Act (CAFA), signed into law by President Bush on February 18, 2005. This makes it more difficult for plaintiffs' attorneys to manipulate venues to prevail in court.[14])

What about insurance policies and cases being handled by insurance companies?

Each and every insurance policy must be reviewed to ensure that pending claims for compensatory damages will be covered. What is the deductible? What are the liability limits per occurrence and in total? Are punitive damages excluded by the policy or by state law? Does the policy contain regulatory or other exclusions? For large companies, there may be overlapping policies; all policies must be reviewed in light of these questions. (This can be subcontracted to firms specializing in the area of insurance-based risk analysis, *provided* that they are reviewed for their deal-killing potential before being retained.)

Another consideration when reviewing insurance policies is whether they are for claims incurred or for claims made. Coverage under a claims-incurred policy continues after the cancellation or termination of the policy and includes claims that arose during the period of insurance coverage, whether or not those claims are reported to the insurance company during that period. Claims-made policies cover only those claims actually made to the insurance company during the term of the policy. In addition, under some policies, coverage will continue only if a *tail* is purchased. A tail is a special policy purchased to continue coverage that would otherwise be terminated. It is important that the reviewer identify the nature of the seller's policies and determine any potential problems that may result from a failure to give the insurance company notice of claims during the policy period or from a failure to purchase a tail.

Also, cases being handled by insurance companies should be scrutinized.

The reviewer should determine if the insurer has undertaken the representation under a reservation of rights (that is, where the insurer agrees to pay for or provide legal representation, without prejudice to its right to later deny coverage), if the insurer has preliminarily denied coverage, or if the damages claimed include punitive or treble damages, which may not be covered.[15]

How does counsel determine whether particular litigation is material to the acquiring company in the due diligence context?

Before gathering information through a due diligence request, counsel must determine what litigation is *material.* The materiality determination for litigation, as for other aspects of due diligence, will be relative. A $5 million lawsuit, even if it has merit, may have little significance in the context of a $1 billion deal. On the other hand, even a case with little financial exposure may jeopardize a $20 million deal if the buyer and seller cannot agree on how to handle that case.

When evaluating litigation pending against a midsized company, a materiality cutoff point of $250,000 might be reasonable. In addition, certain types of cases might merit close attention, whatever the financial exposure. For example, a product liability case that looks like it might be the first of many should receive close attention, even if the financial exposure on that one case is insignificant.

In assessing the potential cost of potential litigation, companies should consider the option of settling out of court. Lately, more and more companies have discovered that much litigation is wrongly created and stubbornly maintained by their executive staff, internal and external legal advisors, and even some corporate directors. Many firms, such as Motorola, have set up special groups to reduce litigation costs and are exploring the possibilities of alternative dispute resolution (ADR), a field of law where minitrials that bypass or supplement the courts are held to quickly resolve disputes at a fraction of the usual legal costs. This may also yield hidden income as many companies maintain expensive legal actions that can be replaced by inexpensive ADR processes, and cases are easily, quickly, and inexpensively settled even in the course of an acquisition negotiation.

What material information should the litigator review?

In the due diligence request, counsel should seek a summary of all pending or threatened actions that satisfy the materiality standard that has been established. The summaries should include the following:

- Names and addresses of all parties
- The nature of the proceedings
- The date of commencement
- Status, relief sought, and settlements offered
- Sunk costs and estimated future costs
- Insurance coverage, if any
- Any legal opinions rendered concerning those actions

A summary should also be provided for the following:

- All civil suits by private individuals or entities
- Suits or investigations by governmental bodies
- Criminal actions involving the target or any of its significant employees
- Tax claims (federal, state, and local)
- Administrative actions
- All investigations

In addition, counsel should request copies of all material correspondence during the past five years with government agencies such as the DOJ, EPA, FTC, IRS, OSHA, Department of Labor, and any other regulatory agency (city, county, state, or federal) to which the seller is subject. If the company sells stock through a stock exchange or stock market (e.g., New York Stock Exchange, American Stock Exchange, or Nasdaq) all material correspondence with the listing body should be gathered. If the target itself has subsidiaries, all relevant information should be requested for the subsidiaries as well.

After all this information has been gathered, how is the litigation analysis conducted?

Before the actual analysis begins, the individual in charge of the review must determine who will analyze which claims. Highly specialized claims should be assigned for review to attorneys with the most knowledge of the area involved.

The individual reviewer must arrange to receive pleadings and documents concerning any additional relevant claims. Also, the reviewer should have access to the attorneys representing the target in those matters. This may be difficult, however. Even in an acquisition characterized by cooperation,

obtaining all the relevant pleadings can be challenging. This is particularly true if the target is represented by more than one law firm.

The individuals responsible for this aspect of the litigation analysis must establish a particularly good working relationship with the attorneys representing the target company. In some instances, communications with outside counsel should be handled gingerly because that firm may see some portion of its legal work disappearing as a result of the acquisition. More often, with larger target companies, litigation is being handled by several firms around the country; all those firms will have to be consulted.

In some cases, it will be sufficient to review the case file and consult briefly with the target's outside counsel. In other cases, outside counsel will have to become more involved in the analytic process. The reviewer should be particularly cautious accepting the representations made by the target's outside counsel currently handling the case; those representatives may be overly optimistic.

Finally, each pending material case should be systematically evaluated. Some number should be assigned to the pending liability or recovery, and should include the costs of executives' time. For litigation being handled on the target's behalf by outside law firms, the reviewer should evaluate whether the case is being capably handled. Even a meritless case can create significant exposure if handled by an inexperienced or incompetent firm or practitioner.

What cases should the reviewer consider first?

The reviewer should concentrate only on the worst cases—those that if lost could have a negative ripple effect on the acquired company's business operations in general. The investigation should also identify and study other known cases involving other companies in the same industry. For example, suppose a court decides that a business practice of one company in the industry constitutes a deceptive trade practice or other violation of law. If the target is in the same industry and engages or might engage in the same practice, this can have a significant impact on the future business of the company, even if it is not a party to the litigation in question.

What are the hot topics today in litigation?

Environmental law remains particularly treacherous. The primary federal law governing this area is the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA), also known as *Superfund.* This law focuses on environmental liability stemming from land and water use. Some states have

enacted environmental protection statutes that create a *superlien* on property of those persons liable for pollution. The existence of such far-reaching remedies requires that state and federal environmental laws be considered during due diligence and that the reviewers be familiar with the state of environmental law.

In addition, there is an area of law where environmental concerns combine with concerns for consumer or worker safety with regard to products or the manufacturing process. Some hot areas include:

- Asbestos manufacturers have been subject to lawsuits for over two decades. Some companies have suffered extensive punitive damages claims.
- Paints and adhesives can give rise to claims of personal injury alleged from exposure to volatile organic compounds.
- Pesticides manufacturers offer a wide range of products and each can be subject to litigation based on allegations of poisoning.
- Other chemicals subject to litigation include beryllium (used in manufacturing lightweight alloys incorporated into aerospace and defense items), formaldehyde, carbon monoxide, hydrocarbon and isocyanate (oil companies have been sued because of inhalation), silica, and toluene diisocyanate.

This list is by no means comprehensive. Almost anything chemical can be subject to a health claim. Some states still make it too easy for workers and consumers to sue manufacturers for product flaws even if the manufacturer maintains high safety standards. Some states have enacted reforms but there are still judicial hellholes—jurisdictions where litigation is heavy and verdicts and sentencing is harsh.[16]

What about danger areas for pharmaceuticals?

Litigation-intensive areas include antibiotics, diet drugs, vaccine injury, and hormone replacement therapy, among others.

In assessing a company's potential exposure to environmental liability, where should an acquirer start?

Before getting into details, an acquirer should conduct a broad environmental exposure analysis. Generally speaking, there are two kinds of environmental problems to be feared in a proposed acquisition: those that adversely

affect the balance sheet, and those that adversely affect the financial projections. Either can destroy the economic benefits the buyer hopes to achieve.

What is the difference between a balance sheet environmental problem and a projection environmental problem?

Balance sheet problems result from liabilities, either disclosed or undisclosed, that the buyer becomes subject to as a result of acquiring the business. Such liabilities typically include the cost of cleaning up a mess caused by the seller or one of the seller's predecessors. The costs can include charges for removing contaminated soil or purifying tainted groundwater and can cover not only the site purchased by the buyer but also adjoining properties or remote locations on which hazardous substances generated by the business were dumped.

Moreover, under the Superfund, officers, directors, and even stockholders can be personally liable for cleanup costs, and the liability of companies that contributed to the pollution of a common dump site are jointly and severally liable for such cleanup costs. (Joint and several liability is a legal standard considered unfair to defendants; it is the subject of legal reform.) Finally, even secured lenders that wind up operating or controlling the contaminated property can be liable for such cleanup costs. As a result, the buyer must approach these problems not just from his own point of view; the buyer must also consider how the lender will react.

In addition to cleanup costs, a company can be liable to third parties who have become ill or died as a result of drinking contaminated groundwater, or whose property has been contaminated by pollution emanating from the company's facilities.

Projection problems adversely affect the company's ability to achieve its projected cash flow and earnings goals. They typically arise in situations in which the acquired company has a history of noncompliance with applicable air or water emissions standards. Where the due diligence process discloses such a history of operating problems, the prospective purchaser needs to calculate the cost of bringing the company into compliance and keeping it in compliance. This may involve significant unbudgeted capital costs (to procure needed emissions control equipment) or operating costs higher than anticipated (to ensure that the offending equipment is operated in conformity with applicable environmental standards) or both. In extreme cases, the buyer's diligence may disclose that the company (or a particular plant) cannot be economically operated in compliance with environmental law.

What kinds of acquisitions are most likely to present significant environmental problems?

The classic asset-based LBO, involving a manufacturer, is most likely to present environmental concerns. However, environmental problems are by no means limited to the manufacturing sector. Warehouses, retail businesses, and service companies may own structures that contain asbestos in wall insulation or pipe wrapping; electrical transformers filled with polychlorinated biphenyls (PCBs) are found in many types of facilities; and underground motor fuel tanks can exist in any business that operates or has operated a fleet of trucks or cars. All of these situations are common environmental troublemakers, making environmental problems a common "skeleton in the closet" for many acquirers.

What are the principal environmental trouble spots to look for in an acquired company?

Any diligent buyer should work from a comprehensive environmental checklist in performing due diligence on a target company or retain an environmental consultant to do so. But be sure to do a thorough background check on the consultant. Due diligence requires the buyer or its representative to be sensitive to certain key areas of potential concern:

- Were any toxic or hazardous substances used or generated by the target business? Those most commonly encountered are PCBs, used in electrical transformers and commercial solvents such as those found in paint thinner and degreasing agents, which are potent carcinogens and which migrate readily into groundwater if spilled. Also considered toxic or hazardous are heavy metals (such as lead, arsenic, and cadmium) from various industrial processes and paints.
- Were any hazardous wastes shipped off-site for disposal?
- Are there lagoons or settling ponds that may contain toxic wastes?
- Are there underground tanks that may have leaked and discharged their contents (heating oil, gasoline) into the groundwater?
- Is asbestos present in any structure (as insulation in walls, pipe wrapping, or other application)?

Why should the buyer worry about hazardous wastes shipped off the premises?

If they were shipped to a dump that has been or may be declared a federal Superfund site, the buyer might inherit a potential liability that could be substantial. This liability may flow through to the buyer even if it purchases assets rather than stock. Moreover, the buyer may be liable even though it expressly does not assume the liability, if in fact the buyer does not intend to continue the same business as the predecessor.

What special problems are posed by Superfund liability?

First, Superfund can pierce the corporate veil. Officers, directors, and even shareholders can be held personally liable. Second, cleanup costs can be enormous—well beyond the value of the assets purchased. Third, liabilities of companies that generated wastes dumped in a common site are joint as well as several; every contributor of hazardous waste to that site is theoretically liable for the whole cleanup. Fourth, it can take years before liability is finally determined.

What can the buyer do to protect against environmental litigation after an acquisition?

- Due diligence requires that an acquirer hire an environmental consulting firm to do an environmental liability audit of the target company. Lenders increasingly require delivery of such an audit report, showing an essentially clean bill of health, as a condition to lending. Although the EPA has relaxed lender liability under Superfund, lenders still remain cautious.
- Make sure that the seller's warranties are broad enough to cover (1) environmental liabilities arising as a result of on-site or off-site pollution, and (2) all actions causing pollution, whether or not at the time such actions were taken they were in violation of any law or standard. The latter point is critical because Superfund liability can reach back to actions taken before the adoption of modern environmental protection laws, when the shipment of such wastes by unlicensed carriers to unlicensed sites was not illegal.

- Make sure environmental warranties and any escrows or offset rights survive as long as possible. It may take years before the pollution is discovered and traced back to the company.

Are environmental clearances typically required?

Yes. Federal, state, and local permits and consent decrees relating to water quality, air emissions, and hazardous wastes should be checked carefully to make sure they remain effective after closing. In addition, in at least one state (New Jersey), state approval of a cleanup plan or any cleanup process must be granted or formally waived in connection with the transfer of virtually any kind of industrial or commercial facility in order for the seller to pass an effective title to the buyer.

EMERGING LEGAL ISSUES

What are some of the emerging legal issues to be concerned about in a due diligence investigation—issues that a buyer might never think of but that could hurt the company later?

Such issues crop up constantly as courts around the country offer legal theories, set new precedents, and abolish old ones. No list of such new legal theories could be complete, but here are a few questions to consider:

- To what extent can the head of a company be held accountable for the wrongful acts of subordinates? This agency theory is constantly being tested.
- To what extent can advisors rely on the word of management? To what extent can management rely on advisors? The nature of attorney-client privilege is changing rapidly, with courts demanding more skepticism on both sides.
- How many times can a company be sued for the same action? Is there a limit to the number of plaintiffs who can ask for punitive damages?
- What areas are the trial lawyers targeting? Visit the Web site of the American Trial Lawyers Association if you dare and see what hot topics they are discussing.[17]

- Will fulfillment of change of control provisions give a departing or incoming CEO compensation that is unreasonable? If so, regulators (e.g., IRS) or shareholders could try to sue directors and officers of a failure to fulfill their fiduciary duty of care.[18] Since excessive CEO salaries are a concern right now, make sure you avoid perpetuating the problem with your transaction.

What are the factors considered by regulators and courts when determining whether executive compensation is reasonable?

Regulators usually don't get involved in executive compensation unless tax authorities are challenging the deductibility of the compensation. They can challenge compensation paid to a shareholder of a private company if the pay is excessive. The following are questions used by tax courts to determine whether compensation paid to shareholders is reasonable, according to the AICPA[19]:

- Would an unrelated outside investor consider the compensation reasonable?
- How does the amount of compensation compare with the amount of dividends paid?
- How does the compensation compare with the profit performance of the corporation?
- Was the level of compensation arranged in advance, or was it based on corporate profit?
- What is the typical level of compensation in the corporation's industry?

A compensation package is likely to withstand IRS scrutiny if it approximates the amount that would be paid in an arm's-length transaction.

What about golden parachute payments?

A *golden parachute* is compensation paid to officers, shareholders, or other highly compensated individuals contingent on the change of ownership or control of a corporation. The part of the payment that exceeds three times the recipient's base amount is not deductible as compensation by the corporation, under Section 280G of IRC. (The base amount is average annualized compensation payable for the five years prior to the change in ownership or control.) So, for example, if an officer had been receiving a salary over the

past five years that averaged $500,000 per year, and his parachute was for $2 million, the corporation could only deduct $1.5 million of that parachute amount as salary expense. Also, the recipient would be assessed a 20 percent tax on the excess amount. Finally, it is notable that any compensation paid over $1 million is not tax deductible to the corporation under Section 162(m) of the IRC. (For more on the subject of compensation in the context of mergers, see Chapter 9 on Integration.)

Could you give an example of an M&A transaction that was challenged because of allegations of excessive pay?

Consider the 2005 merger of Gillette and Procter & Gamble. Prior to the successful closing of that merger, shareholders filed lawsuits in a Delaware state court accusing Gillette of giving P&G "unduly favorable" terms while giving Gillette management "excessive compensation." The plaintiffs sought class action status in an attempt to block the merger. Also in mid-2005, Massachusetts Secretary of the Commonwealth William F. Galvin investigated the fairness opinions used to justify the transaction. In the end, the company and executives prevailed and did not have to pay fines or "disgorge" (return) any pay.[20]

DUE DILIGENCE AFTER CLOSING

When does the due diligence process properly end?

As important as it is for due diligence to be completed rapidly, the due diligence effort really should extend *up to, through, and beyond closing.* The discipline imposed by the process—dealing with the realities of the complications of business—should never be abandoned, and it is a rare deal that does not have, on closing day, a revision to the acquisition agreement covering unfinished items of due diligence inquiry.

Many acquisition agreements contain a "bring-down" condition to assure the buyer that, on the closing date, the target will be the same target, from a legal and financial perspective, that the buyer bargained for in the contract. The bring-down condition requires, as a condition to closing, that the seller extend its representation that there has been no material adverse change through the date of the closing.

The buyer's bring-down list can be extensive and makes both buyers and sellers nervous because it provides for a subsequent effective closing.

Many prefer to wait until everything is completed and then sign the acquisition agreement right at closing (rather than before closing).

Under most acquisition agreements, the buyer will not be required to close if:

- The seller has breached any of its covenants
- Any of the representations and warranties of seller and target were not true when made or are not true on the closing date, or as if made on the closing date

This condition provides an escape for the buyer if the representations and warranties were true on the date of signing but are no longer true as of the closing date, either because of events that occurred after the signing or because breaches were discovered after the signing.

Therefore, as important as it is for due diligence to be completed rapidly, the due diligence effort really should extend up to, through, and beyond the closing of the transaction, when both parties have signed on the dotted line.

The significance of final due diligence at closing is twofold:

- First, individuals who had hands-on involvement in the due diligence process will have a particularly good insight into the operational areas they studied, and they may be called upon during the initial post-acquisition "re-start-up" period under new ownership to answer questions or provide guidance. There are *always* items of unfinished business that grow out of the due diligence process that must be resolved after closing. They should be listed and assigned to people to solve with completion dates attached, and someone should be assigned to follow up.
- Second, in the event of a claim by the buyer or the seller against the other, the resolution of the claim may go back to a due diligence issue—that is, whether one party disclosed or made available to the other the documents or pertinent facts. Insofar as the acquisition agreement fails to identify the information the defendant is supposed to know, the due diligence process must be examined to determine where liability lies. For this reason, it is *absolutely essential to maintain complete written reports on due diligence processes and results.*

What happens if a lawsuit arises after closing?

If a lawsuit arises after the signing, the "conditions to closing" clause will not apply. That is why it is so important to conduct a liability exposure analysis prior to closing, and to continue bring-down due diligence right up to the last minute.

In our example, the seller only guaranteed that no lawsuits existed as of the date of the acquisition agreement. Since the representation was true when made, there is no breach of the litigation representation as a result of the post-signing events. A bring-down condition will obligate the seller to make the *same* representation as of the *closing date,* however. On the basis of such a condition, the buyer will be able to terminate the agreement if interim events such as new litigation, liabilities, or other post-signing occurrences reduce the value or viability of the target. For more about this topic, see Chapter 7.

Does diligence continue to be significant after closing?

Yes. The post-closing significance of the due diligence effort is twofold.

First, individuals who had hands-on involvement in the due diligence process will have a particularly good insight into the operational areas they studied, and they may be called upon during the initial post-acquisition "re-start-up" period under new ownership to answer questions or provide guidance.

Second, in the event of a claim by the buyer or the seller against the other, the claim's resolution may go back to a due diligence issue, that is, whether one party disclosed or made available to the other the documents or pertinent facts. Insofar as the acquisition agreement fails to identify the information the defendant is supposed to know, the due diligence process must be examined to determine where liability lies. For this reason, it is absolutely essential to maintain complete written reports on due diligence processes and results.

Ultimately, the purpose of due diligence is to minimize risk. To anticipate and protect itself from future financial, operational, and legal problems, the acquirer must first check for problems common to all acquisitions, and then for problems common to the target's industry, and finally, to risks in the target company. In seeking acquisition candidates in the first place, the acquirer can favor companies that have in place strong *programs for risk management and legal compliance.* In addition, the acquirer can try to minimize the risk of the transaction in other ways:

- The acquirer can consult with a broker of *liability insurance* that protects directors and officers of the acquiring company against acquisition-related risks, and to enter into an agreement with an insurance provider. Since D&O liability insurance providers employ actuaries who specialize in predicting risk, acquirers can learn a lot from talking to them. Insurance vendors are natural allies to those who seek to limit risk.

- Furthermore, the acquirer can make sure that its due diligence phase includes all the steps generally considered to show *due care* under common law.
- If suspicions arise during standard due diligence, acquirers can employ the services of private investigators to confirm them.
- The acquirer can include protective clauses in the documents that record the agreements between the parties.
- The acquirer can structure the transaction to minimize its risk.[21]
- Finally, the acquirer can make sure that the various deal-related agreements it signs include adequate protections against post-acquisition losses stemming from pre-acquisition conditions.

Together with thorough due diligence, such steps can help to ensure the long-term success of any acquisition.

CONCLUDING COMMENTS

Due diligence provides two distinct benefits to any acquirer:

- First, individuals who have had hands-on involvement in the due diligence process will gain good insight into the financial, operational, and legal areas they investigated. They may be called upon during the post-acquisition "re-start-up" period under new ownership to answer questions or provide guidance. (There are always items of unfinished business growing out of the due diligence process that must be resolved after closing. They should be listed and assigned to people to solve with completion dates attached, and someone should be assigned follow-up.)
- Second, in the event of a claim by the buyer or the seller against the other, the resolution of the claim many go back to a due diligence issue—that is, whether or not one party disclosed certain facts or made available certain documents. Insofar as the acquisition agreement fails to identify the information the defendant was supposed to know or learn, the due diligence process gives a paper trail for determining where liability lies. Acquirers that have conducted a thorough due diligence process, and who have kept records of their efforts, will be prepared to meet this challenge—as well as the more important challenge of meeting the newly combined company's future risks and opportunities.

APPENDIX 6A

Sample Confidentiality Agreement

STRICTLY PRIVATE AND CONFIDENTIAL

[Date]

Acquisition, Inc.
Corporate Office Towers
New York, New York

To the Board of Directors:

In connection with your consideration of a possible transaction with Seller, Inc. (the "Company") or its stockholders, you have requested information concerning the Company so that you may make an evaluation of the Company to undertake negotiations for the purchase of the Company. As a condition to being furnished such information, you agree to treat any information (including all data, reports, interpretations, forecasts, and records) concerning the Company which is furnished to you by or on behalf of the Company and analyses, compilations, studies, or other documents, whether prepared by you or others, which contain or reflect such information (herein collectively referred to as the "Evaluation Material") in accordance with the provisions of this letter. The term "Evaluation Material" does not include information which (i) was or becomes generally available to the public other than as a result of a disclosure by you or your directors, officers, employees, agents, or advisors, or (ii) was or becomes available to you on a nonconfidential basis from a source other than the Company or its advisors provided that such source is not bound by a confidentiality agreement with the Company, or (iii) was within your possession prior to its being furnished to you by or on behalf

of the Company, provided that the source of such information was not bound by a confidentiality agreement with the Company in respect thereof, or (iv) was independently acquired by you as a result of work carried out by an employee of yours to whom no disclosure of such information has been made directly or indirectly.

You hereby agree that the Evaluation Material will not be used by you in any way detrimental to the Company. You also agree that the Evaluation Material will be used solely for the purpose set forth above, and that such information will be kept confidential by you and your advisors for five (5) years provided, however, that (i) any such information may be disclosed to your directors, officers, and employees, and representatives of your advisors who need to know such information for the purpose of evaluating any such possible transactions between the Company and you (it being understood that such directors, officers, employees, and representatives shall be informed by you of the confidential nature of such information and shall be directed by you to treat such information confidentially and shall assume the same obligations as you under this agreement), and (ii) any disclosure of such information may be made to which the Company consents in writing. You shall be responsible for any breach of this agreement by your agents or employees.

In addition, without the prior written consent of the Company, you will not, and will direct such directors, officers, employees, and representatives not to disclose to any person either the fact that discussions or negotiations are taking place concerning one or more possible transactions between either the Company or its stockholders, on the one hand, and you, on the other hand, or any of the terms, conditions, or other facts with respect to any such possible transactions, including the status thereof. The term "person" as used in this letter shall be broadly interpreted to include without limitation any corporation, company, group, partnership, or individual.

In addition, you hereby acknowledge that you are aware, and that you will advise your directors, officers, employees, agents, and advisors who are informed as to the matters which are the subject of this letter, that the United States securities laws prohibit any person who has material, nonpublic information concerning the matters which are the subject of this letter from purchasing or selling securities of a company which may be a party to a transaction of a type contemplated by this letter or from communicating such information to any other person under circumstances in which it is reasonably foreseeable that such person is likely to purchase or sell such securities. You consent that you will not, and you will cause each of the aforementioned

persons to not, violate any provisions of the aforementioned laws or the analogous laws of any state.

You hereby acknowledge that the Evaluation Material is being furnished to you in consideration of your agreement (i) that neither you nor any of your affiliates nor related persons under your control will for a period of three (3) years from the date of this letter make any public announcement with respect to or submit any proposal for a transaction between you (or any of your affiliates) and the Company or any of its securityholders unless the Company shall have consented in writing in advance to the submission of such proposal, nor will you, directly or indirectly, by purchase or otherwise, through your affiliates or otherwise, alone or with others, acquire, offer to acquire, or agree to acquire, any voting securities or direct or indirect rights or options to acquire any voting securities of the Company, for a period of three (3) years from the date of this letter without such permission, and (ii) that you will indemnify any director, officer, employee, or agent of the Company and any "controlling person" thereof as such term is defined in the Securities Act of 1933, for any liability, damage, or expense arising under federal and state securities laws from an actual or alleged breach of this agreement by you or your directors, officers, employees, representatives, or affiliates. You also agree that the Company shall be entitled to equitable relief, including an injunction, in the event of any breach of the provisions of this paragraph.

In the event that you do not proceed with the transaction which is the subject of this letter within a reasonable time, you shall promptly redeliver to the Company all written material containing or reflecting any information contained in the Evaluation Material (whether prepared by the Company or otherwise) and will not retain any copies, extracts, or other reproductions in whole or in part of such written material. All documents, memoranda, notes, and other writings whatsoever, prepared by you or your advisors based on the information contained in the Evaluation Material, shall be destroyed, and such destruction shall be certified in writing to the companies by an authorized officer supervising such destruction.

Although we have endeavored to include in the Evaluation Material information known to us which we believe to be relevant for the purpose of your investigation, you understand that we do not make any representation or warranty as to the accuracy or completeness of the Evaluation Material. You agree that you shall assume full responsibility for all conclusions you derive from the Evaluation Material and that neither the Company nor its representatives shall have any liability to you or any of your representatives

resulting from the use of the Evaluation Material supplied by us or our representatives.

In the event you are required by legal process to disclose any of the Evaluation Material, you shall provide us with prompt notice of such requirement so that we may seek a protective order or other appropriate remedy or waive compliance with the provisions of this agreement. In the event that a protective order or other remedy is obtained, you shall use all reasonable efforts to ensure that all Evaluation Material disclosed will be covered by such order or other remedy. Whether such protective order or other remedy is obtained or we waive compliance with the provisions of this agreement, you will disclose only that portion of the Evaluation Material which you are legally required to disclose.

This agreement shall be governed by and construed and enforced in accordance with the laws of the state of New York, U.S.A.

Any assignment of this agreement by you without our prior written consent shall be void.

It is further understood and agreed that no failure or delay by the Company in exercising any right, power, or privilege hereunder shall operate as a waiver thereof nor shall any single or partial exercise thereof preclude any other or further exercise of any right, power, or privilege.

If you are in agreement with the foregoing, please so indicate by signing and returning one copy of this letter, whereupon this letter will constitute our agreement with respect to the subject matter hereof.

Very truly yours,

SELLER, INC.

By: Its:

Confirmed and Agreed to:

ACQUISITION, INC.

By: Its:
Date:

APPENDIX 6B

Due Diligence Checklist

Note: This is a sample only; it should not be used as an exhaustive guide and should be modified for every transaction as appropriate (e.g., a public offering versus a private acquisition). For example, due diligence into the capitalization of a company may be less significant in an asset sale than in a stock sale. This document request list does not contain specialized sections dealing with intellectual property, environmental, and employment matters, and so forth. For a checklist including those elements, see Alexandra R. Lajoux and Charles M. Elson, *The Art of M&A Due Diligence: Navigating Critical Steps and Uncovering Crucial Data* (New York: McGraw-Hill, 2000).[22]

DOCUMENTS

Corporate Documents

Certificate of Incorporation (CI) Including All Amendments, Name Changes, Mergers. The CI is particularly helpful in determining what name to search for title to real estate. Special care should be taken not to overlook name variations, for example, "Rocket Airlines Inc.," "Rocket Air Lines, Inc.," and "Rocket Airlines Corp." These are quite likely to be very separate legal entities. The date and state of incorporation are also critical. There may be different companies with identical names incorporated in different states.

Bylaws. Look for change of control provisions. Many bylaws contain "poison pill" provisions designed to place restrictions on changes in control, or to make such changes very expensive to the potential acquirer.

Minutes. Look in particular for information on past acquisitions or mergers and other transactions affecting capital; this will help trace ownership of assets and equity. Make certain the election and appointment of current directors and officers is duly reflected, and that the issuance of all outstanding stock has been properly authorized.

Financial Statements

Develop breakdowns, by location, of assets (land, buildings, equipment, inventory, vehicles, and, if not billed out of a central office, receivables).

Consider whether those provided are adequate for use in possible SEC filings and whether pro forma financials are needed. Examine footnotes as a source of information for more detailed inquiries into existing debt, leases, pensions, related party arrangements, and contingent liabilities. Especially in leveraged acquisitions, consider the target's debt.[23]

Engineering Reports

Try to find "as-built" drawings, especially if surveys are not available. Review for environmental problems or other concerns that might require major capital expenditures.

Market Studies/Reports on Company's Product

These may be written in-house or by outside consultants. In the case of public companies, if findings are material, they may be mentioned in the company's Management Discussion and Analysis section of its annual report/10-K. Check the 10-Ks and proxies, too.

Key Intangibles

Patents, Trademarks, Trade Names, and Copyrights. These items generally involve "registered" or "filed" rights that can be searched for at the U.S. Patent and Trademark Office and, for copyrights, at the Library of Congress, Washington, D.C. However, such rights may not have been filed for. Also, corporations frequently have other key intangibles that are not filed for anywhere, such as trade secrets. This is especially true of companies that deal in high technology, software, and the like. Due diligence would call for inquiry as to the status of and the methods of protection for these items. Review all related trade secrets, know-how, and license agreements.

Licenses. Whether granted by the government or by a private third party, licenses may be absolutely essential to the ability of a corporation to continue legally to conduct its business. The buyer should ensure that all such necessary licenses are current and in good order and that these licenses will be readily transferable, or remain valid, in the context of the acquisition transaction. It is generally useful to obtain the advice of special counsel or experts in the particular field (for example, FCC counsel in the case of broadcasting licenses).

Key Tangibles

Mortgages. If these are significant, request closing binder. Look for notes or other evidence of indebtedness. In the case of International Development Bank (IDB) or other quasi-public financing, request the closing binder, and be sure to review indenture, etc.

Title Documents to Real Estate and Personal Property. Review title policies and documents creating any encumbrance upon title and deeds or bills of sale by which the company acquired assets. If assets were acquired by stock purchase or merger, find evidence of filing of appropriate corporate documents in jurisdiction(s) where assets are located as well as in state(s) of incorporation.

Real Property and Assets Identification. Ask seller to give the complete address (including county) of every facility or piece of real estate owned or leased by the company, and describe each such facility using the following list of categories (indicate more than one category if appropriate):

- Corporate offices
- Production, manufacturing, or processing facilities
- Warehouses, depots, or storage facilities
- Distribution facilities
- Sales offices
- Repair/warranty work facilities
- Apartments or other residential real property
- Undeveloped real property
- Any other facilities

If *owned,* the seller should indicate as "O" and provide full legal name in which title is recorded. If *leased,* seller should indicate as "L" and provide full name of lessor. The seller should indicate whether there is any *inventory* at any such facility by "I."

The seller should indicate whether any goods, products, or materials at any such facility are there on consignment from a supplier, as "Supp C." Ask the seller to provide the complete address (including county) of every site not described above where any of the company's assets are located, including every facility of any customer, or processor at which the company has raw materials, goods, products, or inventory on consignment, and the name of the party in possession of such assets, including any such customer or processor.

Compare actual documents to title insurance. Look for encumbrances, easements, rights of third parties, and personal property encumbrances appearing on UCC records that should be checked. When in doubt, send someone to the site. (Remember Cascade International, whose founder, Victor G. Incendy, disappeared in 1991 following the discovery that the company had overstated not only its sales and profits but the number of stores and cosmetic counters it owned. By comparing financial records to state tax records and to industry rules of thumb, outside sources were able to determine that the exaggeration was at least 300 percent. Later investigation found that this was a conservative estimate.)

Contracts

Supply and Sales Agreements. Do these meet the company's future business requirements? Review as to assignability, term, and expenditures required. (Some long-time distribution contracts will survive a merger but not an acquisition of assets.)

Employment and Consulting Agreements. These relate both to the current key employees the acquirer wishes to retain, and exposure to claims of past employees or those the acquirer does not wish to retain. They should also be reviewed to discover if they restrict the retaining of proprietary information such as customer lists.

Leases. Get legal descriptions. Have particular concern as to term and expiration dates and renewal rights, rent, and special provisions concerning assignment that may include change of corporate ownership.

License and Franchise Agreements. Look for correspondence concerning extension, expansion, disputes, and estoppels. Franchise relationships are likely to be stormy. Is there a franchise organization? Note assignment clauses and clauses creating a landlord's lien. Are any prior consents required? Are these sufficient for the business's requirements?

Loan Agreements. Review terms, intention, and assignability provisions as to any need to refinance or to obtain consents to an acquisition from lenders. Schedules and exhibits should be reviewed to glean useful information regarding the company's assets and structure.

Shareholder Agreements. Review provisions and their effect on the proposed transaction and, if the agreement will survive, its effect on future transactions, that is, registration rights and antidilution or dissenters' rights.

Sponsorship Agreements. Are these tax deductible to the giver and tax-free to the receiver?

Agreements with Labor. Obtain and study all agreements for unusual provisions that would unduly constrain management's options. Review benefits, severance, and plant closing provisions.

- Will the agreements terminate at sale or are they binding on the buyer?
- Do the agreements have provisions that restrict the buyer?
- Is the company presently in compliance with the agreements? Does the agreement expire soon? Will the buyer want it to be reopened? (Notice may be required.) Is a strike likely?
- Are there any grievances that raise general issues of contract interpretation?

Agreements with Management

- Are there golden parachutes?
- Is there excessive compensation? (Compare with current compensation studies by executive compensation firms.)

Security Agreements or Other Agreements Giving Other Parties the Right to Acquire Assets of the Company. Review financing statements or other evidence of perfected security interests. Lien searches conducted by professional services engaged in this business are usually the most efficient way of uncovering UCC financing statements of record, but it is also sometimes necessary to check for third-party interests recorded against particular assets of the seller, rather than against the name of the seller itself. For example, security interests in assets such as vessels or aircraft are recorded in special registries (outside of the scope of the usual UCC lien search) against the particular vessel or aircraft itself, rather than against the owning company.

Sales and Product Warranty Agreements Review for provisions that vary from the description or understanding of such documents that are provided or

held by management. Review for provisions that may be illegal and/or unenforceable. Review for indemnity obligations of the company.

Selected Correspondence. This is a useful means of uncovering past problems that may recur.

Acquisition Agreements. Review prior acquisition agreements concerning surviving provisions, that is, noncompete clauses and indemnification obligations.

Pension and Profit-Sharing Plans. Check out the fine print in all plans and trust documents and review the personnel handbook and any policy manual.

- Form 5500
- Summary Plan Description (SPD)
- Actuarial valuation
- Auditor's report and accompanying management reports
- Investment manager agreements
- Fiduciary insurance and bonds
- Investment contracts
- Investment policy
- Accrued, unfunded liabilities
- Fringe benefits

Welfare Benefit Plans. Be aware that potential liabilities in this area can be substantial and that valuation of plans requires expert guidance. Check out fiduciary insurance and bonds.

Multiemployer Plans. As shown in Chapter 7, these can be a major problem.

Deferred Compensation Plan and Stock Option Plan. Pursuant to revisions to Regulation S-K issued October 15, 1992, SEC-registered companies are now disclosing more about such plans in their proxy statements.

Supplemental or Excess Pension Plan

- Is the plan exempt from ERISA?
- Will future law affect costs or benefits?
- Are large claims anticipated?
- Are reserves on company books adequate?
- Can the plan be terminated or amended?

- Are there any benefits in pay status?
- Are the benefits in effect funded with insurance?

Insurance Policies

Review all policies and ask at least these questions:

- Do policies cover the areas of risk exposure? (Consider a risk analysis consultant to review this very technical area.)
- What is the deductible?
- What are the liability limits per occurrence? In total?
- Are punitive or treble damages excluded by the policy or by state law?
- Are policies written for claims incurred or claims made?
- Must a tail be purchased to extend coverage?
- Is there a reservation of rights clause?
- Is there a regulatory exemption clause?
- What about coverage for director and officer liability?
- What about environmental liability?

KEY INFORMATION FROM THE COMPANY'S MANAGEMENT

Financial Information. Perform an analysis of the company's past operating and financial performance. Document any planned substantive changes. In conducting such an analysis keep in mind the latest tax and accounting changes. For example, under current Financial Accounting Standards Board rules, companies may report their projections of how current losses may offset future gains, even if it is not certain the losses will trigger an offsetting tax benefit. Under previous rules, companies could not report such projections on the grounds that they were not certain to materialize. (See also Chapter 5.)

Relative Profitability of the Company's Various Classes of Products and Business Segments. Compare to companies of similar size in the industry.

Ownership of Company's Securities. Trace title of present owners of corporation (if privately held). Review for existing pledges or liens that must be released to permit transaction.

Litigation Matters

Potential Defaults under Existing Contracts or Potential Litigation. Identify as many as possible and obtain waivers, consents, and so on. Ask for summary of all pending or threatened legal actions that are material:

- Names and addresses of all parties
- The nature of the proceedings
- The date of commencement
- Current status
- Relief sought
- Estimated actual cost
- Insurance coverage, if any
- Any legal opinions rendered concerning those actions

Summaries should also be provided for the following:

- All civil suits by private individuals or entities
- Suits or investigations by governmental bodies
- Criminal actions involving the target or any of its significant employees
- Tax claims (federal, state, and local)
- Administrative actions
- All investigations
- All threatened litigation

Ask for copies of all material correspondence during the past five years with government agencies. In rough order of likely importance, these include the following:

- Department of Justice
- Internal Revenue Service
- Securities and Exchange Commission
- Environmental Protection Agency
- Department of Labor
- Federal Trade Commission
- Occupational Safety and Health Administration
- Equal Employment Opportunity Commission
- Public Utility Commissions
- Federal Energy Regulatory Commission

Recent or Pending Changes in Laws or Regulations That Might Affect the Company's Business. Evaluate risk and potential existing noncompliance. Don't forget state laws, particularly tax laws. These can carry surprises for new owners. Consider Proposition 13, a 1978 amendment to the California constitution still in effect 30 years later. It set property taxes at 1 percent of assessed valuation, rolled back assessments to 1975 levels, and limited increases to 2 percent per year. When property is under new ownership, it is reassessed and the buyer pays taxes based on the purchase price.

Product Backlogs, Purchasing, Inventory, and Pricing Policies. Is the company accurately tracking the flow of goods in a company? Falsification of records can abet fraudulent schemes of massive proportions. Classic cases in point include Crazy Eddie Stores, where founder Eddie Antar created a "giant bubble" of a company according to the U.S. attorney in Newark, and Miniscribe Corporation, where managers shipped bricks to distributors and booked them as sales.

Pending Negotiations for the Purchase or Disposition of Assets or Liens. The buyer may want to drop real property that it is planning to dispose of into another entity (such as an affiliated partnership) to avoid gain recognition or to provide for means of early investment return to acquiring persons.

Charitable Contributions Claimed Are valuations accurate? If not, this can lead to IRS challenges.

KEY INFORMATION FROM OUTSIDE SOURCES

Market and Product Studies. Whether or not the company has conducted market and product studies, it's always a good idea to consult independent research. (See Chapter 2 for a list of sources.) Try also to obtain product test data from regulatory agencies. Contact major customers to determine their level of satisfaction and copies of test programs they have run.

Capital Confirmation. Confirm outstanding capitalization from the company's stock transfer agent.

Lien Search

Acquirers will want to confirm the absence of liens or judgments via searches of public records. Note that names of debtors to be searched are often difficult to determine.

- Prior names—four-month rule regarding after-acquired collateral—cannot rely on creditor
- Fictitious names or other false information
- Continuation statements

Sometimes a search must be conducted at the state or local level. In such cases it may be necessary to do the following:

- Coordinate between the search firm and title company (sometimes not done)
- Consult Uniform Commercial Code (UCC) and related procedures to determine if state(s) at issue has additional or unusual search requirements
- Obtain the lender's or borrower's approval

Ordering a Search. Send a letter to the search firm or title company listing names, location, cost, and deadline, and request copies of all liens found. Send a copy to the client and lender's or borrower's counsel.

Reviewing a Search. What is your client buying, selling, liening, or loaning against? Are certain equipment, goods, and intangibles supposed to be free and clear? Are they vital to the business? To the closing? If so, watch for liens against those items.

- If certain secured debt is to remain in place, one would expect related UCC-1s to show up on the search report.
- If secured debt is to be paid off at closing, the seller must produce UCC-3 or other required forms of releases from the relevant parties.
- What does the appraisal say? What does the commitment or finance package say?

Check the report for names and jurisdictions. Review the UCC-1s sent for:

- Debtor
- Secured party
- Date (five-year rule)
- Description of collateral

Compare against schedules to be incorporated into loan documents, contracts, and bills of sale. Often, local counsel will need copies of lien searches in order to deliver a priority opinion.

Bring-down of Search. A search bring-down is a telegram or telephone update of lien searches and of corporate good standing certificates. It is often difficult to obtain closer than a few days before closing, but every effort should be made to close on the basis of the most recent bring-downs possible.

Creditor Check

Assumption of Debt. If secured debt is not to be paid off, get security documents to see if, for example, incurring of acquisition debt, imposition of related liens, merger, change of control, or sale of assets is permitted. Are there burdensome covenants? Is prepayment permitted, with or without penalty? (See Chapter 4.)

Confirm absence of defaults from the principal lenders.

Confirm absence of defaults from lessors (landlords).

Recognizing the Unusual or the Potential Problem. The key here is detail and curiosity.

- Is the affiliate of seller named as secured party?
- Are the names of the debtor not exactly right, but must be related?

Other Searches

Patent and trademark searches for possible infringement of products or product names

Certificates of good standing for all corporate subsidiaries whether active or inactive

Title search/acquisition of title insurance

Appraisals of company-owned real property and improvements

Any equipment appraisals made by or for insurance companies

DOCUMENT LIST

Preliminary Document and Information Request List for [Name of Company]

PRIVILEGED AND CONFIDENTIAL
[Draft (Date)]

All references in the following list to the "Company" include [Name of Company] and each of its subsidiaries or divisions.

I. Corporate Records

1. Charter documents and bylaws of the Company, as amended to date
2. Minute books of the Company for the last five years (including copies of reports to members not set forth in the minutes)
3. Stock books, stock ledgers, and other records of the issuance of stock by the Company
4. A copy of the most current organizational chart available for the Company, including all entities or investments in which the Company owns less than a 100 percent interest
5. Schedule showing for the Company and each of its subsidiaries: name, jurisdictions where qualified to do business, and jurisdictions where it owns or leases real property

II. Public Filings and Financial Information

1. Audited consolidated financial statements and the notes thereto for the past five years (or the earliest date available) for the Company.
2. Interim financial statements for quarters since the last audit for the Company.
3. Most recent internal financial statements for the Company (i.e., for the period since the last quarterly statements).
4. Audited financial statements for any enterprises merged with, or acquired by, the Company in the last five years.
5. Current internal budget, operating and financial plans and projections, and any reports or papers relating to any long-term budget, capital development, restructuring program, or strategic

plan, including any plans regarding systems and operations, of the Company.

6. Any private placement memoranda or offering circulars prepared and used by the Company in the last five years.
7. All annual or other letters or reports from the Company's independent public accountants or internal auditors to management during the last five years regarding accounting control systems, methods of accounting, and other procedures. Any other reports prepared by the Company, its internal auditors, counsel, or others regarding similar accounting matters.
8. List of tax returns of the Company and the years thereof which have been audited by state or federal tax authorities, and copies of the determination letters related thereto. List of tax years open. Specify whether the Internal Revenue Service or similar authorities have indicated that there may be a claim relating to open tax years.

III. Corporate Agreements

1. All agreements or documents evidencing borrowings (including bank lines of credit) or guarantees by the Company or any partnership in which the Company holds interests, or security related to borrowings or guarantees of the Company.
2. All documents and agreements evidencing other financial arrangements of the Company, including sale and repurchase or leaseback arrangements, capitalized leases, real estate and other installment purchases, equipment leases, and so on.
3. Any agreement to loan funds or provide working capital to non-wholly-owned subsidiaries, partnerships in which the Company owns an interest, or other third parties.
4. Material correspondence of the Company with lenders during the past five years, including any compliance reports prepared by the Company or its auditors and any waivers provided by the lenders.
5. Any agreements (other than those previously described) that restrict additional indebtedness or the sale, lease, or transfer (by dividend or otherwise) of the assets or capital stock of the Company.
6. All contracts relating to the Company's securities to which the Company is a party, or among shareholders of the Company, or

between shareholders and the Company, including (i) any agreements relating to the purchase, issuance, transfer, or voting of securities of the Company (e.g., stock option plans, forms of stock option agreements, private placement agreements, registration rights agreements, or subscription agreements), (ii) all stockholders' agreements, voting trusts, or other restrictive agreements relating to the sale or voting of shares of the Company, and (iii) any agreements under which any person has any rights concerning issued or unissued securities of the Company (e.g., rights of purchase or sale, preemptive rights, rights of first refusal, registration rights, options, warrants, or convertible securities).

7. Any joint venture, shareholders', partnership, or other management, operating, or consulting agreements to which the Company is a party.

8. All divestiture or acquisition agreements and related documents entered into by the Company in the last five years (or earlier if the Company has any material ongoing commitments in respect of any divestiture or acquisition), including all documents relating to any proposed material divestiture or acquisition by the Company.

9. List of material customers of the Company, giving annual dollar amounts purchased during the last three years, and copies of contracts with such persons.

10. List of all distribution agreements and copies of material distribution contracts (or any form contracts) to which the Company is a party.

11. List of material suppliers and volume of purchases made from each listed source in the last two fiscal years. Copies of material supply contracts of the Company and any correspondence with material suppliers, including the agreements and correspondence with sole source suppliers. Copies of any reports or internal memoranda relating to potential supply or inventory problems.

12. List of all principal properties owned or leased by the Company. Copies of all material leases of real property and personal property to which the Company is a party either as lessee or lessor. Copies of all mortgages and related agreements or other security agreements concerning properties owned or leased by the Company.

13. List of all patents, trademarks, trade names, copyrights, and so on ("Intellectual Property") owned or used in the business of the Company, giving brief descriptions of the use, registration numbers, and dates of issuance of registration, names of any persons to or from whom such Intellectual Property is licensed, and brief descriptions of such arrangements. Description of any claims asserted or threatened by any third party with respect to any Intellectual Property.
14. Copies of all material agreements relating to competition, noncompetition, nonsolicitation, licensing, territorial arrangements, distributorships, or franchises to which the Company is a party, and any Hart-Scott-Rodino filings.
15. Copies of tax-sharing agreements among the Company and any of its affiliates or subsidiaries.
16. Schedule of material insurance policies of the Company.
17. Form of product warranties of the Company.
18. Records relating to customer complaints during the last two years.
19. Material research and development reports prepared by the Company in the last three years.
20. Any material contracts and agreements, not otherwise described previously, to which the Company is a party.

IV. Employees

1. All material employment agreements, consulting agreements, retention agreements, agency agreements, noncompete agreements, collective bargaining agreements, and similar agreements to which the Company is a party, including employment contracts of executive officers.
2. All bonus, retirement, profit-sharing, stock option, incentive compensation, pension, and other employee benefit plans or agreements of the Company. Provide a schedule of all outstanding options and warrants, identifying the holders thereof; issue dates, exercise price, expiration date, price of underlying shares at time of issue, and other material terms.
3. List of any strikes, unusual labor relationships, work stoppages, or employment-related proceedings during the last five years.

4. All contracts or agreements with or pertaining to the Company and to which directors, officers, or beneficial owners of more than 5 percent of the common shares of the Company are parties. All documents relating to any other transaction between the Company and any director, officer, or beneficial owner of more than 5 percent of the common shares of the Company.
5. Indemnification arrangements with officers and directors of the Company, including a description of any pertinent insurance policies.

V. Governmental Regulation and Environmental Compliance

1. List of all material government permits, licenses, and so on, of the Company (obtained or pending).
2. Any correspondence with, reports filed with, or other communications between the Company and regulatory authorities within the last five years with respect to significant regulatory matters, including any correspondence, memoranda, or other communication relating to [specific regulatory authority].
3. Any correspondence, memoranda, or other communications relating to existing or pending governmental regulations affecting the Company's businesses, including any correspondence, memoranda, or other communications relating to any proposed legislation.
4. Any information concerning environmental matters and compliance with environmental law and governmental regulations, including descriptions of any contaminated properties, spills, liabilities to third parties, current or prospective environmental remediation efforts, potentially responsible party letters, and administrative orders.
5. Copies of waste-generation records including generation registration, hazardous waste manifests, and any correspondence, directions, or orders relating to waste disposal sites, including PCB waste disposal sites.
6. Copies of all environmental audits, inspections, surveys, questionnaires, and similar reports (internal or external) relating to the Company, including any commissioned by legal counsel to the Company.

VI. Legal Matters

1. A schedule and status report of any material litigation, administrative proceedings, or governmental investigation or inquiry, pending or threatened, affecting the Company or any of its respective officers or directors, including a brief description (amount in controversy and name of attorney handling matter, etc.) of all such pending or threatened matters.
2. Any memoranda of or correspondence with counsel with respect to pending or threatened litigation or litigation settled or otherwise terminated within the last three years.
3. Any material consent decrees, judgments, other decrees or orders, settlement agreements, or other agreements to which the Company or any of its officers or directors is a party or is presently bound, requiring or prohibiting any future activities.
4. All letters from the Company or from counsel for the Company to the Company's independent public accountants or to any regulatory authority in the last three years regarding material litigation in which the Company or any of its respective officers or directors may be involved, including updates thereof to the most recent practicable date.

VII. Other Material Information

1. Any recent analyses of the Company prepared by the Company, investment bankers, commercial bankers, engineers, management consultants, accountants, federal or state regulatory authorities, or others, including appraisals, marketing studies, future plans, credit reports, and other types of reports, financial or otherwise.
2. Copies of customer profile studies and any other major research projects conducted, undertaken, or completed in the last three years.
3. Press releases issued during the last three years.
4. Any reports or communications to shareholders for the last three years.
5. Responses to the directors' and officers' questionnaires.
6. Product brochures and other marketing material.
7. Backlog and order summary records for the last fiscal year.
8. Copies of accident reports for the Company for the last three years.

9. Any other documents or information which, in the judgment of the officers of the Company, are significant with respect to the business of the Company or which should be considered and reviewed in making disclosures regarding the business and financial condition of the Company.

Note: Add additional specific requests according to the type of company involved in the transaction.

APPENDIX 6C

An Annotated Initial Document and Information Request List

Junior associates in law firms are often handed a document request list similar to the Annotated Initial Document and Information Request List that follows and are instructed to begin due diligence. Unfortunately, this is often done without much explanation as to why certain documents are requested and for what type of information the associate should be looking. To help associates facing this situation we have annotated a sample request list to assist associates in understanding why they are looking at certain types of documents and what type of information is important to cull from such documents. Often, associates are not looking for specific information, but any information that seems unusual or curious. We refer to these items as red flags. *In addition, associates should review all documents with an eye toward provisions of a burdensome nature which may prohibit or inhibit the deal or the company's future plans. We refer to these items as* obstacles. *Red flags and obstacles merit being brought to the attention of the other team members and, generally, the client.*[23]

I. CORPORATE DOCUMENTS

A. Certificates of incorporation with all amendments and restatements to date of each of Parent, Inc. (the "Company"), its direct and indirect subsidiaries (the "Subsidiaries"), and predecessor companies.

- You should obtain all documents on file with the secretary of state of the Company's state of incorporation (e.g., long-form good standing certificate). You should compare documents received from the secretary of state with documents received from the Company to check for discrepancies. Obtain a good standing certificate at the beginning of your investigation as well as at the closing.

- Compare the certificate of incorporation to the relevant corporate statute.
- The certificate of incorporation is the first document that should be reviewed as it will provide important information such as the Company's legal name, the duration of its corporate existence, the Company's powers, the history of the Company's authorized share capital, existence of preemptive rights, and restrictions upon stock issuances or business combinations. In addition, the charter serves as an important basis for checking what the Company's minutes show as to dates and amounts of authorized stock.
- For the Company, it will be very important to understand its capital structure, including amount of voting stock, voting rights, and preferences, particularly if stockholder approval is required for the transaction. For example, you need to know whether a supermajority vote of stockholders is required for the transaction at hand. You should also check applicable state law regarding shareholder approval requirements.
- With regard to the Subsidiaries, your firm may be asked to opine that the Company owns as much of each Subsidiary as it claims. Knowing the amount of authorized capital stock is the first step in supporting this opinion.
- If your firm has been asked to opine that the target or issuer is duly incorporated, you should compare the charter and bylaws with the law of the state of incorporation in effect at the time the Company was incorporated as well as at the time the charter or bylaws were amended, if amended. You must determine whether these documents were properly adopted and amended under the state law governing at that time and if they are in full force and effect.
- You should check closely provisions concerning preemptive rights and rights of first refusal. If such provisions exist, review each issuance of stock. The preemptive rights of the stockholders must have been duly waived or taken into account.
- Check to make sure that the charter contains no restrictions on corporate actions, for example, upon sales or other transfers of stock, issuance of certain types of securities, incurrence of debt, anti-takeover provisions, or other obstacles to your transaction. These types of restrictions may also impact any future plans your client may have.

- Depending on the transaction, you may have to amend or eliminate certain provisions in the certificate of incorporation.

B. Bylaws of the Company and the Subsidiaries.

- The bylaws usually contain a significant amount of information about corporate procedure. Read the bylaws of each of the Companies closely to make sure there are no procedural obstacles to your transaction.
- You need to be aware of the procedure for amending the bylaws, the powers of the corporate officers, whether shareholders and directors may act by written consent, and indemnification of directors and officers.
- Check also for vote requirements, the notice required for meetings, whether notice can be waived, whether telephone meetings are permitted (all for both shareholders and directors), the types of action for which shareholder approval is required, and the general mechanics of how the company is governed.
- It will also be important to understand the procedures for electing, removing, and replacing directors and officers. You will need to verify that the directors and officers have been duly elected, have approved minutes and resolutions regarding the transaction (in the case of directors), and have signed transaction documents (in the case of officers).
- Compare the bylaws to the relevant corporate statute.
- Depending on the transaction, you may have to amend or eliminate certain provisions in the bylaws.

C. Minute books and all materials distributed in connection with any meetings of the Company and each of the Subsidiaries for the last five years.

- You should review the minutes of meetings of the board of directors and any committees as well as meetings of stockholders.
- Prior to reviewing minutes, you should be familiar with any stockholders' agreements or voting agreements that may contain restrictions on corporate actions, vote requirements, and so on.
- You are checking to see whether the actions taken by the directors and shareholders were taken in accordance with the charter, bylaws, stockholders' agreements, and state law.
- If your firm will be opining as to the Company's due incorporation, examine the minutes from organizational meetings and the state law in effect at the time of incorporation to determine

whether the incorporation procedure in effect at the time of incorporation was followed, that the certificate of incorporation was properly adopted, the bylaws were properly adopted, the subscription agreement was properly approved, and that the initial issuance of stock was properly approved.

- Be sure you understand how the Company was formed, who were the initial stockholders or contributors, and what they contributed. There should be clean receipts, canceled certificates, and so on, for everything. Did the Company receive the consideration it was supposed to receive?
- Whenever directors have authorized or issued securities (including options and warrants), have amended the charter or taken other significant action (such as approvals of material contracts, employment and severance arrangements, pension plans, loans, acquisitions, and transactions involving officers, directors, and principal stockholders), verify that the procedures prescribed by applicable securities laws, state law, the charter, and bylaws were followed, including that the directors were properly elected, each of the meetings was duly and properly called, a proper quorum was present, and a proper percentage of votes favorable to the action was recorded (this applies to both director and stockholder meetings).
- Verify that the current directors and officers have been elected in strict accordance with the charter, bylaws, and state law in effect at the time of election.
- If the Company keeps detailed board minutes, the minute books can provide a good overview of the company's operations, material transactions and agreements, litigation, and other business affairs. Keep an eye out for red flags. If the Company does not keep detailed board minutes, that fact alone can be a red flag.
- If there are consents in lieu of meetings, check that the requisite vote was met.
- Verify that no action has been taken to dissolve the Company or its Subsidiaries.
- If you find actions that have not been taken properly, cleanup work will be necessary through ratification action by directors or stockholders.

D. Stock books, stock ledgers, and other records of the issuance of the Company and each of the Subsidiaries.

- You are checking to see whether the outstanding stock of the Company has been duly authorized, validly issued, and fully paid and nonassessable.

- The goal is to track stock issuances, transfers, cancellations, and exchanges. Sometimes it is helpful to create a flowchart. Check to see if stock issuances were properly authorized by the board, were in accordance with the charter bylaws and federal and state securities laws.
- Has the stock described in the minute books as having been issued in fact been appropriately recorded?
- Does the total number of shares indicated in the stock books as outstanding conform to the number of shares indicated as outstanding in the Company's financial statements?
- If there is a corporate transfer agent or registrar, obtain a certificate showing the number of outstanding shares and compare it to the numbers in the financial statements.
- Were there any stock repurchases? Were they completed in accordance with the state law?
- Obtain a certificate from the Company's independent public accountant that the stock is fully paid, otherwise you will have to review the Company's financial statements from past years.

E. List of all jurisdictions in the United States and elsewhere in which the Company is qualified to do business.

- You should obtain good standing certificates from each foreign jurisdiction to check that the Company is duly qualified.
- Also you should check the state laws for all requirements imposed on the Company by foreign jurisdictions.
- Consider whether you need to withdraw from any state or qualify in a new state as a result of the transaction.
- You may also need to check with local counsel in foreign jurisdictions if the Company does business in other countries.

F. A copy of the most current organizational chart available for the Company, including all Subsidiaries and any other entities or investments in which the Company owns less than a 100 percent interest.

- The organizational chart provides a basic understanding of how the Company and the Subsidiaries are structured and operated. It will become invaluable during your investigation in figuring out who can provide you with certain documents and who would be helpful to interview regarding certain issues.

G. Any and all agreements among shareholders of the Company, or between shareholders and any of the Companies, relating to the management, ownership, or control of the Companies, including

voting agreements, rights of first refusal, preemptive rights, and registration rights.

- Look for potential obstacles to the contemplated transaction such as voting agreements, rights of first refusal, preemptive rights, and registration rights. These agreements may affect the potential change of control of a company or the transferability of its stock. Look to see whether the deal will trigger any of these burdensome provisions. In closely held companies, there may be complex agreements between shareholders, including agreements to buy back shares, issue more shares, and so on. Nearly all such agreements have complex registration rights upon a public offering.
- If the contemplated transaction is a sale of stock, determine whether the purchaser will be required to enter into such types of agreements (e.g., voting agreement) or, if appropriate, whether such agreements are assignable.
- Review any shareholder rights plans.

H. Reports or other material communications to shareholders of the Company for the last five years.

- Read these communications to make sure that you and your client are aware of all the material information that has been disclosed to stockholders.
- Look for red flags.

II. FINANCIAL INFORMATION

A. [If the Company is public: All filings by the Company and Subsidiaries with the Securities and Exchange Commission during the last five years.] [If the Company is not public: Audited consolidated financial statements and the notes thereto for the past five years and interim financial statements for quarters since the last audit for the Company and the Subsidiaries.]

- These documents will help you understand the Company's business.
- In the case of public companies, you will review annual reports (a Form 10-K) and quarterly reports (a Form 10-Q). The 10-Ks and 10-Qs will contain a significant amount of disclosure about operations, financials, and management's view of these results (the Management's Discussion & Analysis of Financial Condition and Results of Operations (MD&A)). Public companies

also file a proxy statement annually. In addition to these periodic filings, public companies must disclose extraordinary events on Form 8-Ks. Review these documents to make sure that you and your client are aware of all the material information that has been disclosed to stockholders and the public. Look for red flags.

- The footnotes to the financial statements will contain information on stock options, debt, capital structure; be sure you understand all footnotes and that you have reviewed all agreements discussed in the footnotes.
- You should look for and obtain explanations of any significant losses or unusually good years.

B. Any private placement memorandum or offering document prepared and used by any of the Companies in the last five years.

- Again, these documents provide useful information in understanding the Company and should be reviewed, with the most recent documents getting the most attention.
- Pay attention to the risk factors section. Use it as a checklist to be sure you have caught all potential problems.

C. (If the Company is public: any Schedule 13D* or 13G** filed with the Company in the last five years.)

- In an acquisition, the buyer will want to know who owns stock in the target and how much stock each stockholder owns. Such information will assist the buyer in analyzing the probability of obtaining stockholder consent to the transaction.
- Use these filings as a check to understanding the Company's capital structure.

D. Current internal budget, operating and financial plans, and projections and any reports or papers relating to any long-term budget, capital development, restructuring program, or strategic plan, including any plans regarding systems and operations.

- Internal budgets and forecasts are useful in understanding what management thinks the Company's current and future prospects are, and for highlighting areas of concern to management. Look for red flags.
- Check to see if the internal budget matches what the Company has stated publicly. Are the assumptions overly optimistic? Is the Company ignoring or covering up problems? This review may reveal disclosure issues, such as product backlog.

E. Audited financial statements for any enterprises merged with, or acquired by, the Company or any of its Subsidiaries in the last five years.

- Focus especially on the footnotes. They can provide a checklist for just about everything about the Company, including credit agreements, debt structure, capital structure, compensation, options, and leases. This holds true for all reviews of financial statements.

F. All annual or other letters or reports from each of the Companies' independent public accountants or auditors to management during the last five years regarding each of the Companies' accounting control systems, methods of accounting, and other procedures.

- Look for red flags, especially in terms of hesitancy, qualified opinions, or warnings.

G. Any reports prepared by any of the Companies, their internal auditors, counsel, or others regarding material accounting matters (such as memoranda relating to a change in the Companies' accountants, inventory markdowns, increases in reserves for doubtful accounts, or other reports prepared for the board of directors).

- These reports are helpful as they highlight problems that the Company has had in the past. Look for red flags. As part of your investigation, you will want to note what steps have been taken to resolve the problems and to prevent their reoccurrence.

H. List of returns of the Company and the years thereof which have been audited by state or federal tax authorities, and copies of the determination letters related thereto. List of tax years open. Indicate whether the Internal Revenue Service or similar authority has indicated that there may be a claim relating to open tax years.

- Look for significant potential liabilities either in the operations of the Company being investigated or in connection with the specific proposed transaction.
- Bring these documents to the attention of the tax specialist on your team.
- Do a search of tax havens. Several search firms have a service that can provide this type of search. Remember, though, that havens, while legal, can attract negative public attention. Factor in the potential reputation risk.

III. MATERIAL CORPORATE AGREEMENTS

There may be agreements that could materially affect the Company's operations or the proposed transaction. Your goal is to find business and legal risks. In most cases, you want to make sure the material agreements will remain in effect. Some of the items that you should consider are the following: (i) what is the term; (ii) what are the Company's obligations and liabilities under the agreement; (iii) how is corporate action restricted; (iv) what are the events of default; (v) what are the consequences of a material breach (for example, cross-defaults, termination); (vi) is the contract assignable; (vii) how can the agreement be terminated; (viii) are there any changes in control provisions; (ix) are any consents required; (x) are any notice provisions triggered; (xi) what is the total exposure; and (xii) what types of indemnification provisions are there, etc. Also consider obtaining an officer's certificate certifying that the material agreements are still in effect and have not been amended or modified (otherwise than as set forth in subsequent amendments). Also, if need be, material contracts can be verified with the counterparty. When reviewing minutes, you should double-check that material contracts were approved and authorized by the board of directors. Finally, make sure you have reviewed fully executed copies of the material agreements and that the copies are complete. In the context of a public offering you will have to determine which material agreements should be filed as exhibits to the registration statement.

A. All agreements or documents evidencing borrowings (including bank lines of credit) or guarantees by the Company, each of its Subsidiaries, or any partnership of which the Company holds partnership interests.

- First, it is important to determine the amount of money the Company owes or has guaranteed, the terms of the debt, and the amount and timing of the payments. What are your client's plans? Will it repay debt? Check the repayment and prepayment provisions. Any penalties?
- Second, review these documents to make sure there are no obstacles to the transaction. For example, the contracts may not be assignable, or certain covenants may restrict the transaction. Events of default may be triggered by the transaction. When working on a financing, keep in mind that often the sale of securities is deemed an assignment of the agreement. In these documents, you are looking for obstacles. If there are obstacles, your client may have to renegotiate the terms.

- Identify any consents that may be required and ensure that any such consents or waivers that have been previously obtained are in proper form.
- Debt instruments usually contain affirmative and negative covenants (for example, restrictions on combinations, offering, asset sales, payment of dividends, etc.) that can significantly restrict your client's plans for the Company's operations or the pending transaction itself.

B. Material correspondence of the Company and each of its Subsidiaries with lenders during the past five years, including any compliance reports prepared by the Company or any of its Subsidiaries or their auditors.

- Review this correspondence to verify that the Company is not in default on its loans and that there are no outstanding issues with lenders. Look for red flags.

C. All contracts relating to the Company's securities to which the Company is a party, including stock option plans, forms of stock option agreements, private placement agreements, registration rights agreements, subscription agreements, voting agreements, warrant agreements, and so on.

- Review these documents to verify that your client is aware of their existence, as well as the significant provisions thereof. Look for obstacles and red flags.
- You should be familiar with the total outstanding amount of options or other rights to acquire stock of the Company.
- What are the Company's obligations under these documents?

D. Copies of all mortgages or other security agreements that are material to the Company or any of its Subsidiaries.

- Depending upon the target or issuer, there may be a few mortgages or several thousand. If there are many mortgages, before reviewing all of these agreements, discuss with the other team members whether there is an efficient way to reduce the number of mortgages examined. For example, you might decide to examine only mortgages involving a certain minimum dollar amount. Another option is to examine a randomly selected percentage of mortgages.
- Summarize the key terms of the mortgages, including location and character of property owned, term of debt, payment amounts, due dates of payments, and any covenants or obstacles that may impact the transaction.

- Determine whether there are any disputes under the material mortgages.
- Undertake UCC searches to check for liens in the company's state of incorporation, the state where its executive office is located, and the state where major operations are conducted or facilities are located.
- Note that for certain assets such as aircraft, there are special registries that should be checked.
- Review financing statements.
- Which are the assets in which your client is most interested? Check for liens against those assets.

E. Any agreement to lend funds or provide working capital to non-wholly-owned Subsidiaries, partnerships in which the Company owns an interest, or other third parties.

- Look for red flags, obstacles—do any agreements involve related parties?
- What is the total exposure to the Company?

F. All documents and agreements evidencing other financial arrangements, including sale and repurchase or leaseback arrangements, capitalized leases, real estate and other installment purchases, equipment leases, etc.

- Look for red flags, obstacles—do any agreements involve related parties?
- Has the Company agreed to perform or not perform certain actions in the future?
- What is the Company's exposure?

G. Any joint venture, partnership, or other material management, operating, or consulting agreements to which the Company or any of its Subsidiaries are a party.

- What are the Company's obligations and liabilities? How will the pending transaction affect these agreements?

H. All divestiture or acquisition agreements entered into by the Company in the last five years.

- Which provisions survive?
- What are the Company's continuing obligations (e.g., indemnification, noncompetition)?

I. List of material customers and vendors of the Company and each of its Subsidiaries, giving annual dollar amounts purchased or sold during the last five years, and copies of contracts with such persons.

- Often material relationships may not be documented and you will need to interview company officials. Consider whether your client will want to document these relationships.
- Are there possible disruptions to sales or supplies? Are prices expected to increase or decrease?
- Look to see whether any single customer or vendor accounts for a large percentage of the total amount purchased or sold annually. What are the terms of the contracts with such customers or vendors? What would happen if these relationships were terminated? Any such concentration should be brought to the attention of the buyer or disclosed in the prospectus.
- Review the contracts for red flags and obstacles.

J. List of all distribution agreements and copies of material distribution contracts (or any form contracts) to which the Company or any of its Subsidiaries is a party.

- *See* III.1.
- Review the contracts for red flags and obstacles.

K. List of material suppliers and copies of material supply contracts and any correspondence with material suppliers, including the agreements and correspondence, if any, with sole source suppliers.

- *See* III.1.
- Are the Company's requirements for the future covered by these contracts?

L. List of all principal properties. Copies of all material leases of real and personal property to which the Company or any of its Subsidiaries is a party, either as a lessee or lessor.

- If real estate is a significant asset, a real estate lawyer should review these documents.
- Actual documents should be compared against title insurance.
- You are checking for encumbrances, rights of third parties, etc.
- With regard to leased properties, summarize the key terms of each lease (for example, term, rent, and the square footage of the property).
- Review whether the proposed transaction triggers any provisions in the leases that would be obstacles to the deal.
- Are there renewal rights? What happens upon a change of control?

M. Copies of all material agreements relating to competition, noncompetition, licensing, territorial arrangements,

distributorships, or franchises to which the Company or any of its Subsidiaries is a party.

- Obstacles and red flags—does the Company have burdensome obligations or is it relying on unenforceable provisions?
- You may wish to consult an antitrust lawyer.
- Will these agreements cover the Company's needs in the future?

N. Copies of tax sharing agreements among the Company and any of its Subsidiaries.

- These documents should be brought to the attention of the tax specialist on your team.

O. Schedule of material insurance policies of the Company and its Subsidiaries currently in effect.

- Are all areas of risk covered (for example, environmental, product liability, directors and officers)?
- You should review each material insurance policy.
- What is the deductible?
- Are there liability limits?
- What types of exclusions exist?
- Sometimes a firm specializing in risk analysis should be engaged.

P. Form of product warranties of the Company and its principal Subsidiaries.

- Look for red flags such as material contingent liabilities.
- What are the Company's indemnification obligations?

Q. Company records relating to customer complaints during the last two years.

- Look for red flags, such as patterns of complaints.

R. Any material foreign currency exchange agreements, including, without limitation, any hedging agreements, and a summary of derivative trading.

- Given the times, you must make sure you understand these agreements and the exposure and risks to the Company.

S. All material contracts and agreements, not otherwise previously described, to which the Company or any of its Subsidiaries is a party.

- Make sure that you have asked the target or issuer to provide you with copies of any documents that you may have overlooked or any agreements or relationships that are not documented.

T. All contracts or agreements with or pertaining to the Company or the Subsidiaries to which any director or officer of the Company

or the Subsidiaries or any beneficial owner of more than 5 percent of the common stock of the Company and the Subsidiaries is a party.

- The concern with respect to affiliate transactions is that the agreements may be on terms more favorable than an arm's-length agreement. If that is the case, the termination of such agreement may adversely affect the Company's business.
- Review these documents as you would any similar document that does not have an insider or large stockholder as a party.

U. All documents pertaining to any receivables from, or payables (including loans) to, any director or officer of the Companies or any beneficial owner of more than 5 percent of the common stock of the Company.

V. Indemnification arrangements with officers and directors of any of the Companies, including any pertinent insurance policies.

IV. GOVERNMENTAL REGULATION

You must understand the significant regulations affecting the Company's business, operations, and the proposed transaction. Are any regulatory approvals or consents required? Are any regulatory issues presented by the transaction and/or the Company's business that must be addressed? Are there any regulatory proceedings pending or threatened that may materially affect the Company's business?

A. Filings with regulatory authorities for the past five years.

- Are any filings or approvals required in connection with the transaction?

B. Any correspondence or other communications with regulatory authorities within the last five years with respect to significant regulatory matters, including any correspondence, memoranda, or other communication relating to the applicable regulatory authorities.

- You should review all material correspondence with regulatory authorities.

C. Any correspondence, memoranda, or other communication relating to existing or pending governmental regulations affecting the Company's business, including any correspondence, memoranda, or other communication relating to any proposed legislation.

- What effects may proposed legislation have on the Company's business?
- What will the cost of compliance with any such new legislation be?

D. A list of all governmental permits, licenses, etc. of the Company and its Subsidiaries.

- You will usually have to consult with expert counsel—FCC, FDA, environmental, and so on.
- What is the impact of the transaction on the permits, licenses, and so on? Can the permits and licenses be transferred? Must your client reapply for such permits and licenses?

V. LEGAL MATTERS

A. A schedule and status report of any material litigation, administrative proceedings, or governmental investigation or inquiry (including, without limitation, tax and customs matters), pending or threatened, affecting any of the Companies or any of their officers or directors, including brief descriptions (amount in controversy and name of attorney handling matters, etc.) of all such pending or threatened litigation, proceedings, and so on.

- The primary reason for reviewing litigation documents is to determine the total amount of contingent liability and the likelihood of liability. Also look for any patterns of suits. What types of problems does the Company seem to have?
- You want to understand the scope of any ongoing material lawsuit, investigation, or inquiry, and the potential consequences, including monetary damages. You probably will have to consult with the litigation counsel handling the case.
- You may have to review complaints and pleadings and discuss exposure with litigation counsel. If the claims are very specialized, you may have to consult expert counsel in that area (e.g., environmental).
- Many times you cannot rely on the information provided to you, and you also should do an independent search through one of the search services.
- Is the potential liability covered by insurance?

B. Any memoranda of counsel or correspondence with counsel with respect to pending or threatened litigation or litigation settled or otherwise terminated within the past five years.

- If you are told a matter has been resolved, make sure you review signed settlement agreements.

C. Any material consent decrees, judgments, other decrees or orders, settlement agreements, or other agreements to which any of the Companies or any of their officers or directors is a party or is bound, requiring or prohibiting any future activities, regardless of when issued.

- Look for obstacles to the transaction. In addition, in acquisitions, you need to understand whether there are any activities in which the Company may not engage. This is important as your client may have plans to the contrary.

D. All letters from the Companies or from the attorneys or from any of the Companies to the Companies' accountants or to any federal or state regulatory authority for the last five years regarding material litigation in which the Companies (or any of their officers or directors) may be involved, including any and all updates thereof to the most recent practicable date.

VI. OTHER MATERIAL INFORMATION

A. Any recent analyses of any of the Company or Subsidiaries prepared by any of the Companies, investment bankers, engineers, management consultants, accountants, federal or state regulatory authorities, or others, including appraisals, marketing studies, future plans and projections, credit reports, and other types of reports, financial or otherwise, including reports detailing plans for new divisions for the Company or any of the Subsidiaries.

- These documents will give you insight into how others view the company. Review these analyses for red flags.

B. Any other documents or information which, in the judgment of officers of the Company, are significant with respect to the business of the Companies or which should be considered and reviewed in making disclosures regarding the business and financial condition of the Companies.

- Look for red flags and obstacles.

C. Copies of press releases, issues, or significant articles written about the Companies during the last five years.

- Look for red flags.

D. Copies of responses to the most recent officers' and directors' questionnaires.

- With regard to public offerings, you generally must include information on the Company's officers and directors, their remuneration and employee benefits, and material transactions which they have had with the Company underwriters, and issuer's counsel should review the completed questionnaires and compare them with the disclosure in the registration statement.

E. Product brochures and other marketing material.

- Look for any red flags. Try to determine whether anything in these materials seem misleading or inaccurate.
- If applicable, compare more technical materials to sales-oriented documents. Engineers can often be more frank about a key product's shortcomings.
- Information about customers may not be in writing; interviews of marketing people may be necessary to be sure of the strength of the Company's customer base.

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*A Schedule 13D is a form that must be filed under the Securities Exchange Act of 1934. Generally, this form must be filed within 10 days after an acquisition that brings a stockholder above the 5 percent ownership threshold. It requires disclosure concerning the identity and background of the acquirer, the purpose and funding of the acquisition and the acquirer's plans, agreements, and understandings regarding the issuer.

**A Schedule 13G is a form that must be filed under the Securities Exchange Act of 1934. Generally, this form must be filed and updated annually by every beneficial owner of 5 percent of a registered class of voting securities. This form requires disclosure of the owner's identity and size of holdings.

APPENDIX 6D

Index of Data Room Documents

Source: Battle Fowler LLP, New York

NOTES:
Data Room Files have been color coded as follows:
Green: May be copied freely. Copies will be made by Data Room personnel.
Yellow: May be copied at discretion of Data Room personnel.

Color Code
A. ACCOUNTING DATA

Yellow A.1	Consolidated Balance Sheet 2005
Yellow A.2	Consolidating Balance Sheet 2005
Yellow A.3	Consolidated Balance Sheet 2006
Yellow A.4	Consolidating Balance Sheet 2006

Color Code
E. ENVIRONMENTAL
Overview

E.1 Binder: Overview Manual

Green	Facility Overview
Red	Facility Descriptions
Green	Emissions Data
Red	Accident & Injury Data

E.6 Binder

Green	Plant Description
Red	General Information
Yellow	Permits
Red	Audit Report

Color Code
F. FACILITIES
Plant Facilities

F. 14.3 Not Used
F.4 Binder

Green	Key Facts
Green	Photo
Green	Major Equipment
Green	Production Process
Green	Manufactured Products
Green	Operating Permits Listing

Color Code
H. HUMAN RESOURCES
Benefits Information

H.1–H.4 Not Used

Green H.5	Long-Term Disability Plan Document
Green H.6	Medical Reimbursement Plan Document
Green H.7	Dependent Reimbursement Plan Document
Green H.8	Retirement Income Plan Document
Green H.9	Personal Plan Document
Yellow H.10	Retirement Income Plan for Hourly Employees (in progress of being amended)
Green H.11	Dental Plan Benefit Summary—Comprehensive Medical Plan

Color Code
I. INTERNATIONAL INDEX
FRANCE

Debt/Credit Arrangements

Green 1.1	Debt/Credit Arrangement—Loan Documentation (Loans to Company)
Green 1.2	Debt/Credit Arrangement—Guaranties/Comfort Letters/Promissory Notes/ Pledges/Mortgages/Other Liens

Taxes

Green 1.3	Tax—Taxes Paid/2007

Employment

Green 1.4	Employment Head Count
Green 1.5	Employment Total Compensation—2006 (by division/function)
Green 1.6	Employment Payroll List (showing compensation for management personnel)

Color Code

L. LEGAL

L.1 Binder: Product Liability Litigation

Red	U.S. Product Liability Overview
Red	U.S. Product Liability History—Legal Fees
Red	U.S. Pending Litigation 2007 Legal Fees
Red	Litigation Expenses 2006 and 2007
Red	Case Summaries
Red	Claim Summaries
Red	Letter of Credit

L.2 Binder: Miscellaneous Litigation/Claims (See also related Trademark Binder)

Red	Bankruptcy Litigation
Green	Worker's Compensation Claims Experience 2002–2007

L.3 Binder: Selected Regulations Affecting Business Operations

Yellow	Fair Packaging and Labeling Act
Yellow	Federal Hazardous Substances Act

LEASES

Yellow L.6	Lease
L.7–L.12 Not Used	

Personalty

Yellow L.14	Personalty Lease Telephone Equipment
Yellow L.15	Personalty Lease Copiers

CONTRACTS

Green L.20	R&D Contract
L.21	Not Used
L.22	Not Used
L.23	R&D Contract

Data Processing (including licenses)
SOFTWARE LICENSES

L.24 Not Used
Green L.25 R&D Contract—List of Confidentiality Agreements
L.26–L.27 Not Used
Green L.28 Software License—Software—Accounts Payable System

ACQUISITIONS/MERGER DOCUMENTATION

L.618–L.633 Not Used
Yellow L.634 Acquisition of XYZ Company (Bound Volume)
Yellow L.635 Acquisition of ABC Company (Bound Volume)
Yellow L.636 Purchase of Certain Assets of New York Company (2002) (Bound Volume)
Yellow L.637 Purchase of Certain Assets of New Jersey Company (2002) (Bound Volume)
Yellow L.638 Certificates of Merger
Merger of UV, Inc. and X, Inc.

Corporate Records
Yellow L.639 Corporate Records—(2 Volumes, 1 Book of Stock Certificates & 1 Stock Transfer Ledger)
L.640–L.650 Not Used
Yellow L.651 Corporate Records (2 Volumes)
L.652 Not Used
Yellow L.653 Corporate Records (3 Volumes)
L.654 Not Used
Yellow L.655 Corporate Records (2 Volumes)

Color Code

P. PATENTS

Red P. I Listing of Patents

Color Code

R. RESEARCH AND DEVELOPMENT

R.1 Binder: Research and Development Overview
Green Overview
Green Building Facilities
Green Product Development Process
Green R&D Capabilities
Green R&D Organization

Color Code

T. TRADEMARKS

Red T.1 Binder
1. Printout (and update) of worldwide trademark registrations and applications of marks (by marks; by owner; updates)
2. Printout of trademarks

Red T.2 Binder: Printout of pending conflicts
(Selected trademarks pertaining to products with sales exceeding $5 million)
T.3–T.6 Not Used
Red T.7 Binder: Encumbrances on trademark: exclusive licenses, consents, and agreements

NOTES

1. The previous (1999) edition of this book warned against engaging auditors who do consulting work for the company. Today (2007 and beyond) this warning is moot for public companies, because under the 2002 law known as Sarbanes-Oxley, professional firms that perform financial audits may not do other consulting work for the company (except in the tax area). The warning does pertain to companies not covered by Sarbanes-Oxley. Such companies should make sure that the audit firms helping with financial due diligence are not also engaged in management consulting for the company.
2. Acquirers who are sued by plaintiffs supported by expert testimony should know about the Daubert test, which arose out of the United States Supreme Court case *Daubert v. Dow Chemical,* 509 U.S. 579 (1993). The Daubert test, which is also used in Federal Rule of Evidence (702), requires four things to be shown:
   1. Whether the theory has been or can be tested
   2. Whether the theory has been peer reviewed
   3. What the theory's rate of error is (the higher the rate, the less reliable the theory)
   4. Whether the theory is "generally accepted"

   Although subsequent judicial decisions have challenged the strictness of the Daubert test, it is good to keep in mind when basing a decision on "science."
3. For example, in 2005, nine directors of WorldCom had to pay a total of $20 million out of pocket to settle allegations that they had failed to exercise due diligence in the company's stock issuance. For a discussion of this case, see William K. Sjostrom, Jr., Northern Kentucky University, Salmon Chase College of Law, "The Due Diligence Defense Under Section 11 of the Securities Act of 1933," *Brandeis Law Journal,* vol. 44, p. 549, Fall 2006.
4. See note 2 for guidelines on "scientific" expertise.
5. *Director Liability: Myths, Realities, and Prevention—Report of the NACD Blue Ribbon Commission* (Washington, D.C.: NACD, 2006).
6. *Exchange Act Rules, Vol. 1* (*Rules 0-1 through 12h-5*) *General Rules and Regulations Under the Securities Exchange Act of 1934* (New York: Aspen Publishers), January 15, 2006, p. 63.
7. For a guide to director and officer liability and insurance, see *Report of the NACD Blue Ribbon Commission on Director Liability: Myths, Realities, and Prevention* (Washington, D.C.: National Association of Corporate Directors, 2005).
8. *Bar Chris Construction Corp.* 283 F. Supp. 643, (SDNY 1968). For more about this case, see the Table of Cases at the end of this book.
9. For an internal report on Enron, see William C. Powers, Jr., et al., *Report of Investigation by the Special Investigative Committee of the Board of Directors*

of Enron Corp. February 1, 2002, http://fl1.findlaw.com/news.findlaw.com/wp/docs/enron/specinv020102rpt1.pdf (internal report re Enron). For an external report on Enron, see the Permanent Subcommittee on Government Investigations, Governmental Affairs Committee of the U.S. Senate, Role of the Board of Directors in Enron's Collapse, July 8, 2002. (Note: External reports on Enron are numerous. For a comprehensive bibliography by Stephanie J. Burke, senior reference librarian at Boston University's Pappas Law Library see www.llrx.com/features/enron.htm#doj.) For an internal report about Enron, see Dennis R. Beresford et al., *Report of Investigation by the Special Investigation Committee of WorldCom Inc.* (March 31, 2003), http://fl1.findlaw.com/news.findlaw.com/hdocs/docs/worldcom/bdspcomm60903rpt.pdf. For an external report about WorldCom see Richard Breeden, Restoring Trust, August 26, 2003, www.nysd.uscourts.gov/rulings/02cv4963_082603.pdf (an external WorldCom report).

10. For example, the Enron report by the Special Investigations Committee identified 12 red flags that directors should have noticed. Also, law firm letters about the 2005 Delaware Chancery Court decision in the case of Michael Ovitz, upheld by the Delaware Supreme Court in June 2006, *In Re: The Walt Disney Company Derivative Litigation,* No. 411/2005, focused on red flags directors should have noticed concerning compensation. When reviewing compensation practices of an acquired company, these red flags are good to keep in mind. See Michael J. Connolly, "Delaware Supreme Court's Disney Decision—Guidelines for Directors," Thelen Reid & Priest, June 26, 2006.

11. See Tillinghast—Towers Perrin, Directors and Officers Liability 2005 Survey Executive Summary www.towersperrin.com/tp/getwebcachedoc?webc=TILL/USA/2006/200601/DO_2005_Exec_Sum.pdfgl.

12. As of 2006, there seems to be a backlash against excessive damage awards in product safety cases. As of July 2006, the Consumer Product Safety Commission (CPSC) has proposed revisions that would make it easier for manufacturers to defend themselves against allegations of product defects. The proposed revisions add the following factors for CPSC staff to use to evaluate the existence of a defect:

- Obviousness of the risk
- Adequacy of warnings and instructions to mitigate the risk
- Role of consumer misuse of the product
- Foreseeability of such misuse

Not surprisingly, the American Trial Lawyers opposes these. For more details, see www.atla.org/pressroom/PressReleases/2006/June26.aspx. Also, on July 6, 2006, in *Howard A. Engle, M.D., et al., vs. Liggett Group Inc., et al.,* the Florida supreme court upheld a lower court's decision to toss out a

$145 billion punitive-damages award against a tobacco manufacturer. See www.floridasupremecourt.org/decisions/2006/sc03-1856.pdf.

13. Unfunded pension liability, which first came under intensive scrutiny two decades ago, remains an object of increasing concern for acquirers and regulators alike. Severance agreements also rank high among potential litigation sources. Landmark cases in the field have held that severance plans are "employee welfare benefit plans" and that such plans are subject to the disclosure, reporting, and fiduciary requirements imposed by the Employee Retirement Income Security Act of 1974 (ERISA). Plans may also be treated as contracts that must be honored after a change of control. This is a complex legal area with dozens of relevant cases. For a recent overview, see Peter J. Marathas, Jr., Current Pension and Employee Benefits Law and Practice, a 19-page course booklet from American Law Institute https://d2s.ali-aba.org. For a comprehensive summary of cases through early 2000, see Paul E. Starkman, Primer on Successorships: Practical and Legal Implications, a client letter from Arstein & Lehr, March 10, 2000, www.bnabooks.com/ababna/rnr/2000/primer.pdf.

14. Class Action Fairness Act, 28 U.S.C. Section 1332 (d)2. *Product Liability Law and Strategy* (*Law Journal Newsletter*) July 2006. This law improved venue for cases by allowing national class actions to be heard in federal (rather than state) courts.

15. For a guide to director and officer liability and insurance, see *Report of the NACD Blue Ribbon Commission on Director Liability: Myths, Realities, and Prevention,* cited in note 3.

16. The American Tort Reform Association has compiled a list of judicial hellholes, as well as a list of "points of light" where there have been judicial reforms. See www.atra.org/issues/index.php?issue=7341.

17. The association's Web site is www.atla.org. Note also that an organization called Online Legal Marketing, www.lawyersandsettlements.com/hot_issue.html, accepts advertising from a variety of class action and personal injury lawyers. It lists hot topics that include the following as of early 2007:

Asbestos and Mesothelioma (lung cancer)
California Labor Laws (overtime pay and other labor law violations)
Cell Phone Termination Fees (early termination fees)
Credit Card Rate Hikes (abusive fees and rate hikes)
Employee Stock Options/ERISA (misrepresentations to employees)
Ink Jet Printer Cartridges (unfair business practices)
Overtime (unpaid overtime, especially in service industries)
Securities/Stock Fraud (financial losses)
Television Price Fixing (antitrust)

18. As stated elsewhere in this chapter, there are no laws that limit compensation to a particular amount. However, there are guidelines for deductibility of compensation. Also, courts can apply the duty of care and duty of loyalty under state corporation law to it. Directors must exercise care in setting it, and that they be free of conflicts of interest. In July and December 2006, the Securities and Exchange Commission passed new rules on executive and director compensation disclosure. Shareholders now have more ammunition for litigation over CEO compensation.

19. This question and answer are reprinted verbatim from a Web site operated by the American Institute of Certified Public Accountants: http://pfp.aicpa.org/Resources.

20. For the actual contract, see http://contracts.onecle.com/gillette/procter.mer.2005.01.27.shtml.

21. For more on this topic, see *The Art of M&A Structuring: Techniques for Mitigating Financial, Tax, and Legal Risk,* by Alexandra R. Lajoux and H. Peter Nesvold (New York: McGraw-Hill, 2004).

22. Source: Battle Fowler, LLP, New York. Reprinted with permission. For full credits, and for many other due diligence tools, see Alexandra Lajoux and Charles Elson, *The Art of M&A Due Diligence: Navigating Critical Steps and Uncovering Crucial Data* (New York: McGraw-Hill, 2000), p. 48.

23. Source: Battle Fowler, LLP, New York. For guidance on highly leverage transactions, see Chapter 4 of this book.

24. Source: Battle Fowler, LLP, New York.

CHAPTER 7

Negotiating the Acquisition Agreement and the Letter of Intent

INTRODUCTION

The legal centerpiece of any acquisition transaction is the acquisition agreement. It is difficult—if not impossible—to comprehend the negotiation of any acquisition without understanding the rationale underlying the typical provisions of the agreement that makes it possible. Although negotiations begin earlier with the crafting of the letter of intent or term sheet, it is the acquisition agreement that is most likely to make or break a deal.[1]

This is not to downplay the importance of the letter of intent. Although some lawyers dislike letters of intent and will insist on going directly to the final agreement, this is generally the exception and not the rule. Therefore, this chapter begins with a discussion of the purpose and uses of that vital document as it is employed in the acquisition context, and Appendix 7A contains a sample letter of intent. The majority of this chapter, however, is devoted to the acquisition agreement and the most basic negotiation issues it raises. Appendix 7B contains the principal provisions of a typical merger agreement, together with analytical comments discussing the basis for their inclusion, and highlights the alternatives available to the buyer and the seller. For a discussion of the process involved in securing debt financing, which is common in certain transactions such as management buyouts, we recommend *The Art of M&A: Techniques for Mitigating Financial, Tax, and Legal Risk.*

Numerous issues must be negotiated in connection with these complex agreements, including many that are purely legal issues. Primarily, the legal

points discussed in this chapter are those that lawyers bring to their clients as business issues, the type of issues that lawyers normally do not and should not be asked or expected to address. This chapter will not review every conceivable issue that might confront the parties in the negotiation of a transaction agreement; instead, it will serve as a guide to the major themes of negotiation. As always, there is no substitute for experienced legal counsel.

The form of agreement analyzed in this chapter is one that would be prepared by a buyer; it is comprehensive and contains many provisions that favor a buyer. Accordingly, many of these provisions may not appear in a document prepared by a seller. Indeed, unless the seller is represented by highly inexperienced counsel, there is no way the buyer should expect to get everything that's in this form into the final contract. But from a buyer's perspective, it is a good starting point. In addition, a document used for the acquisition of a public company is likely to be quite different from the form set forth in this chapter. Those differences will be noted, both in the general discussion and, where appropriate, in the context of the agreement itself. Before proceeding further, it is advisable to review the table of contents of the form agreement at the end of this chapter to become familiar with key provisions of a typical merger agreement.

LETTER OF INTENT

What is a letter of intent?

A *letter of intent* is a written instrument that defines the respective preliminary understandings of the parties about to engage in contractual negotiations. In most cases, such a letter is not intended to be binding except with respect to certain limited provisions. The terms of a typical letter of intent are set forth in Appendix 7A at the end of this chapter. Every transaction is different, so the scope of letters of intent varies. This said, however, Appendix 7A can serve as a checklist of items that usually appear in letters of intent.

What is the purpose of the letter of intent?

The letter of intent memorializes in writing the basic terms of the transaction, which up to that point have been the subject of oral negotiations between the parties. The letter typically will set forth the proposed structure of the transaction, the price and how it will be paid, the terms of notes or stock to be conveyed as part of the price, and other important, but general, features

of the transaction such as proposed timing, scope of the representations and warranties, and termination provisions.

The letter of intent also sets forth the conditions for consummating the transaction including, among others, the need for regulatory approvals, collateral agreements, legal opinions, and, most important, the completion of due diligence and the execution of mutually satisfactory definitive documentation.

Does the letter of intent create a binding legal obligation?

Not necessarily. Most letters of intent specifically state that the letter does not create a binding obligation to close the transaction. But simply declaring that the letter is nonbinding in a given area may not be enough to make it nonbinding. The legal test for the binding character of an agreement is the intent of the parties as determined from the circumstances. Some courts have held that a party to an otherwise nonbinding letter of intent has a duty of good faith to negotiate definitive agreements with the other side, even where no such duty is specified in the letter.

In addition, in cases where the parties have agreed on most substantive issues and do not anticipate many closing contingencies, they may consider entering into a fully binding letter of intent. Also, even with respect to nonbinding letters, the parties typically seek to create binding obligations with respect to the provisions governing such things as confidentiality, the bearing of expenses, and such things as "no shop" provisions (see discussion that follows).

If the letter of intent is not binding, is it really needed? Why not proceed directly to the contract itself?

Except in rare cases, use of a letter of intent is recommended. First, because the parties have agreed in principle on basic deal terms at this stage, they have an incentive to protect the time and expense they have invested in the transaction, and certain binding provisions of a letter of intent afford them the opportunity to do so. For example, experienced buyers do not want to serve as a stalking horse while the seller shops an offer around to other potential buyers. Thus, the buyer may wish to obtain a *no-shop* agreement from the seller, a provision requiring the seller to refrain from negotiating with other parties for a specified period of time in order to give the buyer a proper chance to negotiate a binding agreement.

Second, the parties will have to expend a considerable amount of time and money to complete due diligence and negotiate and draft a contract. Thus, the parties may enter into a letter of intent agreement before incurring the expense of negotiating definitive documentation to ensure that the parties agree on the basic terms and increase the likelihood that negotiations will be successful.

Third, although the document is not typically a binding agreement, the execution of the letter often has the effect of creating a moral commitment to use good-faith best efforts to consummate the transaction in accordance with the outlined terms. After investing the energy to negotiate a letter of intent, neither party wants to be the one to walk without a very good reason. A carefully drafted letter can often be used by a party in the negotiation of a definitive agreement to establish initial positions and to rebuff the opposing party's efforts to retake lost ground. The document discourages attempts to "retrade" long-settled terms, which can lead to ill will between the parties even before they come to the closing table.

There are some rare exceptions to this rule that should be noted, however. If negotiations will be difficult and time consuming, the parties may want to negotiate only once. Also, if the agreement can be struck quickly, why waste time negotiating a separate letter of intent? In some cases, a buyer may look upon the signing of a letter of intent as a ticket to start talking to employees of the target. Frequently, the seller does not want employees to be aware of the potential transaction until the parties sign a formal agreement. Finally, if either of the parties is a public company, the signing of a letter of intent may be considered material and require a public announcement—a scenario that might not be appealing to one or both parties until the deal is finalized.

When should the letter of intent be executed?

In most circumstances, the parties execute the letter after the acquirer has completed its basic financial due diligence but before it embarks on its major legal due diligence. This timing reduces the likelihood of incurring substantial expenses before the parties have reached an agreement in principle as to basic business terms.

Many times, the buyer and seller will have reached an agreement on the details of the transaction, and will set forth these details in a letter of intent while making the signing of a definitive agreement conditional on the occurrence of one or more external events, such as obtaining financing.

What can happen if buyer and seller have different expectations regarding the letter of intent?

The *Texaco v. Pennzoil* decision highlights the magnitude of problems that can result when buyer and seller have a different understanding of their respective obligations arising from the letter of intent. The primary question before the court in the *Pennzoil* case, which rendered a $10.2 billion judgment against Texaco for tortious interference, was whether Pennzoil's agreement with Getty Oil via Gordon Getty, a major shareholder in Getty Oil, was a binding contract.

How can negotiators avoid the "Pennzoil problem"?

When writing the letter of intent, the parties should define the terms under which it is and is not acceptable to withdraw from negotiations and, in the case of an unacceptable withdrawal, the amount of the liquidated damages, if any. The parties should also agree in advance on their freedom to undertake parallel negotiations, defining the contract as exclusive or nonexclusive. Inclusion of such clauses in the letter of intent may help to avert tort liability, as they support the conclusion that the parties did not intend the letter to be a binding agreement in respect of the terms of their transaction.

THE ACQUISITION AGREEMENT

Who usually drafts the agreement?

Customarily, the buyer controls the drafting of the agreement, and it is in the buyer's interest to safeguard this prerogative. It can be a grave mistake to assume that control of the drafting of the document is not significant. The drafter sets the initial framework of discussions and can regulate the pace of negotiations by controlling the pace of drafting. No matter how many agreements you've worked on, it is always difficult to be certain that an agreement prepared by the opposing party isn't missing some crucial provision or that it doesn't contain the seeds of subsequent legal destruction.

As a buyer, do not be surprised if the seller tries to wrestle control of the documents from you and put it on its own word processing system. The explanation can sound convincing: "We respect your normal prerogative as the

buyer to draft the document, but our business is so complex and we anticipate such substantial changes that it just seems to make more sense to put it on our machines."

Do not fall for this argument, however well-meaning the seller may be. It is important for the buyer to protect its customary right to control the drafting of the documents, and for the buyer's attorneys to be skillful about pressing the point and forestalling attempts to usurp control. It is the shortsighted buyer who tries to save legal fees by letting the other guys do the drafting. First, the savings in fees are illusory because substantial redrafting will be necessary to make the agreement work from the buyer's perspective if the sellers are allowed to do the drafting. Moreover, the change in the tone of the negotiation and the loss of control over its pace is likely to cost the buyer more in the long run. Every time new sections of the agreement are negotiated, the buyer is left to the less-than-tender mercies of the seller's attorney to draft the changes. Even well-intentioned lawyers may have a hard time shedding their adversarial instincts to include things that will protect the buyer's interests.

Notwithstanding the usual rule, when a company is sold in an auction process, it is customary for the seller to submit the first draft of the contract for comment by the buyer. The buyer submits a bid for the target together with its comments on the draft.

What is the purpose of the acquisition agreement?

A definitive agreement, of course, will set forth almost all of the legal understandings of the buyer and seller about the transaction. Ideally, it accomplishes four basic goals:

1. It sets forth the structure and terms of the transaction.
2. It discloses all the important legal, and many of the financial, details of the target's operations, as well as the comments of each party prior to closing.
3. It obligates both parties to do their best to complete the transaction and obligates the seller not to change the target in any significant way before the deal closes.
4. It governs what happens if, before or after the closing, the parties discover problems that should have been disclosed either in the agreement or before the closing but were not properly disclosed. It contains the conditions to each party's closing the transaction as well as the comments of each party prior to closing.

Unlike the typical letter of intent, an acquisition agreement is a completely binding agreement. Once it is signed, a party that fails to consummate the transaction without a legally acceptable excuse can be liable for damages.

The negotiation of the agreement is, in large part, an effort by the parties to allocate the risk of economic loss attributable to legal (and certain financial) defects in the target that surface before or after the closing. A question might arise, for example, if the parties discover legal problems after the contract is signed (such as a major lawsuit against the target, or identification of the main plant site of the target as a toxic waste dump): Should the buyer still be required to close the transaction and thus bear the risk of loss, or will the seller suffer the loss because the buyer is not required to close?

The same question can be asked if the bright financial prospects of the target are suddenly dimmed by a new ruling on import quotas affecting the target's entire industry. Similarly, if after the closing the buyer discovers a liability that existed at the time of the closing but that was not properly disclosed in the agreement, will the buyer suffer the loss, or will it be able to recover damages from the seller pursuant to indemnification provisions in the definitive agreement? The representations and warranties section of the agreement is extremely important on this point, as much postdeal litigation revolves around the representations and warranties made by the seller.

What are the buyer and seller really concerned about when negotiating the acquisition document?

Once the parties agree to the key substantive aspects of the transaction (price and terms), the seller wants to be as certain as possible of at least two things: (1) that the closing will occur as soon as possible after the agreement is signed; and (2) that no post-closing events will require a refund of any of the purchase price.

The buyer's concerns are the converse of the seller's. The buyer would like flexibility to abandon the transaction in the event that it discovers any legal, financial, or business defects in the target. After closing, the buyer would like to know that it will be compensated penny for penny for any economic loss resulting from legal or financial problems that were not disclosed to it beforehand. This is not to be confused with the business risk of operating the target after the closing: general economic downturns, new competition, and failures of management after the closing are business risks that any sensible buyer knows it assumes when it acquires a business. But the buyer will seek to protect itself against hidden flaws in the target's business; these

include pending litigation, undisclosed liabilities, and environmental problems—to name only a few—that existed at the time of the closing and that undermine the target's intrinsic value compared to the agreed-upon purchase price.

It is the extraordinary case where the buyer or the seller is entirely satisfied with respect to these basic points. Without fail, the buyer will try to increase its flexibility to withdraw from the transaction before the closing. However, with such flexibility, the contract is simply an option to acquire the target and not a contract that legally binds the buyer to acquire the target. If the buyer really wants to buy the target, it should be willing to be legally obligated, within reason, to do so.

On the other hand, the seller can never be certain that the transaction will close, simply because there are too many conditions beyond the control of both buyer and seller that must be satisfied before any transaction can close. (These conditions are discussed in greater detail next.) Moreover, although the seller invariably would like to sell the target on an "as is" basis, the vast majority of private companies are sold with at least modest post-closing protection. Thus, the reasonable seller will typically grudgingly give the buyer a modicum of protection in the event that the target is not what the seller represented it to be.

In this process of risk allocation, who should bear the risk of loss associated with undisclosed legal defects in the target discovered after the closing—the buyer, the seller, or both? Is there one correct answer?

At the outset, it is important to understand the basic themes for the negotiation. The smart seller will say:

> Look, before you sign anything, we'll show you everything we have. Talk to our management, our accountants, and our lawyers. Kick the tires to your heart's content. If you discover problems, we'll negotiate a mutually fair resolution in the agreement. Then tell us how much you'll pay on the assumption that any unknown problems are simply your risk of buying and owning the business. Once we close, the business and the risk are yours.

The canny buyer's answer will be along the following lines:

> Our contractual arrangements should be structured to provide both of us with strong incentives to unearth problems before the closing. You will have a strong

> incentive to uncover all the issues only if you share some or all of the risk of undisclosed problems. Anyway, if the target suffers a dollar loss attributable to undiscovered problems after our mutual diligent efforts, and if the buyer bears the entire risk of loss, we will effectively be paying an additional purchase price. In the end, we may be paying more than the target is worth. Our price is premised upon the target's not having any material undisclosed problems. We're willing to do our share of tire kicking, but at some point it's absurd for us to absorb a loss that surfaces notwithstanding our extensive due diligence, a loss that is so large as to make our price far exceed the value of what we acquired. Surely, you don't want to exact an unfair price under these circumstances.

The real issue is, what is a fair price for the target? The answer hinges on the assumptions of the parties when the transaction was negotiated. The buyer can either (1) determine a price based upon assuming the risk; that is, an "as is" deal, which presumably would be less than the price that would be paid if the seller retains some or all of the risks; or (2) determine a higher price premised on the seller's retention of some part of the risk.

The first alternative is more of a gamble, but it may be acceptable to a buyer comfortable with its familiarity with the target, or where the target doesn't engage in activities that could give rise to extraordinary liabilities (for example, violations of environmental laws or products liabilities).

The second alternative is much more common, however. In most sales of private companies, the seller bears a significant portion of the risk of target defects, and the deal is priced accordingly. The seller, however, does have legitimate concerns about being pestered incessantly about relatively insignificant items that prove not to be true about the target. Everyone knows going into an acquisition that no company is perfect and that in due course blemishes on its legal and financial record will undoubtedly surface. Accordingly, although seller accountability is the general rule, that accountability is usually limiting by specifying the time during which it can be held liable and by requiring the buyer to limit its claims to significant problems.

Does the customary practice make sense? Yes. First, an "as is" transaction may force the buyer to reduce the purchase price even though the likelihood of a claim is insubstantial. A seller's concern about post-closing hassles would typically not be serious enough to justify the trade-off in price that might result from forcing a buyer to price the deal on an "as is" basis. Second, a sharing of the risk between buyer and seller will provide both with a strong incentive to discover problems before the agreement is signed or the deal is closed. Thorough investigation by both parties who have a stake in the outcome reduces the likelihood that a claim will arise. Third, if the problem

were discovered before the closing, it probably would result in a price adjustment, even to an "as is" deal. Logically, the result should not be different because the problem arises after closing.

This does not mean that every seller should cave in on this issue. In certain circumstances, the seller may prefer taking a lower price to avoid the risk of post-closing adversities. Nor should one assume that the pricing will necessarily reflect the risk of an "as is" approach. In the case of a deal-hungry buyer, or a buyer that has confidence in its assessment of the risk of loss, the seller may get the best of both worlds—a high price with little or no post-closing risk. This is especially true in a competitive bidding situation. In the end, the allocation of risk will depend more on the bargaining power and negotiating skills of the parties than the niceties of pricing theories.

COMPONENTS OF THE AGREEMENT

What are the major parts of the agreement?

The major segments of a typical agreement are as follows:

1. Introductory material
2. The price and mechanics of the transfer
3. Representations and warranties of the buyer and seller
4. Covenants of the buyer and seller
5. Conditions to closing
6. Indemnification
7. Termination procedures and remedies
8. Legal miscellany

How are the general concerns of the buyer and seller reflected in the acquisition agreement?

The major concerns of the parties are focused on in two sections of the agreement: the Conditions section and the Indemnity section. The former lists the conditions that must be satisfied before the parties become obligated to close the transaction and thus controls whether the buyer or seller

can "walk" from the deal with impunity. The Indemnity section establishes the liability, if any, of each party to the other for problems relating to the target that are discovered after the closing. Both sections are generally keyed to two earlier parts of the agreement: the Representations and Warranties and the Covenants.

INTRODUCTORY MATERIAL

What is covered in the introductory material and pricing mechanics of a transfer?

It is often useful in a legal document to describe the intentions of each of the parties. If set out in the agreement, the parties' intentions may aid in interpreting the agreement in the event of a dispute. Therefore, it has become customary to introduce the agreement with a series of "recitals" that set forth the purpose of, and parties to, the agreement. The legal significance of the introductory material is usually not great, however.

The next sections of the agreement set forth the most significant substantive business points of the agreement, the price and the mechanics of transfer. This section identifies the structure of the transaction as a stock disposition, an asset disposition, or a merger and describes the mechanics to be utilized to transfer the property from seller to buyer. The parties may also provide in this section the requirement for a deposit by the buyer, or other security for the buyer's obligations to close.

In the case of an asset acquisition, this section identifies exactly which assets are to be conveyed to the buyer and, often more important, which liabilities of the seller will be assumed by the buyer. In the case of a merger, these sections contain the consideration per share to be received by the exchanging shareholders, as well as all of the other terms of the merger, including the identity of the surviving corporation, the articles of incorporation and bylaws governing the surviving corporation, the composition of its board of directors, and the names of its officers. For both asset purchases and mergers, this section will, of course, also identify the nature of the consideration to be received by the seller as well as the timing of its payment.

Frequently this section will contain provisions regarding intercompany liabilities, and how they must be satisfied by the surviving company or forgiven by the seller and capitalized as additional equity in the transaction.

For a detailed discussion of issues relating to pricing, see Chapter 3.

REPRESENTATIONS AND WARRANTIES

What is the purpose of the representations and warranties section of the agreement?

In this section of the agreement, the seller makes detailed statements about the legal and financial condition of the target, the property to be conveyed, and the ability of the seller to consummate the transaction. The representations and warranties reflect the situation as of the date of the signing of the agreement and, together with the exhibits or schedules (see the discussion of exhibits and schedules), are intended to disclose all material legal, and many material financial, aspects of the business to the buyer. The seller also gives assurances that the transaction itself will not have adverse effects upon the property to be conveyed. Some of the representations and warranties are not related to the legal condition of the target but serve to provide the buyer with information. For example, the seller might represent that it has attached a list of all the major contracts of the target. The buyer makes similar representations and warranties about its legal and financial ability to consummate the transaction and certain other limited representations and warranties.

The buyer should be aware that lenders providing acquisition financing will require the buyer to make extensive representations and warranties about the target as a condition to funding. To the extent that the acquisition agreement does not contain comparable representations from the seller, with appropriate recourse in the event of a breach, the buyer will take on the dual risk of a loan default and any direct loss as a result of the seller's breach. In some cases, it may be more difficult to obtain adequate financing if there are insufficient representations and warranties about the business. The buyer should make every effort to anticipate the representations and warranties that the lenders will require and attempt to include language in the acquisition agreement to obtain coverage for these areas.

What is the role of exhibits or disclosure schedules?

The exhibits are an integral part of the representations and warranties. Each exhibit is usually keyed to a specific representation or warranty and sets forth any exceptions to the statements made in the representation. For example, a representation might provide that there are no undisclosed liabilities of the target "except as set forth on Exhibit A," or state that there is no litigation that might

have an adverse effect on the target "except as set forth on Exhibit B." Another representation might state that "except as set forth on Schedule C," there are no contracts of a "material nature," or there are no contracts involving amounts in excess of a fixed sum, say $100,000. Schedule C would contain a list of all the contracts that meet the criteria in the representation, that is, contracts that either are material or involve dollar amounts above the threshold.

By design, then, the exhibits list all of the items the buyer needs to investigate in its due diligence effort in anticipation of pricing and financing the deal. The exhibits are a crucial part of that due diligence; because they require the seller to make statements about all of the pertinent aspects of the target, the schedules constitute a succinct legal and business synopsis of the target.

The use of exceptions to create exhibits might seem odd, but it is merely a practical drafting device. The alternative would be to incorporate each of the target's documents in the acquisition agreement, which would make the agreement unwieldy. The basic contract and the exhibits, because the former contains the terms of the parties' agreement and the latter provides vital information about the target, are a simpler and more practical method.

Time needed to prepare lengthy exhibits can often be used by the seller as an argument to reduce the scope of the representations and warranties. When the seller has prepared the agreement, it will have prepared its exhibits, usually skipping representations and warranties.

When the buyer submits proposed changes, including significant beefing up of the representations and warranties, the seller will say,

> Look, if we want to sign in this milieu, we can't possibly prepare exhibits based on these representations and warranties. We'll have to recirculate questionnaires to all the officers of each member of the target's corporate group (often scattered around the world) and review once again all the pertinent documents (and, of course, there are hundreds of documents) to make sure we don't violate these tighter representations and warranties.

Where there is a need to sign quickly, this tactic pressures the buyer's lawyers, whose client will ask, "Are we really asking for a lot of unnecessary garbage?" First, the lawyer should be aware of applicable time pressures in preparing the representations and warranties. Having done so, he or she must be ready to defend the relative importance of the various requests. One way to deal with the problem is to sign the contract but give the seller additional time to prepare the exhibits. The buyer would reserve the right to abandon the deal if the revised exhibits reveal any material problems. A word of caution—don't leave too much time or you'll be getting revised schedules the night before the closing.

Should exhibits be used if the target is, or will become, a public company?

In the event that the target is a public company, or the buyer has intentions to take the target public, the buyer would be well advised to use a disclosure statement as opposed to an exhibit or disclosure schedule in order to avoid the public disclosure of information about the target. The utility of a disclosure statement is that it is a separate document that otherwise sets forth all of the items that would be listed in exhibits or schedules to the acquisition agreement. However, since the disclosure statement is a document separate from the acquisition agreement, the target may not be required under the securities laws to file the disclosure statement with the SEC.

Just how important are the representations and warranties in an acquisition agreement?

Very important. A buyer or seller will be able to back out of the agreement if it discovers that the representations or warranties of the other party are untrue to any material extent. Thus, the fewer the items represented to, the less is the risk that the other party will be able to back out of the agreement. Also, the seller must indemnify the buyer for problems that surface after the closing only if the seller breached a representation or warranty in the agreement. Again, the fewer the representations and warranties and the narrower their scope, the less is the exposure to the seller. For these reasons, a great deal of the negotiation of the agreement centers around the scope of the representations and warranties.

How can a seller narrow the scope of its representations and warranties?

There are several ways in which the seller can attempt to reduce its exposure attributable to representations and warranties. First, the seller may steadfastly refuse to make any representation or warranty about specific items, for example, accounts receivable or the financial condition or liabilities of certain subsidiaries.

Second, the seller may refuse to make representations and warranties about matters not *material* to the transaction or the target, or may attempt to make representations and warranties only to the "best of its knowledge." To protect itself, the seller can seek to insert the word "material," or phrases with

the same effect, in every place in the representations that it can. For example, it can state that it is disclosing only "material liabilities," or "material litigation," or that it knows of no violations of law by the company that will have a "material adverse effect" on the company.

What does the term "material" mean when it appears in representations and warranties?

It is often said that materiality is in the eyes of the beholder. Although the courts have defined material information in specific cases, and accounting standards bodies have issued definitions,[2] the concept remains vague. Generally, the case law holds that *material* means important to a normal, prudent investor in determining whether to make a given investment. In many contracts the parties agree that a "*material*" *fact must be material to the business* of the target and any subsidiaries taken as a whole. The purpose of the emphasized language is to ensure that the importance of the fact relates to the entire enterprise acquired and not solely to the parent corporation or to a single subsidiary.

In order to reduce the opportunity for disagreement, the parties often set a dollar threshold that defines materiality in particular circumstances. For example, rather than asking for representations about material contracts, the buyer will substitute a request for disclosure about all contracts involving payments above a specified dollar amount. Similarly, the buyer may request disclosure of all liabilities greater than a certain sum. Use of numbers tends to fine-tune the disclosures and in many ways provides protection for the seller as well. If there is a dollar threshold of, say, $100,000 for liabilities, the seller can be assured that a $95,000 undisclosed liability will not be deemed material in a later dispute.

How and to what degree can the buyer resist the narrowing of the scope of the representations and warranties?

Generally speaking, it is in the buyer's interest to have the broadest possible representations and warranties. However, unreasonable requests for disclosure can threaten a deal. Pressuring the seller of a large, complex target to make comprehensive disclosures may cause the seller to fear that it will inadvertently fail to disclose minor matters, jeopardizing the transaction or leading to unfair liabilities after the closing.

Moreover, anyone buying a business must recognize that no business is more perfect than the human beings who conduct it. Therefore, there are bound to be a variety of problems in connection with the operation or ownership of the business, including litigation, liabilities, or violations of law, which the buyer must accept as part of the package of owning the business. As a result, in most transactions the buyer will permit the seller to limit the scope of the matters that are being represented to those things that are material, individually or in the aggregate, but—where appropriate—will negotiate over dollar threshold amounts to require more, rather than less, disclosure.

What different motivations might a seller have for narrowing representations and warranties?

For negotiation purposes it is important for the buyer to understand the seller's real concerns. The seller may be concerned simply about the time and expense necessary to uncover a lot of detailed information that in its view shouldn't matter to a buyer or that, under the time pressure of the deal, just can't be obtained. Or the seller may be far more concerned about making representations and warranties that will increase the risk that the buyer will be able to back out of the transaction. Alternatively, the seller's most significant concern may be with post-closing liabilities for breaches of representations, warranties, and covenants in the agreement.

How can a buyer address these different motivations?

Concern about time and expense is legitimate only to the extent that the buyer is asking for truly inconsequential or irrelevant representations or warranties. Remember that the seller's negotiator on these points is likely to be an in-house lawyer or technician more worried about being imprecise than about the broad scope of the deal. Where time is truly a crucial factor (as opposed to a negotiating point for the parties), the buyer's lawyer should exercise care and use good judgment to pare down the more burdensome, yet noncrucial, representations and warranties.

The buyer should, however, address the more legitimate concerns of the seller. The buyer can address the risks of the deal's failing to close or of post-closing liability while still including very broad representations and warranties with low dollar thresholds. The buyer can explain to the seller that it wants very broad, in-depth disclosure of items so that the buyer can determine

on its own what is material. Most buyers prefer to determine the materiality of information themselves rather than leaving it up to the lawyers or officers of the seller in the target, whose idea of materiality may differ from the buyer's, and who may not be aware of the buyer's specific concerns about certain legal or financial aspects of the target or the assets to be acquired.

The seller should be assured that extensive disclosures will not increase the risk of a terminated transaction or post-closing liability. The buyer may provide the requisite assurance by agreeing not to terminate the transaction, and that the seller need not indemnify the buyer, except in the event of material breaches of representations, warranties, or covenants. In summation, the buyer must look through the stated position of the seller, determine its real interests, and deal creatively with those concerns, rather than simply viewing negotiations as an argument over whether or not the word *material* is going to modify a particular representation or warranty.

What is the purpose of the phrases "best of knowledge" and "ordinary course of business" often found in representations and warranties?

These phrases are simply other ways in which the parties can agree to narrow the scope of the representations and warranties required of the seller. The phrase *ordinary course of business* is usually found in representations and warranties to exclude certain things from the representations. For example, the seller may not be required to disclose supply contracts entered into in the ordinary course of business, or may not be required to disclose liabilities accrued in the ordinary course of business. The definition of *ordinary course of business* will depend upon the normal practice of the specific business being acquired and the industry of which it is a part, including the normal character and size of routine transactions. It can be generally defined not to include business activities that the seller does not engage in on a regular and consistent basis. For greater clarification, the parties could enumerate in the acquisition agreement the seller's ordinary practices. An important point is that any transactions that are extraordinary in nature, price, or size will be included in such representations and warranties.

The phrase *best of knowledge* serves a similar function. A seller may ask that its representation as to litigation be limited to the litigation about which it has knowledge, so that it will not be required to represent and warrant absolutely that there is no material litigation. The seller often argues that the phrase should modify other representations and warranties.

At each juncture the buyer should ask, Is the "best of knowledge" modification appropriate? Usually it is not, but it is often agreed to in respect to the existence of threatened litigation and infringements by third parties of copyrights and patents. Beyond those few customary areas, the buyer should vigorously resist efforts to base the representations on the knowledge of the seller. Because such a representation and warranty tells the buyer only that the seller is unaware of any problems, it protects the buyer only if problems known to the seller are not disclosed. Thus, "best of knowledge" representations have the effect of allocating to the buyer all the risk of defects no one knows about.

From a philosophical perspective, the knowledge of the seller is not pertinent to the key question of the buyer: "Am I getting what I am paying for?" The fact that the seller didn't know that the buyer was overpaying is of little comfort to a buyer who discovers significant defects in its acquisition. Thus, the "knowledge" caveat should be used sparingly unless the buyer is willing to accept a substantial risk in connection with breaches of representations and warranties.

"Best of knowledge" qualifiers may be presented as a compromise to a seller who adamantly refuses to indemnify the buyer for breaches discovered after closing. At the very least, an indemnity should be forthcoming in respect to problems the seller knew about but didn't disclose.

There are other issues in connection with the phrase *best of knowledge.* First, whose knowledge are we talking about? Careful sellers will attempt to limit the knowledge to a narrow group of people, such as the executive officers of the target. Theoretically, the argument will go something like this: "We don't want to be held responsible if one of the loaders on the trucking platform happens to overhear something bad about the target or knows something bad about the target and we didn't seek his information about the transaction." Aside from the fact that any proposition reduced to that level can become absurd, there is some merit to the idea that a large organization ought to be careful about making representations about what the corporation knows. Consequently, a buyer accepting a "best of knowledge" representation will often permit the seller to limit the persons whose knowledge will be tested. The buyer ought to be certain that everyone who has material information about the target is included in the selected circle of officers. This will force the seller to quiz the officers whose knowledge will be pertinent for purposes of the agreement.

Another issue is whether the phrase *best of knowledge* implies any obligation of the seller to look into the matter; that is, does it assume that the knowledge is based upon a reasonable effort to ascertain the existence of any

problems? The general answer is that the seller's inquiry would be limited to information already in the seller's possession. A buyer wishing to impose a duty on the seller to make reasonable investigations into the matters represented to the buyer should augment the "best of knowledge" phrase with the words "after due inquiry."

What if the seller claims to have no knowledge, or ability to get knowledge, about an area that is the subject of a representation or warranty?

In this era of rapidly changing ownership of companies through restructurings and leveraged buyouts, the seller often has not had a chance to become acquainted with the details of the business it is selling. It is not unusual to hear the seller say, "I really don't know that much about this company, so I don't want to take much risk on these representations and warranties. I don't want to make representations about too many matters or in too much detail."

This may be reasonable from the perspective of the seller, but the buyer should not give the argument much weight. In every transaction, the seller will want to reduce its exposure to losses attributable to breaches of representations or warranties. That concern may be heightened by the insecurity of not knowing enough about the target, and possibly not having enough time to become acquainted with the details of the operations of the target. Nevertheless, the knowledge of the seller is not necessarily relevant to a logical allocation of the risks associated with breaches of representations and warranties. As noted above, if the loss due to a breach is absorbed by the buyer, the buyer pays an increased purchase price. The knowledge of the seller should not bear upon the buyer's resolution of the question whether an increased price makes sense.

An appropriate response to the seller might be the following:

> We certainly understand your concern, but we have even less of a basis for intimate knowledge of the target's operations. The real issue is, Who should absorb the risk in the event that there are undisclosed material defects in the business? We have different views, of course, of who should bear the risk, but let's really talk about what matters, not about what each of us knows about the company right now. The agreement between us ought to be structured to provide incentives for both of us to do the best job possible to unearth problems and to increase our knowledge of the company now, before we close, rather than wait for problems to surface afterward. Then, if something does surface later, either after we sign or after we close, we need to decide where the risk should reside.

This response addresses the real interest of the parties and will prevent digressions into who knows most about the company or who can know the most about the company.

Sometimes the seller is leery of making legally important statements without being absolutely certain of their truth. It is important for both sides to recognize that the representations and warranties are not a test of the integrity of the parties making them. A party cannot properly be accused of dishonesty if it makes a representation about which it is not certain (provided, of course, that it has no knowledge that the representation is in fact untrue). In order to reduce legal exposure, it makes sense to try to verify the accuracy of the representations and warranties as much as possible. There will always be, however, some degree of uncertainty. But if the parties recognize that the representations are not a test of integrity but a legal device for allocating risk, the process becomes more manageable and less subject to emotional decision making.

When might the knowledge of the parties about the target be relevant?

The traditional format under which the seller assumes the risks associated with breaches of representations and warranties might be attributable to the fact that the seller, rather than the buyer, is in the position to know the most about the target. The seller is the logical candidate for assessing and bearing the risk of loss arising from any breach of the representations and warranties.

There may be unique circumstances, however, where the seller will be in a position to argue persuasively that the buyer has much more knowledge about the target and should be more willing to accept the risk associated with the sale. For example, in an MBO, where management will own the lion's share of the target and has operated the target for several years, it is very possible that management could be persuaded to accept the risk of inaccuracy in the representations and warranties of the target because management is in the best position to assess that risk and make a business decision based upon it.[3] As has been discussed in relation to pricing, the shift of the risk to management is not necessarily fair or logical. If a latent problem causes a loss, the management buyers absorbing the loss are paying an additional purchase price. The fairness of that result has little to do with the state of management's knowledge.

Moreover, this line of reasoning will not apply in most MBOs because a promoter, investment bank, or the lenders, and not the management group, typically end up owning the majority of the equity. They, unlike management, have no basis for certainty with respect to the accuracy of the representations and warranties, and they should be much less willing to accept the risk that

management inadvertently neglected to properly assess the accuracy of the representations and warranties.

Are some representations and warranties more important than others?

Yes. The representations regarding financial statements, litigation, undisclosed liabilities, and taxes are usually the most important. If a buyer is pressed to get indemnities only for what it absolutely needs, it should, at a minimum, argue vociferously for solid representations and warranties on these points. Protection for breaches of the representations on financials should be the last point the buyer concedes; the buyer should make this concession only if it is fully apprised of, and is committed to taking, the associated risk. In general, the audited financial statements represent the best picture of the target as a whole, and any undisclosed material problems will cause that representation to be breached.

COVENANTS

What is the major purpose of the covenants?

The Covenants section of the agreement defines the obligations of the parties with respect to their conduct during the period between the signing and the closing. For negotiation purposes, the most significant covenant relates to the obligation of the seller to conduct the business in the ordinary course, with such exceptions as are agreed upon by the parties between the time of signing and closing. In the representations and warranties, the seller assures the buyer of the legal characteristics of the target as of the date of the signing of the agreement; in the Covenants section, the seller in essence agrees not to do anything to change that picture in any material way, except as necessary in the normal operations of the business.

Typically, changes other than those that are specifically permitted under the agreement can be made only with the consent of the buyer. However, it is often necessary to limit the restrictions by requiring the buyer not to "withhold consent unreasonably." This limitation should be used sparingly so as to ensure that it achieves its limited purpose; that is, in narrow circumstances the seller may be required to take certain actions in order to preserve the business, and the buyer should not be allowed to prevent them unless such actions have a material impact on the transaction.

Many attorneys feel that this limitation is never appropriate because, provided that the conditions to closing are fulfilled, the buyer is obligated to purchase the target. The buyer should therefore have control over any extraordinary actions pending closing. That position, however, must be tempered with the following consideration: if there is a specific area of business conduct about which the seller has a great deal of concern, liberalizing the restriction may be the only way to close the gap between the parties. If the phrase *reasonable consent* is troublesome, it is often possible to craft language that more carefully defines the circumstances under which the seller should be permitted to do things not otherwise permitted by the agreement.

CONDITIONS TO CLOSING

What role do the conditions to closing play in the acquisition agreement?

The form agreement appearing as Appendix 7B at the end of this chapter contains the typical conditions that must be satisfied before the buyer or the seller is obligated to close.

The agreement typically sets forth separate closing conditions for each of the parties. If a condition to the buyer's obligation to close is not satisfied, the buyer will have the right to terminate the agreement without being liable for damages to the seller. Similarly, if one of the seller's conditions is not satisfied, the seller will not be obligated to close. Under appropriate circumstances, a condition might be established that applies to both parties. One mutual condition might be the receipt of certain key governmental consents; another is the absence of litigation or any administrative ruling that precludes the closing. Either party may waive a condition and proceed to close the acquisition notwithstanding the failure of the other party to satisfy each condition.

How do the conditions to closing affect the key concerns of the buyer and seller?

The Conditions to Closing are the first part of the agreement that addresses one of the two major concerns of the parties. The Conditions section sets forth the ability of each party to terminate the contract with legal impunity. For example, if any condition is not met by the target or the seller, the buyer will be free to terminate the contract.

The most significant condition is the so-called *bring-down condition,* which makes the buyer's obligation to close contingent upon two factors: The buyer will not be required to close if (1) the seller has breached any of its covenants or (2) any of the representations and warranties of seller and target were not true when made or are not true on the closing date, or as if made on the closing date. This condition provides an escape for the buyer if the representations and warranties were true on the date of signing but are no longer true as of the closing date, either because of events that occurred after the signing or because breaches were discovered after the signing.

In a typical representation, the seller warrants that the target's financial statements, which always predate the signing, represent a true and accurate picture of the target. In a different representation, the seller must state that there has been no material adverse change in the financial condition, operations, or prospects of the target between the date of the financial statements and the date of signing. The bring-down condition requires, as a condition to closing, that the seller extend its representation that there has been no material adverse change through the date of the closing.[4]

The effect of the bring-down condition is to assure the buyer that, on the closing date, the target will be the same target, from a legal and financial perspective, that the buyer bargained for in the contract. Because the buyer is not required to close the transaction if any bring-down condition is not satisfied, the condition allocates to the seller the risk of loss attributable to any adverse change during the period between signing and closing. Interim losses probably reduce the value of the target, and the bring-down condition allows the buyer to renegotiate a lower price reflecting the changes.

The form agreement requires a corporate officer to certify that the representations and warranties are accurate in all material respects as of the closing date, providing this certificate is a condition of closing, but it has another very important effect: it is a restatement of all the representations and warranties as of the closing date.

If the certificate is not accurate, the inaccuracy will constitute a breach of a representation or warranty and may give rise to liability from buyer to seller under the Indemnity section of the agreement. In the absence of an officer's certificate, a buyer might be unprotected against certain adverse events occurring between signing and closing. For example, if a material liability arises and is discovered before closing, a closing condition will be unsatisfied, and the buyer can walk from the deal. But if it is not discovered, the parties may close because to their knowledge each closing condition—including the condition that the representation and warranty

about undisclosed liabilities is true—was satisfied. Clearly, the buyer needs more than a condition to closing to fully insulate it from undiscovered problems. Requiring the seller to represent that the closing condition is satisfied allows the buyer to treat the seller's failure to satisfy the condition as a breach of the representations. If the buyer is indemnified for losses attributable to such breaches, the buyer, by virtue of the certificate, will be protected against losses resulting from undiscovered problems.

What is a financing condition and when is it appropriate?

The *financing out condition* provides that the buyer need not close if it is unable to finance the transaction. It is a very broad exception to the buyer's obligation to close the deal, and the seller must be wary of allowing such a condition. The seller may have kept the target off the market for a long period of time and incurred substantial expenses only to find out that the buyer failed to obtain the necessary financing. For these reasons a seller should resist the use of a financing condition or narrow the risk if there must be one.

The seller's initial position should be that, if the buyer is confident of the financing, it should be willing to take the risk that the financing will not be available; that is, there should be no financing out. Next, the seller can attempt to require the buyer to have its financing commitments in place before the contract is signed. This strategy limits the seller's risk to those cases where the lenders refuse to consummate the transaction. In addition, the parties will know in advance that the basic transaction is acceptable to the lenders who propose to finance the transaction. Another alternative is to require the buyer to provide financing commitments (or executed loan agreements) within a specified number of days after the contract is signed. After that period, the financing condition falls away. This approach may be preferable to a buyer that doesn't want to incur what can be very costly commitment fees to lenders before it has a contract signed. In addition, the seller should attempt to require the buyer to pay the seller's expenses if the transaction is abandoned because the commitments could not be obtained.

At the very least, the seller should know what the proposed financing structure will be. For example, how much equity will be invested? How much mezzanine and senior debt will be necessary? What are the buyer's assumptions about the lender's interest rates and equity demands? With this information, the seller's financial advisers can assist in evaluating the feasibility of the proposed financing. It should go without saying that the buyer should be required in a covenant to use its best efforts to obtain the necessary financing.

Many contracts do not contain a financing out because the buyer is a shell company with no assets. Even if the buyer breaches the contract, a lawsuit by the seller will not yield significant damages. For this reason, a seller should investigate the buyer's financial strength and inquire who will stand behind the buyer's contract obligations.

All this being said, the buyer has a strong interest in obtaining a financing out. Often, financing can fall through for reasons beyond the control of the buyer, and it needs protection in such a case. Moreover, in periods of volatile interest rates, a transaction that is financeable when the contract is signed may not be when the time for closing arrives because new rates may place too high a financial burden on the target. The buyer, forced to put more equity in the transaction, may not have the required funds or may no longer find the deal attractive. When all else fails, the buyer should try to obtain a dollar limit on its exposure, in the form of a liquidated damages clause, in the event it refuses to close a deal in which there is no financing out.

This controversial provision generally should be addressed by the seller as early as possible, usually in the letter of intent. The buyer, on the other hand, is better off letting this issue ride until the seller becomes emotionally committed to the deal by signing the letter of intent. Once the letter of intent is signed, the seller also may be bureaucratically (if not legally) committed to selling and may be more amenable to compromise on the point. The parties must approach this problem by crafting a solution that is carefully tailored to the specific concerns of the parties. Compromise can often be reached by adjusting (1) the time within which financing commitments must be provided and (2) the consequences of the buyer's failure to finance the transaction.

What is a material adverse change?

One of the typical conditions to closing for the buyer is that there has been no *material adverse change* in the financial condition of the seller. Who bears the risk if there is a general business downturn or a specific problem in the industry of the seller that causes a deterioration in its financial condition—and what if the adverse change will clearly occur, but only after the closing?

The buyer's right to abandon the deal usually does not depend upon the reason for the deterioration in the target's financial condition. Some sellers try to shift to the buyer the risk of general or industry-specific economic reversals, but buyers are usually successful in resisting the attempt. The seller's argument is not fatuous, however. The buyer clearly gets the benefit of unanticipated improvements in the financial condition due to such factors because the seller still must close; why not the downside as well as the upside?

This issue stems from the signing of a contract binding the parties to close the transaction before they are ready to close. The seller benefits because the buyer is legally obligated to close unless material seller's problems surface. The buyer, on the other hand, has the deal locked up; yet if significant problems arise, the buyer can terminate or renegotiate the acquisition. But from the seller's perspective, it has given up the upside (which should be reflected in the purchase price) but still retains the economic downside until the deal closes. Thus, if the parties' expectations prove untrue—for example, because oil is discovered on the property—the buyer gets the benefit. But if a new material lawsuit arises, the buyer can walk. In other words, once the contract is signed, the buyer is the owner, but only if things continue to look good.

It is for this reason that many sellers lately have attempted to shift the date of the transfer of risk from the seller to the buyer to the date the contract is signed. Their theory is that the buyer has to accept a balanced economic deal—it gets both the good and the bad occurring after the signing. So long as (1) the representations and warranties as of the signing date are accurate on the closing date and (2) the seller doesn't breach its covenants concerning the conduct of the business pending closing, the buyer is getting what it bargained for.

The argument has logical appeal, particularly if there will be a great deal of time between the signing and closing, say, on account of the need for regulatory approvals. If the seller is going to push this point, it must also be willing to give up any earnings during the interim period.

Logic notwithstanding, the seller has an uphill battle. This is one of those situations where one custom is worth a thousand arguments. A buyer can be expected to resist strenuously: "Deals just aren't done this way," "Hey, you still control the operation of the business," or "My price doesn't take into account this type of risk." Because tradition is on the buyer's side, the seller can expect to have to give up something significant to win this point. Where the time span between signing and closing is customarily 30 to 60 days, it may not be worth the fight.

The seller's argument may prove too much. The buyer rarely is expected to assume the risk of other post-signing adverse changes, such as new lawsuits, major undisclosed liabilities, or major uninsured casualty losses. There is no logical basis for distinguishing financial deterioration resulting from a general recession from other types of risks. In any event, the buyer must resist this attempt by the seller, because the buyer may not be able to close its financing in the face of negative events. It does not seem fair to tag

the buyer with damages for failing to close in this situation, particularly if the seller knows it is selling in a highly leveraged transaction and if the buyer has obtained financing commitments in advance.

In order to govern events that occur before closing that will harm the financial condition of the company afterward, the conditions to closing should require that there be no material adverse change in the "prospects" of the target. In the absence of such a provision, the buyer would be obligated to close under these circumstances. The seller often argues that the word *prospects* is too vague. The proper response is to be more specific, but not to eliminate the concept and shift the risk to the buyer. Of course, there is no one correct answer as to who should bear the risk of loss associated with clear changes in the prospects of the target, and the buyer may be willing to undertake the risk of adverse events.

What happens if the buyer is aware of a material breach in a representation or warranty and nevertheless proceeds to close?

The buyer would be stopped from asserting a claim for damages based on the material breach because it had notice. In that circumstance, the buyer has most likely negotiated the price accordingly or does not consider the breach of the representation or warranty as substantially altering the basic terms or desirability of the transaction.

INDEMNITY SECTION

Why is there an indemnity section?

The purpose of the indemnification section is to set forth the circumstances under which either party can claim damages or take other remedial action in the event the other party to the agreement has breached a representation or warranty or failed to abide by its covenants. This section usually includes provisions concerning the procedural aspects of indemnity claims and the rights of the parties to take part in any legal proceedings that could give rise to an indemnity claim. In effect, the Indemnity section supplements the parties' general legal rights because the section typically provides specificity regarding the kinds of recovery to which the parties may be entitled.

Why is there a need for an indemnity section? Can't the parties simply rely on their general legal rights?

The parties would have the right to collect damages or take other legal action in the event of a breach of a representation or warranty or a specific legal covenant. However, those rights are often vague and do not always include the kinds of recovery to which the parties may feel entitled. For example, it is typical for the indemnity provision to provide specifically that all losses, including reasonable attorney fees and out-of-pocket expenses, will be recovered by the indemnified party. This is often not the result under general case law. In addition, the indemnification provisions contain specific rules governing the involvement of the indemnifying party in proceedings that could give rise to indemnification claims, as well as specific provisions governing the length of time that the representations and warranties will survive the closing.

The Indemnity section also governs items that do not constitute a breach of a representation or warranty because they were specifically disclosed to the buyer at the time of the signing or closing but in respect of which the buyer nevertheless wishes protection. For example, the seller might, in the course of its due diligence, discover that there is a significant potential environmental claim under the federal Superfund laws, or that there is a continuing stream of uninsurable litigation claims attributable to a specific product manufactured by the target. Because the seller disclosed this fact to the buyer, there is no breach of a representation or warranty in connection with these items. However, the indemnification provisions may allocate to the seller the risks associated with disclosed items.

For what period of time is the buyer protected under the indemnity?

This issue is generally expressed in a different way: How long do the representations and warranties survive after the closing? Without a specific provision to the contrary, it is not clear that the representations and warranties survive at all. Consequently, the duration of the indemnity term is often the subject of substantial negotiation. Theoretically, the statute of limitations applicable to actions for breach of contract could govern the claims under the contract, but in most cases the sellers feel that the statutory period is too long.

The buyer should request at least a two-year indemnity period. As a fallback position if the seller resists (and it will), the buyer can suggest that the

indemnity continue until the buyer receives audited financial statements of the target for a full fiscal year of operations after the acquisition. Because of the time necessary to prepare the target's financials for its first full fiscal year, the buyer may obtain an indemnity period as long as 15 months after the acquisition closes.

One further point: It is important to provide that each party will be indemnified for all breaches discovered during the indemnity period, not merely for losses actually realized during that period. For example, a lawsuit brought by a third party during the period might not be finally resolved by the end of the period. The indemnified party should nevertheless be entitled to recover so long as the claim arose during the survival period.

Should the time limitation for recovering under the agreement apply to all claims under the contract?

The time limitation should not apply to breaches of covenants that involve a willful act, or to willful breaches of representations or warranties. The seller shouldn't be offered reduced exposure for purposeful breaches. Representations and warranties about taxes customarily survive for the full period of limitation under applicable federal, state, or local law.

What is a basket, and how does it work?

A *basket* is the dollar amount set forth in the indemnification provision as the loss that must be suffered by the buyer before it can recover damages under the indemnity provisions. In a transaction involving a purchase price of $100 million it would not be uncommon for the basket amount to be $1 million or even higher. The buyer is often successful in arguing that the seller should indemnify losses resulting from breaches of covenants or willful breaches of representations and warranties without regard to the basket amount.

The basket closes the gap between the buyer and seller and permits reasonable negotiation of the post-closing liability issue. The typical argument that the seller will make is, "You're buying my business, warts and all." The standard buyer's response to this is, "We understand that we are accepting the risks of operating the business on a going forward basis, but we fully expect to get what we paid for without any significant deviation from the target described in the representations and warranties."

Both parties must assume that there will be problems with the business and realize that dollar-for-dollar compensation for imperfections is not realistic. The purchase price should take into account material deviations from the expectations of the parties about the target. However, significant damages flowing from the breach of the representations or warranties may cause the buyer to overpay for the target. The happenstance that the problem arises after the signing or the closing rather than before should not put the buyer in a substantially worse position than if both parties knew of the problem in advance of the closing.

The dollar amount of the basket and the exact mechanics of its operation are often the subject of a great deal of negotiation between the buyer and the seller. It is unwise for the parties, particularly the buyer, to commit to an exact amount early in the negotiation process, since basket flexibility can become a negotiating tool. Seemingly intractable issues can often be resolved by adjusting one feature or another of the basket, including the dollar amount, even when the problematic issue is unrelated to the basket. For example, differences over the representations and warranties can be resolved if the parties negotiate the minimum amount of the claims, the basket amount, how claims are aggregated, or the length of the survival period.

What are the kinds of issues that most frequently arise in connection with a basket?

The first question is the size of the basket. Basket amounts in the range of 1 to 2 percent of the purchase price are most common, but much larger baskets (in the 4 to 5 percent range) are not unheard of.

The next question about the basket is whether the buyer or the seller should absorb the amount of the basket once the threshold is crossed. For example, if the basket is $1 million and the buyer suffers $1.5 million in damages, is the seller liable for the $500,000 over the basket amount, the full $1.5 million, or the $500,000 excess plus part of the $1 million? Most often the buyer absorbs the entire amount of the basket (so that in the example, the seller would be liable for only $500,000).

There is a cogent argument that buyer and seller ought to split the losses up to the basket amount. The basket is an incentive for the buyer to be thorough in its due diligence, since the basket provision requires the buyer to absorb a significant part of any losses due to breaches of representations and warranties. Splitting liability for the basket amount has the same due diligence incentive for the seller, because if the basket threshold is passed, the seller will be required to pay some part of the initial basket amount. If the

basket amount is not split, the buyer may have a legitimate concern that the seller will not be diligent in unearthing problems because it is protected by the basket, especially if the basket amount is large.

Another issue relates to minimum claims. Because the seller does not want to be bothered with small claims—however many of them there might be—the seller often asks for the following additional protection: no claim can be brought if the claim is for less than a specified amount (the "minimum amount"). The seller may insist that such claims not even count toward meeting the basket amount. Of course, the buyer should be expected to resist this approach, particularly if the minimum amount is significant in light of the size of the target's business. In addition, the buyer will likely request that these smaller claims be subject to the indemnity if in the aggregate they are a significant amount.

What is the relationship between the basket amount, the minimum amount, and the word "material" when used in connection with representations and warranties?

As discussed above, in order to limit the exposure of the seller to frivolous claims or claims that are normal to the business being acquired, many of the representations and warranties require disclosure only of material items, or items that are material to the business of the target and its subsidiaries taken as a whole. In the absence of a specific dollar threshold to define what is material, it is unclear exactly how much damage the buyer must incur before it can claim that there has been a breach of a representation containing a materiality limitation. These materiality limitations can create an unfair result for the buyer if there are several legal problems for the target that cause a significant aggregate loss for the buyer but there is no single breach that has a material adverse effect on the business.

The precise effect of the basket amount on all of this is uncertain. It might be argued that the basket amount is a numerical definition of the word "material." Thus, if the basket amount is $1 million, a loss of less than $1 million arising from a breach of a single warranty might not be viewed by a court interpreting the agreement as material to the business as a whole. But what if there are claims in five areas covered by representations and warranties, averaging $750,000 each? If the agreement is construed to mean that only a loss of more than $1 million is material, the buyer will suffer $3.75 million of damage and will have no recourse against the seller. The result may not be sensible, but in the absence of any other guidance it is, unfortunately, plausible. If

the parties do not wish the basket amount to be used as a definition of material, they should state so in the agreement.

Can use of a basket and a minimum amount provision eliminate the need for including materiality limitations in the representations and warranties?

It is possible to resolve the ambiguity of using "material" by using the concepts of the basket amount and minimum amount in the following manner: A representation or warranty would not be breached unless the resulting loss exceeded the minimum claim amount (say $50,000), and there would be no recovery by the buyer until all of the potential claims add up to the basket amount. This way, the seller is assured that relatively minor imperfections in the business will not result either singly or in the aggregate in exposure for indemnity claims, and both parties will have a much better idea of the expectations surrounding the indemnity provisions.

The seller must exercise care here. The materiality limitations in the representations and warranties serve another function: They limit the ability of the buyer to terminate the transaction without penalty between the time of signing and closing. If the materiality limitations are eliminated altogether, the buyer could point to a minor legal defect in the business causing a loss equal to the minimum amount and say that the representations and warranties were not "true as of the closing date." This problem can be remedied either (1) by leaving the materiality limitations in the agreement solely for this purpose, as is often the case, or (2) by leaving them out and requiring that potential losses equal the basket amount or some other agreed-upon figure before the buyer would be permitted to terminate the transaction.

The latter solution can be very risky for the buyer. The basket amount is frequently the subject of negotiation and manipulation having little or nothing to do with the concept of materiality as incorporated into individual representations or warranties. The buyer may assess the risk of an unknown or undisclosed problem arising after the closing as small because it knows the target or the industry extremely well, or because it has tremendous faith in the management co-participants in the acquisition. The buyer may also feel that it is getting a bargain. In this situation, and because of the speculative nature of the losses, the buyer may be willing to agree to a very large basket amount.

On the other hand, the buyer might well feel that if problems actually arise before the closing, it should be free to reevaluate the wisdom of its

decision to buy the target long before its losses reach the basket amount. To meet this concern, either a different threshold amount should be established for the Conditions to Closing section or, as is most often the case, the materiality caveats should remain in place in the representations and warranties for purposes of the Conditions to Closing section.

Is the indemnity sufficient protection for the parties, or are escrows or setoff rights necessary?

The indemnity alone is meaningless unless the indemnifying party is creditworthy. The parties should take care to satisfy themselves about the financial strength of indemnifying parties. This is achieved, in part, by the representations and warranties made by the buyer and its owners about its and their respective financial condition. Where there are doubts about the ability of the seller to meet its obligations, or where the target has many stockholders, it may be advisable to place a portion of the purchase price in escrow to serve as security for the seller's obligations under the indemnity. Under a typical escrow, which often (but not always) lasts as long as the survival period, the buyer has access to the escrowed funds after it is finally determined that the seller is liable under the indemnity portion of the contract.

Another device that is useful when the seller has a right to receive deferred payments is to give the buyer a right to set off any damages it suffers for breach of the contract against payments due the seller. Agreements may permit a setoff either after a final determination of liability or when a loss is suffered despite the fact that the buyer has not yet established the seller's liability. The latter arrangement reverses the normal posture of the parties negotiating a claim for indemnification—normally the indemnifying party has control of the money and the party who has suffered damages must sue to get it. For this reason, an immediate setoff right is fiercely, and usually successfully, fought off by the seller.

In the absence of a specific setoff provision, in most jurisdictions it does not appear that a buyer has the legal right to withhold payments from the seller until there is a final determination of liability under the indemnity. If note payments to the seller are withheld before such a determination, it is probable that a court would grant a summary judgment to the seller and force the buyer to pay principal and interest on the note in accordance with the terms, even if the buyer has a separate claim under the contract.

Are there any special concerns of the seller in connection with the indemnity?

Most of the issues for the seller are covered in the preceding text since the basket amounts, survival period, and minimum amount are all issues of great concern to both parties. Obviously, the seller will try to avoid all indemnity completely.

In the case of a privately held target, the major thrust of the seller's argument is often to reinforce the basic argument outlined above about who assumes the risk of owning a business with the additional argument that if the target were a public company the representations and warranties would not survive the closing. This argument is more persuasive if there are public securities issued by the target so that it has been regularly filing public reports with the SEC and has a relatively long history of audited financial statements. One major reason for the different treatment of public companies is the impracticality of bringing suits against hundreds or even thousands of stockholders. This burden is not usually present in the sale of a closely held private company. Nevertheless, the apparent willingness of buyers in the public arena to live without indemnities, together with the sale of companies through auction procedures (discussed later), has allowed sellers to avoid indemnities in an increasing number of situations.

When there are several selling stockholders, the sellers ought to (1) try to limit each stockholder's liability to "several" liability, meaning that one stockholder is not liable if another is unable to satisfy its liabilities under the indemnity, and (2) be certain that breaches of representations and warranties that are specific to a stockholder, such as a stockholder's failure to have or convey good title to its shares being sold, will not create liability for other stockholders.

The sellers also should argue that there should be a limit on liability. Most buyers will agree to limit liability to the purchase price paid, and some sellers have been successful in arguing for a lower cap on liability, although a lower cap doesn't make much sense.

Finally, the sellers ought to pay close attention to the terms of notes they accept as part of the payment. In order to placate senior lenders, seller notes are often deeply subordinated (see the discussion in Chapter 4) and contain provisions that limit the ability of the seller to sue if there is a payment default. A buyer should not be permitted to take advantage of this provision to hold back payments (that is, create a payment default) when there is a potential claim under the indemnity. The subordination provisions are for the benefit of the senior lenders and are not designed to allow the buyer to use the

seller's funds to finance indemnity claims; the limitation on the seller's remedies under the note ought not to apply to a constructive setoff by the buyer because of potential indemnity liabilities.

Are there any special items that a buyer is indemnified for even if they are disclosed, such as litigation?

Yes. In the course of due diligence, the buyer will often uncover items for which it will either seek a price adjustment or request specific indemnification. Typical examples are unusual litigation that is not insured or reserved for on the balance sheet, and major environmental problems.

What about litigation arising after the closing based on business conducted before the acquisition?

In an asset transaction, the buyer usually does not assume the risk of such litigation and will obtain a specific indemnity against any losses from the seller.

In the case of a merger or stock acquisition, many contracts contain indemnities specifically protecting the buyer against this type of loss. Even in the absence of specific protection, it is at least arguable that such litigation is an unmatured and contingent undisclosed liability that constitutes a breach of the warranty, or an undisclosed liability to which the general indemnity applies.

Before engaging in lengthy negotiation about this issue, the parties should focus on insurance coverage for this type of loss. In this area, the availability of insurance coverage may render the parties' exposure immaterial. In most cases, insurance is on a "claims made" basis; that is, the insured is protected against losses from claims made during the insurance period. If so, the target's insurance policy will provide protection in the ordinary course, and it would be unfair to expect the seller to cover such losses. It is critical to avoid an insurance coverage gap during which neither the old policy (because it is a claims made policy) nor the target's new policy (because it only insures claims based on events occurring during the insurance period) will make good on a legitimate claim. A gap is more likely to arise when the target is part of a conglomerate and coinsured under a single umbrella policy covering all members of the seller's corporate group. In this situation, the target must take out separate policies effective as of the closing date.

What is the purpose of the termination section of the agreement?

The Termination section of the agreement sets forth the circumstances under which either party may terminate the transactions and the consequences of such termination. This section normally includes a date by which the closing must occur. If the closing fails to occur by that date as a result of the action or inaction of one party, the party that was capable of closing typically can elect to terminate the contract and sue the other party for breach of contract.

The section also allows a party to terminate if it discovers a material breach by the other of a representation, warranty, or covenant that would cause the bring-down condition to be unsatisfied. A party should not have to wait until the termination date to terminate if it is clear that it won't be obligated to close in any event.

This section will also set forth any limitation on damages that can be collected by the successful litigant for breach of the contract and any special remedies, such as specific performance, that a nonbreaching party may avail itself of. The requirements for security for the buyer's obligations as well as the condition under which the seller can resort to the security are set forth often in this section.

What are the advantages and disadvantages of arbitration provisions in the agreement?

The oft-stated benefits of arbitration—such as quick and inexpensive resolution of disputes—may make arbitration a satisfactory mechanism by which parties to an acquisition agreement can enforce their rights. As discussed earlier in Chapter 6, alternative dispute resolution (ADR) is gaining acceptance by both courts and companies. It should be noted, however, that the benefits of arbitration can be offset by its risks.

Arbitration is best suited for resolution of disputes of little economic consequence or of technical issues, such as valuation of inventory, not readily within the ken of a trial judge. Even in the latter situation, the parties should consider whether the savings in time and money by arbitration are outweighed by the protections of judicial resolution, particularly where the amounts involved potentially constitute a significant multiple of litigation costs. Where the benefits of arbitration outweigh its disadvantages, the arbitration clause should be drafted to minimize the negative aspects of arbitration.

One factor that contributes to prompt resolution by arbitration is the use of a nonjudicial or extrajudicial decision maker. An arbitrator's schedule will

usually be more open and flexible than that of a court. However, an arbitrator may have biases or lack sufficient knowledge of the law or subject area to reach a proper decision. This disadvantage can be minimized by careful drafting. For example, if the agreement designates arbitration under the rules of the American Arbitration Association (AAA), the parties will have to choose an arbitrator from one or more lists of names provided to them. These arbitrators may be unsatisfactory. To avoid this situation, the acquisition agreement can designate another means of choosing an arbitrator, such as having each party choose its own arbitrator, and then having these select a third arbitrator.

A second factor that contributes to the speed of arbitration, as well as its lower costs, is the absence of discovery. In certain situations, the lack of discovery may not be a serious disadvantage. For example, if each party has sufficient familiarity with, or access to, the company's books and records, discovery may not be necessary to resolve a dispute concerning those documents. Even if discovery is necessary with regard to a particular issue, arbitration may still be a viable alternative to court proceedings. The parties can draft the agreement to allow some discovery but not so much as to make the arbitration process comparable to a judicial one. Furthermore, the extent of discovery can be made subject to decision of the arbitrators.

In drafting an arbitration agreement, the parties should attempt to anticipate all future disputes. If arbitration is broadly required for all disagreements, the parties may be barred from seeking emergency injunctive relief from a court. A narrow arbitration clause, however, may result in requiring counterclaims to be filed in court, thereby compounding, rather than simplifying, resolution of disagreements.

The parties should also draft the arbitration agreement with the controlling law of the relevant jurisdiction in mind. In many jurisdictions, for example, absent the parties' agreement to the contrary, only the arbitrators have the power to subpoena witnesses. However, in New York State, the parties themselves have the power to issue subpoenas. Certain jurisdictions, such as California, are less likely than others to limit the scope of the arbitration clause. In those jurisdictions, courts tend to interpret narrow arbitration provisions to require arbitration of issues that the parties neither mentioned nor intended to be arbitrated.

One caveat: In the M&A area, arbitration proceedings, even before an AAA tribunal, can be very expensive if they are pursued by lawyers normally involved in litigative court proceedings. Both sides should recognize that the services of law firms specializing in ADR are now widely available and resolution of disputes using their services is highly efficient.

Do auction procedures for selling companies have any effect on the contract negotiation process?

Yes, a significant effect. In the auction process, a seller hires an investment banker to sell the target on a bid basis. The investment banker prepares a "book" describing the target and solicits bids from potential buyers. The buyers receive a form contract and are told that the bid should be accompanied by the form contract together with any changes to it required by the buyer. The buyer is expressly warned that extensive changes will be considered negatively in evaluating the competitive nature of the bid. Often, the buyer is offered limited access to the target's management and carefully controlled opportunities for due diligence before the initial bid must be made. Needless to say, the form contract typically provides the buyer no indemnities and only limited representations and warranties. Typically, extensive changes are required to make the contract similar to a typical and reasonable buyer's contract.

After the investment banker winnows out unacceptable bids, the seller will deal with only a few serious bidders who are given the chance for more thorough due diligence, often including full, rather than limited, access to management. The seller's representatives will often negotiate the contracts submitted by those bidders in order to finalize the contract before a decision is made. Nevertheless, contract negotiations often continue even after the deal has been awarded to a specific bidder.

How should a buyer respond in this process? There is simply no clear answer. The response will depend entirely upon the strength of the buyer's desire to buy the target and its confidence that it knows the target well enough to take the risk of an "as is" transaction. Even if the buyer is willing to take such risks, certain points should be addressed in the contract, and the buyer must insist upon the opportunity to do thorough due diligence:

- First, the twofold purpose of representations and warranties must be remembered. The representations and warranties not only provide the basis for indemnities but also establish the buyer's right to refuse to close a deal if legal defects are discovered before the closing. The buyer should get representations and warranties ensuring that if the buyer finds legal problems, it may terminate the contract without penalty.
- Second, the same arguments about the unfairness of the buyer's overpaying apply here. The question is how far to carry the aforementioned actions.

The bid process often has an intended psychological effect on many buyers. The purchaser's lawyer is likely to hear: "Don't give me the world's most perfect contract. I want the absolute minimum protection I need. Don't overlawyer and get me knocked out in the first round." The buyer, who often believes that the contractual protections are overkill by lawyers, gets spooked and doesn't want the lawyers to lose the deal. Assuming that (1) the first two points previously listed are accounted for in the contract, (2) the deal is priced on an "as is" basis, and (3) the buyer is fully informed of the risks, the buyer may indeed be wise to keep it simple.

If additional protection is desired, the buyer might require indemnification for breaches of representations and warranties made regarding the financial statements, undisclosed liabilities, taxes, and litigation. This requirement can be made easier for the seller to accept with generous minimum amount and basket provisions.

As a final word, the buyer should not be fooled by the putative formality of the bid procedures and the investment banker's stern admonitions. Most buyers do submit changes to the contract along the lines described earlier, and in the end the insiders will tell you that the price and a credible ability to close, and not the contract terms (provided they are reasonable), will dictate the results in most cases. A buyer that has concerns about the legal aspects of the target or its business should not hesitate to say that it reserves the right to submit further changes after it has been given complete access to management and an opportunity for full due diligence. It is not unusual for the buyer to submit a solid bid and indicate that it would like the opportunity to negotiate the terms of the contract with the seller face-to-face. Typically, the buyer would also indicate the several areas where it would require changes.

Another favored approach is to do a relatively extensive markup and suggest that the contract can be watered down in face-to-face negotiations after due diligence is completed. This approach is constructive because the seller will usually negotiate the contract with the two or three top bidders. Whatever the buyer sends in will be the starting point for negotiation. Even if the buyer is willing to accept only minimum protection, it is important to start ahead of where the buyer wants to end up.

What are the main advantages of auction procedures?

Although not as popular today as they once were, auctions are still generally believed to be the best way of ensuring that the highest possible price

is obtained. The same sentiment probably drives the seller to use auction methods for sales of divisions or subsidiaries of companies. Also, who can fault a corporate executive for the price he or she agrees to if it was the result of a competitive bid procedure?

The auction process also saves the seller the time and effort of dealing with dozens of potential buyers, many of whom may be shoppers that never buy anything, and bringing it down to serious negotiations with two or three serious potential buyers. Sellers must be very careful to supervise the way the investment bankers deal with the bidders. The seller should be involved in the negotiations because most serious buyers are justifiably put off by having to negotiate substantive points through an intermediary who may or may not have the authority to cut a deal.

ACQUISITIONS FROM AN AFFILIATED GROUP

Are there any special aspects to be negotiated when the buyer is acquiring the assets of a division or the stock of a subsidiary that is a part of a larger corporate group?

There are numerous issues that arise under such circumstances that should be addressed:

1. Is the buyer getting all of the assets needed to operate the company as a separate business or are some critical assets located elsewhere in the group?
2. Are there any special, advantageous contractual or administrative relationships with the seller that must be continued (for example, supply or purchase contracts), or are there unfavorable ones that must be terminated? This can be a crucial aspect of a transaction for the buyer or the seller. As part of the pricing and as an inducement to complete the transaction, one party can offer a favorable long-term contract to the other.
3. Are there administrative services provided to the target by the group that should be continued for a period of time? In many cases the seller's group provides legal, accounting, billing, and other administrative support as well as shared office and warehouse space. Unless replacements will be available at closing, the agreement should contain provisions to continue

those services at an agreed-upon cost for a specified period of time.

4. Finally, is it clear that the target financial information upon which the deal is based takes into account the need to provide for the services or other arrangements described in the previous paragraphs?

TRANSACTIONS INVOLVING PUBLIC COMPANIES

Are acquisition agreements different when the target is a public company?

Yes. The acquisition agreement in a public company transaction is very different from the type of agreement used for a privately held target. The differences may be divided into two categories: (1) provisions that are present in agreements involving private companies but are typically absent from agreements involving public companies, and (2) provisions that are typically absent from private company agreements but are present in public company agreements.

What provisions common to private company agreements will be missing from agreements involving public companies?

In agreements involving public companies, the representations and warranties do not survive the closing of the transaction; the buyer is not protected in the event breaches are discovered in post-closing. In short, there is no indemnity provision, mainly because an indemnity against hundreds or thousands of shareholders is considered impractical. The buyer therefore must rely on the substantial disclosure required under federal securities laws as the basis for evaluating the legal and financial risks of ownership. It is generally assumed that those disclosures, which if materially inaccurate can give rise to criminal and civil liability on the part of the officers and directors, together with a history of audited financial statements that are also required under the securities laws provide a reliable rendition of the legal/financial history of the target.

Because the representations and warranties don't survive anyway, and because of the extensive public disclosures, the representations and warranties tend to be far briefer in a public company deal. They serve more as a means of organizing due diligence. The buyer shouldn't get too carried away,

however, with agreeing to gut the representations and warranties. As repeated so often in this chapter, these provisions serve another function—they provide the basis for a buyer's terminating the transaction if the representations, warranties, and covenants are breached in a material way. Therefore, although many of the detailed disclosures are eliminated, the key concepts must be retained. The key sections that would be retained in a public deal agreement are discussed in the introduction to the form agreement at the end of this chapter.

What are some of the provisions that appear only in the public deal acquisition agreement?

First, the agreement will contain specific representations and warranties to the effect that the parties have complied with all applicable securities laws and, specifically, that the disclosures made pursuant to those laws are all materially accurate.

Second, the agreement will set forth the specific form of the transaction, for example, a merger or a tender offer or a combination of the two, and what the responsibilities of the various parties will be for preparing, reviewing, and filing the documents that must be filed with the SEC.

NEGOTIATING AND DOCUMENTING AN MBO

What is the course of negotiation between a management group and an outside financial or investor group?

The typical MBO involving an outside financial partner requires at least three separate but coordinated negotiations: (1) the negotiation between management and the financial partner as to the nature of their relationship, (2) the acquisition negotiation between a team consisting of management and the financial partner on the one side and the seller on the other, and (3) the negotiation with lenders, in which the financial partner usually plays the lead role but management participates because of its knowledge of the business and its financing needs, and the lenders' desire to keep management involved.

Because both the second and third negotiations demand close coordination between management and the financial partner and a considerable amount of mutual trust, the first negotiation should, to the extent possible, be completed at the earliest possible stage but is often delayed. MBOs, like most

LBOs, normally take place under acute time pressure, and management and the financial partner may have met for the first time and for the sole purpose of doing the acquisition. The issues between them are difficult and go to basic questions of allocation of benefits and burdens and management self-esteem.

It is often difficult for management to accept how much equity the financiers want to receive when they don't even know how to run the company. Therefore, it is likely that management and the financial partner are working out their relationship at the same time that they are negotiating with the seller and the lenders. To some extent, this is unavoidable, even with ample time and advance contact, because the terms negotiated with the seller or the obligations imposed by a lender cannot be entirely foreseen and will involve changes in the allocations of responsibilities or benefits between the acquirers. It may even be beneficial, as during the course of negotiations both management and the financial partner begin to appreciate how essential each is to the other in bringing the deal to a proper closing.

The first step is reaching an understanding of the terms of management and the financial partner's relationship. Although this is often an oral agreement, occasionally management and its financial partner may enter into a written preincorporation agreement.

What issues should the preincorporation agreement address?

The four main issues are as follows:

1. The terms on which the acquisition will be conducted: that each party will bear its own expenses or how they will be shared; that neither will be liable to the other if the transition is not consummated; that neither will negotiate with another party; that information about the other will be kept confidential; that each will use its reasonable efforts to accomplish the acquisition; and the responsibilities that each party will have in negotiating the acquisition (that is, the financial party will probably commit to obtain financing on a best-efforts or reasonable-efforts basis)
2. The share each party will have in the ownership of the acquired company
3. The voting power or veto power each party will have over the business operations of the acquired company and over sale or refinancing of the company
4. The makeup of the board of directors

Are there any provisions a preincorporation agreement should not contain?

The lender, as part of its due diligence, may well insist upon seeing any written preincorporation agreement. Some will advise that details, such as contingency plans specifying which of the parties will provide personal guarantees for the loan, if necessary, be based on handshakes rather than memorialized in the written agreement, which dilutes their position with lenders.

How is a manager-investor understanding expressed if there is no preincorporation agreement?

These arrangements are then handled as a matter of oral understanding and custom that ultimately, after the acquisition, may be reduced to writing in various agreements such as employment, consulting, and stockholder agreements, and in the target's articles of incorporation and bylaws. Informal agreements are often indicators of a more healthy and successful relationship between the management and the investor group, since the key elements in most MBOs are trust and cooperation. Getting everything in writing at an early stage is nearly impossible anyway since the parties are dealing, in part, with ephemera, and attempts to reduce verbal agreements to precise language can lead to arguments, delays, mistrust, and perhaps the breakup of the deal before it's had a chance to get going.

In a typical LBO, what levels of equity does management hold?

Without a partner, management may own all of the equity. In a typical LBO, key management will often receive between 10 and 25 percent of the equity. In an MBO, a CEO who controls the deal can sometimes achieve a 50-50 or even a 60-40 deal or better for management. Equity percentages are good reflections of the relative negotiating strength of the parties and of which of the two parties brought the deal to the other. Such stakes will be reduced or diluted by equity, or equity equivalents such as warrants or convertible securities, issued to a seller or to a financial institution and sometimes to a finder.

What are typical allocations of control over corporate decisions?

Again, allocations vary greatly according to which party controls the deal, how badly they need each other, and how much they trust each other. Discussions tend to reflect a basic division of interest: management tends to think in terms of preservation, expansion, and meeting operating needs of the company, whereas the financial partner tends to think of satisfying a lender in order to achieve the acquisition and, thereafter, realizing value by payment of dividends, sale of stock, or divestitures.

Management will presumably make "ordinary course of business" decisions, subject to the board of directors, which may be equally divided between the parties at first but will swing one way or the other depending on events. Sometimes, board membership is divided proportionate to stockholdings. If management has less than 50 percent of the stock, it may have the protection of a supermajority provision for stockholder votes affecting major transactions, such as sale of the company, public issuances of stock, or refinancings. If the financial partner does not have a majority of the stock, it may insist on the ability to sell its interest or to take the company public after a certain period of time if certain conditions are met.

How many members of management are typically included in a management LBO?

Key management can range from as few as one or two managers to over 20 people. The numbers may be limited because of securities law limitations on purchasers in a Regulation D private offering (75 unaccredited investors) or tax limitations on the number of shareholders in an S corporation (75 individuals, no corporations). For more information about what constitutes an unaccredited investor, see Chapter 5.

How can the value of management be locked in—for example, if key people leave or die?

Two very important factors in a management LBO are:

- Employment contracts with key personnel for three-year or five-year terms
- Key-executive life insurance

Compensation and equity participations can be structured through employment and stockholder agreements so that key managers have everything to gain and nothing to lose by staying; therefore, the risk of voluntary departure can be minimized.

Key-executive life insurance should always be part of any MBO planning. No group of financial wizards will substitute for a strong CEO who knows the business, particularly if the plan is to place the company deeply into debt to finance the acquisition. Lenders will frequently require life insurance on the chief executive and perhaps one or two others. Even if they don't require it, any financial group working with management probably will. The senior author of this book was advising a seller some years ago and noticed at the closing that the buyer/CEO was smoking and coughing very heavily. The author insisted successfully that the closing not occur without obtaining key-executive (then called "key-man") life insurance in the amount of the acquisition loan. The closing was delayed until the insurance was obtained. Two weeks later, the buyer/CEO died.

EMPLOYMENT AGREEMENTS

In addition to equity, what other benefits are typically made available to management?

Prior to trying to sell a division or subsidiary to a third party or to managers, a seller must be sure that its managers have signed employment agreements and they conform with what is actually happening and adequately cover bonuses, vacations, stock options, and so on. Such agreements keep managers with the company while the business is being offered for sale.

Should an MBO manager enter into an employment agreement?

Generally, managers should accept such agreements, as they often offer protection against precipitous termination by a new owner. Further, those financing the deal, including lenders, may insist on it. On the other hand, managers should be wary of signing off on broad "covenants not to compete" that will prevent them from working for competitors for long periods of time. If an employee must agree to such provisions, which is likely given the strong interest the company will have in protecting its business, he or she will want to

be compensated during the noncompete period if it results in hardship and will want to limit the period, for example, to one year, and perhaps limit the territory affected.

After purchasing the business, key members of management will want to have new employment agreements replacing those entered into before the sale of the business. Such an agreement will at the least provide a term, a specified salary, and noncompetition provisions. Management's partner or its bank lenders will usually also want key management to have such agreements.

What provisions relating to noncompetition normally appear in employment agreements?

Such agreements prohibit an employee from doing any of the following:

- Competing with the employer by participating in a competing business or aiding a competitor
- Disclosing confidential information
- Owning equity in a competitor (other than insubstantial interests—less than 5 to 10 percent) of publicly held companies

Will courts enforce covenants not to compete?

Courts will enforce the restrictions of covenants not to compete that are reasonable in duration and territory. In general, however, courts are reluctant to prevent employees from earning their livelihood in their chosen profession, and so tend to favor employees in their decisions.

What are the typical terms of a post-buyout employment agreement with managers involved in an MBO?

An employment agreement should specify the term of employment, the amount of compensation and bonuses, and the conditions under which an executive can be terminated.

Employment agreements can be for a fixed term of years or can be extended from year to year under an "evergreen" provision unless one party gives notice to the contrary to the other within a limited period before the start of each year.

The agreement will specify a base salary. The agreement can provide that the salary can be increased by specified increments or by an adjustment such as a rise in the Consumer Price Index. The agreement may also require that the executive receive a percentage of the excess of the company's pre-tax earnings or net income over projected levels of earnings or income. The agreement might also incorporate an existing bonus plan, as well as special pensions or stock plans, and might guarantee specific benefit levels.

The employer will have the right to terminate the employee for just cause, which usually includes at minimum willful misconduct or gross negligence in the course of employment, fraud in the course of employment, or the conviction for a crime. Just cause may include other matters, but the employee's interest is in limiting the bases for termination for just cause. If the employer has the right to terminate an employee without just cause, the employee is usually compensated by receiving his or her base salary through the end of the term in a lump sum or periodic payments, or by receiving payments in addition to his or her base salary. In any event, the basis for the terms of the severance agreement should be anticipated in the employment agreement. For instance, if the employee gets a new job, his or her salary may or may not reduce the amount that must be paid under these provisions by the terminating employer.

The agreement protects the employer and the employee if the employee is disabled for a continuous period of time. If an employee is disabled or dies, the employee or his estate may be entitled to receive benefits after disability or death.

What other provisions may be included in an employment agreement?

Other employment agreement provisions may stipulate that

- The executive work in a specified city and not be required to relocate.
- The executive receive a company car.
- The company pay for country club memberships and other expenses.
- Other special benefits be provided, such as guaranteed vacation leave policies or the right to run for public office.

An employee may also negotiate for a deferred compensation agreement. Deferring income can have financial and tax benefits to individuals. The employee may be able to negotiate funded deferred compensation, with amounts payable out of insurance or a special trust.

A word of caution: Make sure that you do not create or inherit agreements that contain provisions that can award excessive compensation. The financial cost of such provisions can do financial and reputational harm, as the long-running compensation case involving the Walt Disney Corporation has shown.[5]

What are the benefits and detriments of a deal-induced severance agreement?

Occasionally, an employee who is not offered an employment agreement or is resistant to entering into an employment agreement will enter into a severance agreement instead. The severance agreement, sometimes called a "golden parachute," will provide that the employee receive two or three times his or her annual salary if he or she is terminated as the result of a change in control of the company. The employee may also be entitled to receive substantial severance benefits if he or she chooses to leave under such circumstances. Such agreements are more prevalent in public companies than the private companies that emerge from an MBO.

Such agreements can harm the employer by giving the employee a strong incentive to become uncooperative and even disruptive in order to cause termination and trigger the severance payment. It is not uncommon for management to be asked to give up or scale back its golden parachute protections as part of the price for participating in an MBO.

Golden parachutes can have significant tax consequences to the employer. (See the following paragraphs.) But they also can trigger corporate governance concerns, as well. For instance, pension fund CalPERS opposed Anthem's acquisition of WellPoint because it disapproved of the executive compensation packages likely to be earned by WellPoint executives.[6]

What are the tax penalties for golden parachute payments?

Under current law, if a corporation makes an "excess parachute payment" to an employee, the payment may not be deducted by the corporation, and the employee will be subject to a 20 percent nondeductible excise tax on the excess parachute payment in addition to any regular income tax.

The definition of an excess parachute payment is complex. Generally an excess parachute payment is made to a high-level management employee, is exceptional in relation to the employee's previous compensation, and is contingent upon a change of control of the company. The definition of change of

control is broad enough to include circumstances in which a friendly buyer enters into a compensation arrangement with the employee. Management equity participation that results in taxable compensation under Section 83 of the IRC will be taken into account along with all other compensation under the golden parachute rules and thus may be subject to additional tax as an excess parachute payment.[7]

STOCKHOLDERS' AGREEMENTS

At or shortly following the acquisition closing, it is usually advisable for the acquirers to enter into a stockholders' agreement. If the post-acquisition entity is a partnership, the partnership agreement will contain comparable provisions.

What are the main reasons for the buyers of a business to enter into a stockholders' agreement?

To the extent that they have not already done so in a preincorporation agreement, a stockholders' agreement will allow the buyers to do the following:

- Obtain advance commitments for additional equity or debt
- Exercise control over who the owners of the business will be
- Specify their respective legal rights over the governance of the business

Why might the buyers want to exercise control over who the owners of the business will be?

Presumably, one of the main reasons the buyers completed the transaction was their particular individual and collective strengths. They wanted to be in business together rather than with other persons or entities. In an MBO (with or without an outside investor group), equity ownership by the persons who will be running the business is a key ingredient of the future success of the enterprise. Therefore, especially in the early period following the acquisition closing, the buyers will want to limit the ownership of the business to those who are active employees or members of the initial investor group. Moreover, the acquisition lenders will have similar concerns and usually will require that the equity ownership of management and the initial

investor group be maintained at certain levels for as long as their loans are outstanding.

What are some of the typical ways to limit the equity ownership of the target?

The stockholders' agreement will contain "restrictions on transferability," which are limitations on the persons or entities to whom the stockholders may transfer their stock, the time periods during which the stock may be transferred, or the manner in which the stock may be transferred. For example, the stockholders may agree that, in order to give themselves an opportunity to put the business on a solid footing, for a specified period of time, usually from one to five years after the closing, no stockholder will be allowed to transfer stock to anyone other than to an affiliate in the case of a corporate stockholder or to a spouse or child in the case of a stockholder who is a natural person. Management stockholders may even be locked in for a longer period, perhaps as long as they continue to be employed by the corporation.

Conversely, in the case of a management stockholder, the stockholders' agreement may also provide that upon termination of his or her employment, the corporation or the other stockholders will have the option to purchase the terminated employee's stock. One benefit of a provision like this is that the purchased stock could then be sold to another employee of the corporation, including the terminated employee's replacement, enhancing his or her incentive to perform well. Another benefit is that the stock need not remain in the hands of a fired or otherwise disgruntled former employee.

Are such restrictions on transferability legally enforceable?

Generally speaking, yes, assuming that there is a valid business purpose for the restriction, the restriction is reasonably related to a business purpose, and no stockholder has been induced by deception or forced into agreeing to the restriction. However, the more expansive the restriction, the greater is the risk that a court will find the restriction to be an "unlawful restraint on the alienation of property." In addition, most states' laws require the existence of transfer restrictions be noted in the form of a legend on the stock certificate in order for those restrictions to be enforceable against third-party transferees who have no knowledge of their existence.

Are there any other ownership restrictions that management may want to have in a stockholders' agreement?

Where management is in a minority position vis-à-vis the other stockholders, it may want some protection against dilution of its interest or some influence over when, and to whom, additional stock may be issued.

Through the stockholders' agreement, management could be given an option to purchase such additional stock, or a proportion thereof, for the same price and terms on which they would otherwise be sold to a third person or entity. It could also be given certain consensual rights over the issuance of such additional stock (see the following discussion).

How may a stockholders' agreement create the framework by which the corporation will be governed?

The stockholders' agreement may contain provisions (1) whereby the stockholders commit themselves in advance to vote their shares to maintain a certain governing structure, (2) that require that certain matters normally within the province of the board of directors or the president shall be regulated by the stockholders, or (3) that require that, under certain circumstances, normal majority rule by the board or the stockholders, as applicable, will not be sufficient.

An example of the first type of provision is where the stockholders agree that they will exercise their power to adopt and amend the corporation's bylaws to maintain a board of directors of a particular number and that they will vote to elect as directors representatives nominated by various groups of stockholders. In the case of a typical MBO in which the majority of stock is held by an investor group, the stockholders' agreement would provide that the stockholders will at all times vote their shares so as to maintain a board of directors of, say, five members, three of whom shall be nominated by the investor group and two of whom shall be nominated by the management group.

An example of the second type of provision is where the parties agree that the stockholders must approve the dismissal of certain executive officers, or any contracts with affiliates of the corporation, or the issuance of stock—activities that are usually handled by the board of directors.

An example of the third type of provision is where the stockholders agree that the corporation cannot engage in certain major transactions, such as a merger or a sale of substantially all the assets of the corporation, without the approval of all of the stockholders or some greater proportion of the

stockholders than the proportion required under the applicable state corporation statute.

In most, if not all, states it will also be necessary for the second and third types of provisions to be stated in the certificate of incorporation or bylaws of the corporation. For example, Delaware Code Sections 141 and 216 provide, respectively, (1) that the business and affairs of every Delaware corporation shall be managed by its board of directors unless the corporation's certificate of incorporation provides otherwise, and (2) that unless the corporation's certificate of incorporation or bylaws provide otherwise, all matters, other than election of directors, subject to stockholder approval shall be approved by majority vote, and by plurality vote in the case of the election of directors. In this case the stockholders' agreement should also provide that the stockholders will vote their shares to adopt and maintain these types of provisions as part of the company's certificate of incorporation or bylaws, as applicable.

How long are voting agreements enforceable?

This matter is governed by the corporation statutes of the state in which the company is incorporated. In Delaware, for example, such agreements are valid for only 10 years, but at any time within 2 years prior to expiration of a voting agreement, the stockholders may extend such agreement for as many additional periods, each not exceeding 10 years, as they desire. It is possible, however, through the use of devices such as irrevocable proxies, to lock in stockholder votes for a longer period than that permitted for voting agreements.

What kinds of additional financial commitments are usually found in stockholders' agreements?

Because in most cases, especially LBOs, the buyers do not intend to make further equity contributions to the corporation, the stockholders' agreement usually does not contain any provision for additional capital calls. However, where the corporation is in a volatile industry, or where the acquisition is highly leveraged, serious consideration should be given to requiring the stockholders to commit themselves to contributing additional equity to, making loans to, or extending personal guarantees on behalf of the corporation. In addition to the conditions under which such a commitment will be triggered, the extent to which any group of stockholders, such as the investor group, will assist the other stockholders in obtaining the funds to meet their commitment should also be incorporated in the stockholders' agreement.

What are some of the exit strategies typically embodied in a stockholders' agreement?

The following are the major kinds of provisions relating to opportunities for the stockholders to liquidate their investment:

1. Voting provisions pursuant to which the stockholders agree to vote their shares in favor of any arm's-length merger or asset sale recommended by a certain group of stockholders (such as the investor stockholder group) or a certain percentage of all the stockholders
2. The right to sell stock to any third-party person or entity, subject to the right of the corporation or the other stockholders to purchase the stock for the same terms offered by the third party (a "right of first refusal")
3. The right of any stockholder to sell stock to any other stockholder
4. The right of a stockholder to "tag along" with other stockholders, that is, to require a third-party offeror to purchase a pro rata portion of each stockholder's stock rather than purchase the same number of shares from the original offeree
5. The right of any stockholder or group of stockholders to force along the other stockholders, that is, to sell their shares to a third-party offeror
6. The right of a stockholder or his or her heirs to sell his or her stock to the corporation in the event of death, disability, or termination of employment
7. The right of a stockholder to require the corporation to register his or her shares in a public offering

From management's point of view, what are the important negotiation points of a "buy/sell" arrangement upon termination of employment?

The following are crucial:

1. *Mandatory versus optional requirement.* Management wants a mandatory obligation or, preferably, a "put," particularly in the case of death or disability.

2. *Price.* Management wants fair market value, preferably at all times, but at least in the case of death, disability, retirement, or termination without cause.
3. *Determination of price.* Management at least wants an opportunity to get an independent appraisal at the time a buyback is triggered.
4. *Payment terms.* Management wants the payout period to be as short as possible, preferably in cash at the closing (particularly in case of death or disability).
5. *Security for payment.* Unless premium payments would cripple the company, where the buyout price is significant or where acquisition loan agreements have low caps on the amount of noninsured buybacks the corporation can make, management wants the corporation to purchase life insurance and, if possible, disability insurance, to fund the buyback. In other cases involving deferred payments, management wants protections such as an opportunity to get the stock back free of transfer restrictions in the event of uncured payment defaults and prepayments out of the proceeds of public offerings.

As in the case with every contractual arrangement, each party must carefully consider the tax consequences associated with the various provisions under negotiation.

CONCLUDING COMMENTS

The documentation of a merger, acquisition, or buyout presents an opportunity to record the most important aspects of the transaction for the future. By following the guidance in this book, dealmakers can ensure that expectations are clear—a good start for any venture.

APPENDIX 7A

Sample Letter of Intent

STRICTLY PRIVATE AND CONFIDENTIAL
[Date]

Target Corporation[1]
Corporate Office Park
New York, New York

To the Board of Directors:

This letter of intent sets forth the basic terms and conditions under which Acquisition, Inc. (the "Purchaser") will enter into a definitive merger agreement (the "Merger Agreement") with Target Corporation (the "Company") for the merger of the Purchaser with and into the Company (the "Merger"). It is anticipated that the consummation of the Merger will occur on or before _____, or on such other date to which the parties may agree.

Purchase Price

Pursuant to the Merger Agreement, upon consummation of the Merger, the selling stockholders of the Company will receive in exchange for each share of the Company's common stock and preferred stock (the "Stock") outstanding as of the date of this letter:

(5)_____ Dollars ($_____) in cash; and

(6) One share of preferred stock ("Preferred Stock") of the surviving corporation of the Merger with a liquidation preference in the amount of _____ Dollars (_____) and containing the terms set forth on Exhibit A hereto.

Conditions to Closing

The consummation of the Merger shall be subject to the satisfaction of the following conditions:

(a) the parties shall have received all required approvals and consents from governmental authorities and agencies and third parties;

(b) the Purchaser and the Company shall have executed on or prior to _____, a definitive Merger Agreement containing mutually acceptable provisions relating to, among other things, representations, warranties, conditions and indemnification;

(c) the truth and accuracy of all representations and warranties and the satisfaction of all conditions;

(d) the consummation of the Merger on or prior to _____ ;

(e) Purchaser and certain members of management of the Company designated by Purchaser having entered into mutually satisfactory employment contracts simultaneously with the execution of the Merger Agreement;

(f) since _____, [date of last audited balance sheet] the business of the Company and its subsidiary shall have been conducted in the ordinary course, and there shall have been no material adverse change in the business, prospects, operations, earnings, assets or financial condition of the Company and its subsidiaries;

(g) Purchaser shall have obtained financing in an amount and upon terms satisfactory to it to consummate the Merger; [and]

(h) there shall have been no dividend, redemption or similar distribution, or any stock split, recapitalization or stock issuance of any kind, by the Company since _____, [date of last audited balance sheet] other than regularly scheduled dividends on the preferred stock.

General

After executing this letter and until _____, the Company agrees, and shall use its best efforts to cause its officers, directors, employees, agents and stockholders, not to solicit or encourage, directly or indirectly, in any manner any discussion with, or furnish or cause to be furnished any information to, any person other than Purchaser in connection with, or negotiate for or otherwise pursue, the sale of the Stock of the Company or the capital stock of its subsidiaries, all or substantially all of the assets of the Company or its subsidiaries or any portion or all of its business or that of its subsidiaries, or any business combination or merger of the Company or its subsidiaries with any other party. You will promptly inform Purchaser of any inquiries or proposals with respect to the foregoing. [In the event that the agreements in this paragraph are violated by the Company or its officers, directors, employees, agents or stockholders, and Purchaser does not consummate the Merger, then, in addition to other remedies available to Purchaser, Purchaser shall be entitled to receive from the Company all out-of-pocket expenses (including reasonable attorneys' fees and expenses relating to the financing), which Purchaser has incurred.]

Neither of the parties to this letter shall disclose to the public or to any third party the existence of this letter or the proposed sale described herein other than with the express prior written consent of the other party, except as may be required by law.

From and after the date hereof, upon reasonable prior notice and during normal business hours, the Company will grant to each of Purchaser and its agents, employees and designees full and complete access to the books and records and personnel of the Company and its subsidiaries. Except as may be required by law or court order, all information so obtained, not otherwise already public, will be held in confidence.

[Except as provided herein,] each party will be responsible for its own expenses in connection with all matters relating to the transaction herein proposed. If this proposed transaction shall not be consummated for any reason other than a violation of the agreement not to solicit other offers or negotiate with other purchasers, neither party will be responsible for any of the other's expenses.

Each party will indemnify, defend and hold harmless the other against the claims of any brokers or finders claiming by, through or under the indemnifying party.

Except for matters relating to (i) the confidentiality of this proposal and the business operations of the Company and its subsidiary, (ii) the agreement not to negotiate with others for or otherwise pursue the sale of the Company or its subsidiary, and (iii) the agreement that each party will bear its own expenses in connection herewith, this letter does not create a binding, legal obligation on any party but merely represents the present intentions of the parties.

In the event that for any reason the definitive Merger Agreement is not executed by _____, any party may discontinue negotiations and terminate this letter without liability to any other party.

Your signature below shall indicate your agreement with the foregoing letter of intent. We look forward to working with you on this transaction.

Very truly yours,

Acquisition, Inc.
By: _____
Its: Vice President, Strategic Planning

Agreed to and Accepted this _____ day of _____,

Target Corporation

By:_____
Its:_____

APPENDIX 8B

Typical Merger Agreement and Commentary

The following articles and sections typify the content of an acquisition agreement used in a merger.

RECITALS

ARTICLE I	**THE BUSINESS COMBINATION**
Section 1.1	The Merger
Section 1.2	Stockholders' Meeting
Section 1.3	Filing of Articles of Merger; Effective Time
Section 1.4	Effect of Merger
Section 1.5	Certificate of Incorporation and Bylaws
Section 1.6	Directors
Section 1.7	Officers
Section 1.8	Alternate Structure of Merger
Section 1.9	Taking of Necessary Action
ARTICLE II	**CONVERSION AND EXCHANGE OF SHARES**
Section 2.1	Conversion of Shares
Section 2.2	Dissenting Stockholders
Section 2.3	Stock Transfer Books
Section 2.4	Surrender and Exchange of Stock Certificates
Section 2.5	Determination and Payment of Merger Payment
ARTICLE III	**CLOSING**
ARTICLE IV	**REPRESENTATIONS AND WARRANTIES OF SELLER AND TARGET**
Section 4.1	Organization; Subsidiaries and Other Ownership Interests

Section 4.2	Authorization
Section 4.3	Capitalization of Target and Subsidiaries
Section 4.4	Title to Securities of Target and Subsidiaries
Section 4.5	Financial Statements and Projections
Section 4.6	Absence of Undisclosed Liabilities
Section 4.7	Accounts Receivable
Section 4.8	Most Recent Inventory
Section 4.9	Solvency
Section 4.10	Debt
Section 4.11	Fairness Opinion
Section 4.12	Product and Service Warranties and Reserves
Section 4.13	Reserve for Public Liability and Property Damage Claims
Section 4.14	Insurance
Section 4.15	Real Property Owned or Leased
Section 4.16	Fixed Assets; Leased Assets
Section 4.17	Title and Related Matters
Section 4.18	Intellectual Property
Section 4.19	Assets Necessary to the Business
Section 4.20	Additional Contracts
Section 4.21	Customers and Suppliers
Section 4.22	Competing Lines of Business
Section 4.23	Restrictive Covenants
Section 4.24	Books and Records
Section 4.25	Bank Accounts
Section 4.26	Employee Benefit Plans; Labor Relations
Section 4.27	Litigation
Section 4.28	Compliance with Laws
Section 4.29	Non-Contravention; Consents
Section 4.30	Unlawful Payments
Section 4.31	Brokers and Finders
Section 4.32	Absence of Certain Changes or Events
Section 4.33	Accuracy of Information Furnished
Section 4.34	Reports Filed with the Securities and Exchange Commission
Section 4.35	Investment Purpose
Section 4.36	Dealership and Franchises

ARTICLE I: THE BUSINESS COMBINATION

The following is a discussion of the material items that are usually included in Article I of a merger agreement (the "Agreement"). The section headings listed below provide the topics frequently covered in this article.

Section 1.3	Filing of Articles of Merger; Effective Time
Section 1.4	Effect of Merger
Section 1.5	Certificate of Incorporation and Bylaws
Section 1.6	Directors
Section 1.7	Officers
Section 1.8	Alternate Structure of Merger
Section 1.9	Taking of Necessary Action

Article I of the Agreement typically (a) describes how the merger will be accomplished (the "Merger"), (b) identifies which corporation's legal existence will cease and which corporation will be the "Surviving Corporation" in the merger, and (c) identifies the state laws that will govern the surviving corporation's legal existence. This section also contains the agreement of the parties to meet the corporate legal requirements of the states of incorporation of the respective parties in order to obtain approval of the Merger.

The disappearing corporation frequently commits itself to call a special meeting of stockholders and to use its best efforts to obtain stockholder approval of the merger. These undertakings tend to be more elaborate where the disappearing corporation is a publicly held corporation and therefore must provide a proxy statement or information statement to its stockholders.

Once the stockholders of the disappearing corporation have approved the merger and the additional corporate actions and the conditions contained in Articles IX and X of the Agreement are satisfied, the Agreement provides that the articles of merger will be filed in the respective offices of the secretary of state (or comparable authority) of the states in which each corporation is incorporated. The merger will become effective upon such filing. The effect of the merger is described by reference to a section of the business corporation laws governing the corporate existence of each corporation involved in the transaction. Some states require the surviving corporation to appoint an agent for service of process if the surviving corporation will no longer be present or resident within the state following consummation of the merger. This requirement is intended to enable creditors in the state to continue to have recourse against the disappearing corporation. The merger will have no effect on the rights of creditors or on any liens on the property of either company; liens and debts of the disappearing corporation will become the obligations of the surviving corporation.

The parties stipulate in this article which corporation's articles and bylaws will apply to the surviving corporation and whether any changes or amendments to these documents will be made upon the consummation of the merger. The officers and directors of the surviving corporation may also be identified.

In order to preserve structural flexibility, the buyer can suggest the inclusion of language that gives the buyer the right to restructure the transaction for tax, financial, or other reasons. Because a change in the structure of the transaction could have a significant adverse impact on the seller if, for example, the direction of the merger were to be changed from downstream to upstream, the buyer and seller must reach a resolution that satisfies each of their concerns.

ARTICLE II: CONVERSION AND EXCHANGE OF SHARES

The following discussion pertains to the mechanics of the conversion of shares of the merging corporations and the transfer of the purchase price. The section headings listed below provide the topics generally covered in this article.

Section 2.1	Conversion of Shares
Section 2.2	Dissenting Stockholders
Section 2.3	Stock Transfer Books
Section 2.4	Surrender and Exchange of Stock Certificates
Section 2.5	Determination and Payment of Merger Payment

This article describes the manner in which shares in each of the merging corporations will be converted or, in the case of the surviving corporation, the number of shares that remain outstanding upon consummation of the merger. It also describes the nature of the cash or securities consideration to be received by each holder of stock of the nonsurviving corporation.

Where the disappearing corporation has a diverse group of stockholders, the buyer may wish to consider the potential effects of stockholders' exercise of their dissenters' or appraisal rights under the laws of a particular jurisdiction. In transactions where exercise of dissenters' rights may occur, the buyer should include a provision that describes the effect of the merger on such stockholders' rights and imposes an obligation upon

the seller and target to give the buyer notice of any communications by stockholders with respect to their dissenters' or appraisal rights. The notice obligation is frequently included in the covenant section. The buyer should also attempt to procure for itself the opportunity to direct all negotiations and proceedings concerning these rights.

Also included in this article is the method of surrender and exchange of stock certificates that enables the stockholders of the disappearing corporation to receive the merger payment. For a closely held target this may simply involve the seller's surrender of the certificates to the buyer and the buyer's payment to the seller of the agreed-upon merger consideration. However, in the case of a public target or where the target has a significant number of stockholders, the method for surrender of certificates is somewhat more complicated. The buyer and target will agree that the stock transfer books of the target will be closed as of a particular time, usually the time of the filing of the certificate of merger with the secretary of state, and that stockholders must surrender their certificates to a paying agent that will be responsible for the disbursement of the merger payment. Typically, the buyer will agree that simultaneously with the consummation of the merger it will transfer the entire amount of the merger consideration to an account that will be administered by a paying agent. Funds in the account are then disbursed to the target's stockholders upon the surrender of their stock certificates. See Chapter 5 for a discussion concerning the timing of the payment of the merger consideration and the filing of the certificate of merger.

In the event that the target has outstanding preferred stock, options, warrants, or securities convertible into common stock, the buyer should make provision in this article for the effect that the merger will have on such securities. The buyer's preeminent concern in dealing with these securities is to extinguish through the merger, to the extent possible, any right that a third party may have to receive common stock of the surviving corporation and not be subject to any dilution as a result of the exercise or conversion of any such securities. This assures the buyer that it will hold 100 percent of the common stock of the surviving corporation immediately after the merger. In certain cases the terms of such securities require the surviving corporation to honor the holder's right to receive common stock; other securities merely fail to provide for their termination in the event of a merger. The buyer should always attempt to include, as a condition to the buyer's obligation to close the transaction, the agreement of all holders of such securities to surrender their securities for cancellation at the closing.

ARTICLE III: CLOSING

This article provides the date, time, and place for the closing of the transaction (the "Closing"). Typically, the parties agree to close the transaction at the offices of the legal counsel for the buyer. Closings generally commence early in the morning so that wire transfers of funds can be accomplished prior to the afternoon close of the federal wire. The parties further agree that at the closing the parties will deliver all of the documents and instruments required to be delivered by the acquisition agreement. (The date that the certificate of merger is filed with the appropriate officials governing the merger is referred to as the "Closing Date.") For a more detailed discussion of the closing procedures, see Chapter 8.

ARTICLE IV: REPRESENTATIONS AND WARRANTIES OF SELLER AND TARGET

The representations and warranties included in this article are extremely comprehensive and may, in some instances, be inappropriate in light of the size of the transaction or the nature of the target's business.

In an acquisition of a publicly traded target, it would not be customary to include all of these representations and warranties. As we previously mentioned, the reason for fewer representations and warranties in a public context is that there is usually no one to sue after closing for a misrepresentation or breach of warranty. It is unrealistic for the buyer to expect to recover from thousands of public stockholders. Accordingly, some of the representations and warranties, which are of less importance to the buyer or not directly related to the buyer's ability to terminate the acquisition agreement because of certain adverse changes in the target, are frequently omitted. For example, the following seller/target representations and warranties are typically omitted in the acquisition of a publicly traded target:

Section 4.4	Title to Securities of Target and Subsidiaries
Section 4.9	Solvency
Section 4.10	Debt
Section 4.12	Product and Service Warranties and Reserves
Section 4.13	Reserves for Public Liability and Property Damage Claims
Section 4.18	Intellectual Property
Section 4.19	Assets Necessary to the Business

Section 4.21 Customers and Suppliers
Section 4.22 Competing Lines of Business
Section 4.23 Restrictive Covenants
Section 4.24 Books and Records
Section 4.25 Bank Accounts
Section 4.35 Investment Purpose
Section 4.36 Dealership and Franchises

The following language is typical of the seller/target representations and warranties sections in a merger agreement.

The Seller and the Target represent and warrant to Buyer as follows:

Section 4.1. Organization; Subsidiaries and Other Ownership Interests. The Target and the Seller are each corporations duly organized, validly existing and in good standing under the laws of the jurisdiction of their incorporation. Section 4.1 of the disclosure statement of even date herewith delivered to Buyer by Seller (the "Disclosure Statement") sets forth the name of each Person (as defined in Article XII) in which the Target or any other Subsidiary (on a combined basis) owns or has the right to acquire, directly or indirectly, an equity interest or investment of ten percent (10) or more of the equity capital thereof or having a book value of more than _____ Dollars ($_____) (a "Subsidiary"). Each Subsidiary is duly organized, validly existing and in good standing under the laws of its jurisdiction of incorporation or organization. Each of the Target and the Subsidiaries has the corporate or other necessary power and authority to own and lease its properties and assets and to carry on its business as now being conducted and is duly qualified or licensed to do business as a foreign corporation or other entity and is in good standing in each jurisdiction in which the properties owned or leased by it or the nature of the business conducted by it makes such qualification or licensure necessary except where the failure to be so qualified or licensed and in good standing would not have a Material Adverse Effect. For purposes of this Agreement, the term Material Adverse Effect shall refer to any event which would have a material adverse effect on the financial condition, business, earnings, assets, prospects or condition of the Target and its Subsidiaries taken as a whole. Section 4.1 of the Disclosure Statement sets forth the name of each jurisdiction in which the Target and each Subsidiary are incorporated and is qualified to do business. The Target has delivered to the Buyer true and correct copies of its Certificate of Incorporation and Bylaws and true and correct copies of the certificate of incorporation or comparable charter documents and bylaws of each of the Subsidiaries. Except as set forth in Section 4.1 of the Disclosure Statement, neither the Target nor any Subsidiary owns any equity investment or other interest in any Person other than the equity capital of the Subsidiaries which are owned by the Target or a Subsidiary.

It is customary in acquisition agreements to have the seller and target warrant that the seller, the target, and its subsidiaries are duly organized, and that each is qualified to do business in every jurisdiction in which each is required to qualify. If the seller or the target is not duly organized, the acquisition agreement may not be binding against it since it will not have the authority to execute the document in a corporate capacity. The utility of this representation is often debated in a theoretical context but is rarely heavily negotiated. Underlying the debate is the following question: If the agreement is not binding on the seller or the target, whom do you sue and for what? The answer is not carved in stone; the buyer could probably sue the person who signed the document in an individual capacity for misrepresentation, although a sizable recovery is unlikely. More importantly, the buyer would certainly have the right to walk from the deal, and that right is the primary reason the buyer should require this representation.

It is also prudent for the buyer to know that the subsidiaries are duly organized and qualified to do business in order to be assured of the subsidiaries' ability to conduct business or maintain a suit in a particular jurisdiction.

The definition of subsidiaries in this provision is extremely broad as it includes entities in which the target may only have a small equity interest. Depending upon the particular situation, the seller may want to increase the 10 percent ownership requirement in order to avoid making representations and warranties about entities with which it may not be overly familiar. In addition, the seller may wish to specifically exclude from this definition entities that are not material to the target.

> ***Section 4.2. Authorization.*** The execution, delivery and performance of this Agreement and any instruments or agreements contemplated herein to be executed, delivered and performed by Target or Seller (including without limitation [list important agreements to be executed on or before the Closing]) (the Related Instruments), and the consummation of the transactions contemplated hereby and thereby, have been duly adopted and approved by the Board of Directors and the Stockholders of the Target and the Board of Directors of the Seller, as the case may be. The Target and the Seller have all requisite power and authority to execute, deliver and perform this Agreement and the Related Instruments, as applicable, and to consummate the transactions contemplated hereby and in the Related Instruments. This Agreement has been and as of the Closing Date, and each of the Related Instruments will be, duly and validly authorized, executed and delivered on behalf of the Seller and the Target. This Agreement is and the Related Instruments will be as of the Closing Date, the valid and binding obligation of the Target and Seller, as applicable, enforceable against the Target or Seller, as the case may be, in accordance with their respective terms.

It is customary for the seller and target to represent to the buyer that the Agreement is properly authorized and enforceable. Certainly, the buyer is entitled to know that the seller and target have taken all the steps that are necessary to authorize the agreement and any documents that are material to the consummation of the transaction (referred to above as the "Related Instruments") in order to ensure that such documents are binding. The Related Instruments might include a noncompete agreement, a separate purchase agreement relating to certain other assets, and other documents containing agreements between the parties that are special to the transaction and therefore are not specifically covered by a stock purchase, asset purchase, or merger agreement.

The most important aspect of this representation relates to enforceability of the agreement and Related Instruments, as this will directly affect the buyer's rights under these documents.

A similar issue arises here as was discussed in connection with Section 4.1. What damages would be recoverable by the buyer if the seller breached this representation? If the breach arises because the signatory to the document on behalf of the seller or the target did not have authority to bind that party, the buyer may have a cause of action against the signatory (if the signatory misrepresented his or her authority) or against the party on whose behalf the signatory executed the document (if such party knew of the misrepresentation, or if the acts of such party created the appearance of authority on the part of the signatory). In addition, the buyer faced with a seller or target who refuses to close the deal because the Agreement was not signed by an authorized agent may be able to force the seller or target to close the transaction if its acts created an appearance of authority, or if it ratified the Agreement after it was signed. Partial performance of the terms of the deal—application for regulatory approval, permitting continued due diligence investigation, or complying with representations requiring the consent of the buyer to certain actions by the target, for example—may provide convincing evidence of such ratification. In any event, the buyer would definitely have the right to refuse to close the transaction.

In a representation by the seller that an agreement is enforceable, the seller may request the inclusion of an exception for certain future events that are beyond its control. For example, a court applying bankruptcy laws or equitable principles may not honor the express terms of the documents if such terms are not in accordance with the principles of bankruptcy or equity. Although the seller may have a basis for arguing for the inclusion of this exception, it seems unfair for the buyer to bear this risk. If the documents prove to

be unenforceable in some respect against the seller, the buyer should be able, at least, to attempt to recover damages for this misrepresentation, rather than be forced to waive rights in the case of bankruptcy.

Section 4.3. Capitalization of Target and Subsidiaries.

(i) The authorized, issued and outstanding shares of the Target's capital stock consist of _____ shares of common stock, $ _____ par value per share, of which _____ shares are issued and outstanding [and any other shares, such as preferred stock] (the "Company Capital Stock"). The issued and outstanding shares of the Company Capital Stock are duly authorized, validly issued and fully paid and nonassessable and were not issued in violation of the preemptive rights of any person or of any agreement, law or regulation by which the issuer of such shares at the time of issuance was bound. The authorized, issued and outstanding equity capital of each Subsidiary is listed in Section 4.3(i) of the Disclosure Statement. The outstanding shares of, and the outstanding units of equity capital of, the Subsidiaries have been duly authorized, validly issued and are fully paid and non-assessable. Neither the Target nor any Subsidiary has issued any securities, or taken any action or omitted to take any action, giving rise to claims for violation of federal or state securities laws or the securities laws of any other jurisdiction.

(ii) Except as set forth in Section 4.3(ii) of the Disclosure Statement, at the date hereof there is no option, warrant, call, convertible security, arrangement, agreement or commitment of any character, whether oral or written, relating to any security of, or phantom security interest in, the Target or any Subsidiary, and there are no voting trusts or other agreements or understandings with respect to the voting of the capital stock of the Target or the equity capital of any Subsidiary.

A representation that requires that a seller set forth the capitalization of the target and its subsidiaries is rarely negotiated. Rather, discussions between the buyer and seller generally involve the factual circumstances surrounding the matter being represented. In order for a buyer to understand the effect of its purchase of the capital stock of the target (including the capital stock of the subsidiaries), it must be aware of the capital structure of the target and its subsidiaries.

Section 4.4. Title to Securities of Target and Subsidiaries.

(i) Except as set forth in Section 4.4(i) of the Disclosure Statement, the Seller has good and valid title to all of the issued and outstanding shares of the Company Capital Stock free and clear of all claims, liens, mortgages, charges, security interests, encumbrances and other restrictions or limitations of any kind whatsoever (other than pursuant to this Agreement). The Seller is

not party to, or bound by, any other agreement, instrument or understanding restricting the transfer of such shares.

(ii) Except as set forth in Section 4.4(ii) of the Disclosure Statement and other than pursuant to this Agreement, the issued and outstanding units of equity capital of each of the Subsidiaries are owned by the Persons listed as owner on Section 4.4(ii) of the Disclosure Statement, in each case free of preemptive rights and free and clear of all claims, liens, mortgages, charges, security interests, encumbrances and other restrictions or limitations of any kind whatsoever.

Generally, a buyer entering into an acquisition agreement is acquiring the entire company. Therefore, it is essential that the buyer know that it is purchasing all of the outstanding capital securities of the target, and that no one can challenge its ownership thereof after closing.

Section 4.5. Financial Statements and Projections.

(i) Seller has furnished to Buyer true and complete copies of the audited consolidated financial statements (including balance sheets, statements of income, statements of changes in stockholder's equity and statements of changes in financial position) of the Target and its Subsidiaries as of and for the years ended [fill in fiscal year-end for last five years] accompanied by the related opinions of the Target's official independent auditors as of such dates and for such periods (collectively, the "Financial Statements"). The Financial Statements, together with the notes thereto, fairly present the consolidated financial position of the Target and its Subsidiaries at the dates of, and the combined results of the operations and the changes in stockholders' equity and financial position for each of the Target and its Subsidiaries for the periods covered by, such Financial Statements in accordance with generally accepted accounting principles ("GAAP") consistently applied with prior periods except as indicated in the accompanying opinion of the official independent auditors. Seller has furnished to Buyer true and complete copies of the unaudited consolidated and consolidating balance sheets of the Target and its Subsidiaries as at [fill in the date of the most recent quarterly or fiscal period then ended] (the "Most Recent Balance Sheet") and the related consolidated and consolidating statements of income, statements of changes in stockholders' equity and statements of changes in financial position of the Target and its Subsidiaries as of and for the period then ended (collectively, the "Unaudited Financial Statements"). The Unaudited Financial Statements fairly present the financial position of the Target and its Subsidiaries at the date of, and the consolidated results of the operations and the changes in stockholders' equity and financial position for the Target and of its Subsidiaries for the period then ended. Such Unaudited Financial Statements have been prepared in accordance with GAAP consistently applied with prior periods, except that the Unaudited Financial Statements do not

contain any or all of the footnotes required by GAAP, are condensed and are subject to year-end adjustments consistent with prior practice.

(ii) Seller has delivered to Buyer true and correct copies of the projected balance sheets of the Target for the fiscal years ending [fill in appropriate information], and the related statements of projected earnings and projected cash flow for the periods then ended (the "Projected Financial Statements"). The Projected Financial Statements are reasonable and mathematically accurate, and the assumptions underlying such projections provide a reasonable basis for such projections. The factual data used to prepare the Projected Financial Statements are true and correct in all material respects.

Generally, the most important representation that a buyer must require of the seller is that the consolidated financial statements of the target fairly present the financial condition of the target in accordance with GAAP. Almost every other representation in an acquisition agreement is in some way related to the financial statements of the target. For example, representations relating to receivables, inventory, real property, and tangible and intangible assets and liabilities concern items that are included on the balance sheet of the target to the extent required by GAAP. Accordingly, although the financial statement representations are somewhat standard in their format, they are vital to the buyer because the buyer has based its entire investment decision on either the overall financial condition of the target or certain financial characteristics of the target such as operating performance or net assets. As a result, the financial statements are usually the basis for fixing the purchase price of the target. Although situations exist where financial statements are less vital to the buyer's investment decision (for example, in the purchase of a start-up company), such statements are usually of critical importance.

The financial statement representation is usually not the subject of intense negotiation. The most frequently negotiated aspects of this representation relate to the kind of financial statements to be included in this representation and the periods to be covered by such financial statements. For example, will the financial statements that are the subject of the representation include balance sheets, operating statements, statements of changes in financial position, and stockholders' equity? Will the seller warrant the accuracy of historical financial statements covering a five-year period? Another area of discussion may relate to specific problems in preparing the financial statements that require the buyer to grant certain exceptions from GAAP. This problem usually arises when the buyer is already aware of the target's accounting problems. However, exceptions

from GAAP can have the effect of diminishing the reliability of the financial statements. The determination whether the buyer is entitled to certain financial statements or should accept statements not prepared in accordance with GAAP depends on what information about the target was provided to the buyer prior to striking a deal with the seller, and what the buyer honestly relied on when it made its decision to purchase the target.

In many circumstances, the seller has provided the buyer with projected financial statements of the target. In such cases, if the buyer has relied on them, it is prudent for the buyer to have the seller warrant the reasonableness of the assumptions used in the preparation of the projected financial statements and the accuracy of the financial data underlying such projections. This representation is frequently negotiated and will certainly be more difficult to obtain from the seller than representations regarding the historical financial statements of the target. The reason for this is that projections, no matter how reasonable the assumptions that underlie them, are always the subject of hindsight. For example, a buyer might claim a breach of this representation if, one year after Closing, the target fails to meet its projections. The buyer would argue that the projections were obviously based upon unreasonable assumptions given the post-closing performance of the target. The decision whether or not this representation should be pursued is, like decisions related to historical financials, largely dependent on the degree of the buyer's reliance on these projections in its decision to buy the target. If the buyer is heavily relying on the projections, which may very well be the case if the target is a company that does not have a long operating history, then this representation should be vigorously pursued. In addition, this representation will commonly be found in loan agreements and lenders will be able to gain some additional comfort from the buyer's right of action back to the seller on this representation.

> ***Section 4.6. Absence of Undisclosed Liabilities.*** As of the date hereof and as of the Closing Date, except as and to the extent reflected, reserved against or otherwise disclosed on the Most Recent Balance Sheet or the notes thereto, or set forth in Section 4.6 of the Disclosure Statement, or otherwise properly disclosed in any other Section of the Disclosure Statement and except for those incurred in the ordinary course of business, the Target and its Subsidiaries did not have and do not have, any indebtedness or liability of any nature, whether accrued, absolute, contingent or otherwise, whether due or to become due, which is in excess of _____ Dollars ($_____).

The absence of undisclosed liabilities is by and large a representation that serves as a catch-all for any and all liabilities of the target and its

subsidiaries that were not reflected on the Most Recent Balance Sheet of the target or the notes thereto, or were not otherwise disclosed pursuant to any of the other representations in the acquisition agreement. A smart seller should never agree to this representation without some resistance. To begin with, why should the seller (after having made numerous representations about the target) now be asked to warrant something the buyer may have failed to ask the seller to disclose? The answer is one that relates to a shifting of risk. Who should bear the risk of the buyer's omission? There is no clear answer, except that if the seller has agreed to the concept that it will generally warrant that the Most Recent Balance Sheet includes all liabilities of any kind or nature, then this representation does little more than provide additional comfort for the buyer.

If the seller had not made that general warranty, the buyer should be aware that many liabilities need not be disclosed on a balance sheet of the target prepared in accordance with GAAP. For example, when the amount of a liability cannot be determined because of its nature, such as a lawsuit the outcome of which is uncertain, GAAP would not require its disclosure. (See Financial Accounting Standards Board Statement No. 5.) If the target is subject to off-balance-sheet liabilities, this representation provides the buyer with much more than an additional assurance.

Another aspect of this representation that may be difficult to negotiate with the seller is the period of time to be covered by the representation. A buyer often wants protection against material liabilities beyond the date of the Most Recent Balance Sheet. This may be a problem for the seller since it has no financial statements to rely on for that period. The seller may be able to supply a balance sheet that is current as of the closing. If this is not possible, and if the buyer fails to persuade the seller to warrant the period after the date of the Most Recent Balance Sheet, the buyer must rely on the covenants (operation of the business in the ordinary course; see Section 6.1 below) or the conditions (material adverse change; see Section 9.6 below) as its way of addressing undisclosed liabilities.

In light of the nature of this representation it would be overreaching not to incorporate an exclusion for minimal undisclosed liabilities. Accordingly, the form of representation set forth above contains a blank amount for such an exclusion. The dollar amount of this exclusion is negotiable and usually depends upon the size of the target and its subsidiaries. For example, in an acquisition of an extremely large company, the buyer would find it extremely difficult to justify an exclusion of only $1,000 for undisclosed liabilities.

Section 4.7. Accounts Receivable. Seller has delivered, or shall deliver at Closing, to Buyer a list of all accounts receivable of the Target and its Subsidiaries as at [fill in appropriate date] (the "Accounts Receivable") which list is true, correct and complete in all material respects and sets forth the aging of such Accounts Receivable. All Accounts Receivable of the Target and its Subsidiaries represent sales actually made or services actually performed in the ordinary and usual course of their business consistent with past practice. Since the date of the Most Recent Balance Sheet, (A) no event has occurred that would, under the practices of the Target or the Subsidiary in effect when the Most Recent Balance Sheet was prepared, require a material increase in the ratio of (I) the reserve for uncollectible accounts receivable to (II) the accounts receivable of the Target or the Subsidiary, and (B) there has been no material adverse change in the composition of such Accounts Receivable in terms of aging. There is no contest, claim or right of set-off contained in any written agreement with any account debtor relating to the amount or validity of any Account Receivable, or any other account receivable created after the date of the Most Recent Balance Sheet, other than accounts receivable which do not exceed, in the aggregate, the reserve for uncollected accounts. At the date of the Most Recent Balance Sheet, as of the date hereof and as of the Effective Time of the Merger, all accounts receivable of the Target and the Subsidiary, if any, were, are and will be, respectively, unless previously collected, valid and collectible and there is no contest, claim or right of set-off contained in any written agreement with any maker of an account receivable relating to the amount or validity of such account or any note evidencing the same.

In instances where the Most Recent Balance Sheet reflects a significant amount of receivables, the buyer should require this representation in order to get specific protection that the receivables of the target and its subsidiaries are collectible. A representation with respect to the receivables of the target is sometimes unnecessary depending upon the type of company that is being acquired. For example, if the company that is being acquired entered into a factoring arrangement with respect to all of its receivables, then this representation may be altogether unnecessary or to a great degree simplified. Conversely, the buyer purchasing assets may, in circumstances where the collectibility of the accounts is in doubt, require the seller to guarantee the buyer's ability to collect the receivables.

Section 4.8. Most Recent Inventory. The inventories of the Target and the Subsidiaries on a consolidated basis as reflected on the Most Recent Balance Sheet consist only of items in good condition and salable or usable in the ordinary course of business, except to the extent of the inventory reserve included on the Most Recent Balance Sheet, which reserve is adequate for such purpose. Such inventories are valued on the Most Recent Balance Sheet at the lower of cost or market in accordance with GAAP.

In the event that the company to be acquired is engaged in manufacturing or is otherwise involved in the distribution of goods whether retail or wholesale, it is extremely important for the buyer to have the seller make a specific representation with respect to the inventory of the target and its subsidiaries. A buyer needs to understand the relationship between the value of the inventory reflected on the Most Recent Balance Sheet and the condition of the inventory. Items that are or may become obsolete should be reserved against on the Most Recent Balance Sheet. In addition, it is important for the buyer to know whether the valuation of inventory on the financial statements reflects its actual value. Accordingly, the seller's representation that inventories are valued at the lower of cost or market in accordance with GAAP will assure the buyer that the inventories are valued in the most conservative fashion. In some cases, the buyer may include a representation that a particular dollar amount is the minimum value of the target's inventories. That type of representation is more common in an asset purchase.

> ***Section 4.9. Solvency.*** The Seller and each of the Target and its Subsidiaries is on the date hereof, and immediately prior to the Closing Date will be, Solvent. "Solvent" shall mean, in respect of an entity, that (i) the fair value of its property is in excess of the total amount of its debts and (ii) it is able to pay its debts as they mature.

Aside from the obvious pricing implications of acquiring an insolvent corporation, one of the primary purposes of obtaining a solvency representation from a seller regarding the target and its subsidiaries is that lenders providing acquisition debt often require such a representation from the buyer. Especially in leveraged buyouts, one of the principal concerns of lenders is the solvency of the leveraged company because transfers (for example, security interests granted to lenders) from insolvent companies are voidable as fraudulent conveyances. Although the leveraged surviving corporation may certainly be in a more precarious position than the target, this representation provides the initial base from which the buyer will attempt to satisfy its lenders on the solvency issue.

The solvency representation regarding the seller is intended to protect the buyer against the risk of acquiring the target and its subsidiaries in a transaction that could be characterized as a fraudulent conveyance by the seller. A buyer's decision to include the seller in the solvency representation must be based upon the financial condition of the seller, the extent to which the target and its subsidiaries constitute a substantial portion of the seller's assets and the seller's ability to pay its debts as they mature after the sale of the target and its subsidiaries.

> ***Section 4.10. Debt.*** Set forth in Section 4.10 of the Disclosure Statement is a list of all agreements for incurring of indebtedness for borrowed money and all agreements relating to industrial development bonds to which the Target is a party or grantor, which list is true and correct in all material respects. Except as set forth in Section 4.10 of the Disclosure Statement, none of the obligations pursuant to such agreements are subject to acceleration by reason of the consummation of the transactions contemplated hereby, nor would the execution of this Agreement or the consummation of the transactions contemplated hereby result in any default under such agreements.

This representation serves to break down the debt components of the Most Recent Balance Sheet that relate to debt for money borrowed. It also requires the seller to identify debt items that may be accelerated by reason of the consummation of the transactions contemplated by the Agreement. Because this representation has an information-gathering purpose, it is not usually negotiable.

> ***Section 4.11. Fairness Opinion.*** The Target has received an opinion of [name of independent and nationally recognized investment banker], dated the date hereof, addressed to the Target and has delivered a copy of such opinion to Buyer to the effect that, as of the date of the Agreement, the consideration per share to be received by the holders of the Target's Common Stock in the Merger is fair to the holders of the Target's Common Stock from a financial point of view. The Target believes that it is justified in relying upon such opinion.

The buyer should attempt to include this representation where the target has a significant number of stockholders or is a publicly traded company. The buyer should require the target to obtain a fairness opinion because, after consummation of the merger, the buyer will succeed to the target's liabilities, including liabilities that may result from stockholder suits against the target or its officers and directors alleging that the merger price was inadequate. Liabilities could result where stockholders have exercised dissenter's or appraisal rights and sued the target directly or have instituted a derivative suit against officers or directors who are indemnified by the target.

The last sentence of the representation regarding reliance is intended to elicit from the target any facts that might undermine the validity of the opinion, such as facts not disclosed to the investment bankers or knowledge of conflicts of interest that might tend to bias the opinion. Several factors make this reliance representation important. First, investment bankers typically require indemnification in connection with rendering fairness opinions, and the buyer will succeed to any liability of the target

to its investment bankers after the merger. Second, although a target might argue that the buyer is in a position to evaluate the reasonableness of the opinion based on the representations of the target in the Agreement and on its own financial investigation of the target, the buyer is not privy to all the circumstances involving the preparation and delivery of the fairness opinion. Consequently, the buyer should not be reticent about making inquiries into the fairness opinion process and the manner in which the target has attempted to satisfy itself that the opinion rendered is reasonable.

> ***Section 4.12. Product and Service Warranties and Reserves.*** Except as disclosed in Section 4.12 of the Disclosure Statement, the amount of any and all product warranty claims relating to sales occurring on or prior to the Most Recent Balance Sheet Date shall not exceed the amount of the product warranty reserve included on the Most Recent Balance Sheet which reserve was prepared in accordance with GAAP consistently applied and which the Target believes is adequate in light of any and all circumstances relating to its warranties of which it was aware and the amounts actually paid by it for product warranty claims. The only express warranties, written or oral, including without limitation, [insert warranty], with respect to the products or services sold by the Target and its Subsidiaries are as set forth in Section 4.12 of the Disclosure Statement.

One area that may expose a buyer to tremendous liability is product and service warranties made by the target or any subsidiary. A seller is required under GAAP to have "adequate" reserves on its balance sheet to cover such liabilities, but this standard is a very subjective one. Accordingly, a prudent buyer should have the seller specifically warrant the accuracy of this element of the Most Recent Balance Sheet. In addition, the buyer should be apprised of any and all of the warranties made and reserves held by the target so that the buyer can make its own determination of the adequacy of the target's reserves. In certain situations, a buyer may require specific representations setting forth the annual amount paid in satisfaction of claims under a particular product warranty. Gambling on the law of averages, the buyer may derive some degree of comfort.

> ***Section 4.13. Reserve for Public Liability and Property Damage Claims.*** The amount of the public liability, property damage and personal injury reserve included on the Most Recent Balance Sheet was prepared in accordance with GAAP consistently applied and the Target reasonably believes such reserve is adequate.

A buyer may be concerned about this type of liability if it is foreseeable that the target or a subsidiary could have exposure above and beyond the limits of its insurance policies. Similar to the product warranty reserve

discussed in Section 4.12 above, the adequacy of this reserve is a subjective judgment.

> ***Section 4.14. Insurance.*** Set forth in Section 4.14 of the Disclosure Statement is a complete and correct schedule of all currently effective insurance policies or binders of insurance or programs of self-insurance which relate to the Target and its Subsidiaries, which insurance is with financially sound and reputable insurance companies, against such casualties, risks and contingencies, and in such types and amounts, as are consistent with customary practices and standards of companies engaged in businesses similar to the Target and its Subsidiaries. The coverage under each such policy and binder is in full force and effect, and no notice of cancellation or nonrenewal with respect to, or disallowance of any claim under, or material increase of premium for, any such policy or binder has been received by the Target or its Subsidiaries, nor to the Seller. Neither the Target, the Seller nor the Subsidiaries has knowledge of any facts or the occurrence of any event which (i) reasonably might form the basis of any claim against the Target or the Subsidiaries relating to the conduct or operations of the business of the Target or the Subsidiaries or any of the assets or properties covered by any of the policies or binders set forth in Section 4.14 of the Disclosure Statement and which will materially increase the insurance premiums payable under any such policy or binder, or (ii) otherwise will materially increase the insurance premiums payable under such policy or binder.

A representation with respect to the insurance policies of the target is important to the buyer in order to safeguard the assets it is buying against a variety of damage claims. Since the buyer may be unaware of what type of insurance should be carried by the target, the seller should warrant that the target has all of the insurance that is customary for the business of the target and its subsidiaries. The seller will not usually quarrel about this part of the representation; what troubles the seller most is the buyer's desire for assurances that the premiums for such insurance will not increase dramatically because of an event or claim that the seller may be aware of. How can the seller be certain what events will increase the premiums? In a clear case—where the seller has recently become aware that its product is carcinogenic, for example—the seller should be aware that its insurance premiums will obviously increase dramatically when this fact comes to the attention of its insurance companies. The buyer should also investigate whether such policies will survive after the acquisition since many policies lapse on a change of control of the target or, in some cases, a buyer may be prudent to include a representation by the seller stating that such policies will survive after the acquisition.

A second important consideration is whether the insurance policies are "claims made" or "claims incurred" policies. The difference between

these types of policies is that a "claims made" policy covers only those claims that are made to the insurance company while the policy was in full force and effect, whereas a "claims incurred" policy covers all claims made at any time, provided that the events giving rise to a liability occurred during the time the policy was in full force and effect.

Lastly, if insurance is an important aspect of the business and a certain portion of the insurance consists of self-insurance, the buyer should factor this in when analyzing the cost of running the business. In the event the buyer wishes to continue to self-insure, the buyer should require the seller's cooperation in obtaining any regulatory approvals necessary to continue to self-insure the operations of the target.

> ***Section 4.15. Real Property Owned or Leased.*** Section 4.15 of the Disclosure Statement sets forth a complete and accurate list or description of all real property (including a general description of fixtures located at such property and specific identification of any such fixtures not owned by the Target or any Subsidiary) which the Target or any Subsidiary owns or leases, has agreed (or has an option) to purchase, sell or lease, or may be obligated to purchase, sell or lease and any title insurance or guarantee policies with respect thereto, specifying in the case of leases, the name of the lessor, licensor or other grantor, the approximate square footage covered thereunder, the basic annual rental and other amounts paid or payable with respect thereto and a summary of the other terms thereof. True copies of all such leases for real property with aggregate annual rental payments (excluding payments to third parties on account of real estate taxes (or increases therein), insurance, operating costs, or common area expenses), individually in excess of _____ Dollars ($_____) (including all amendments thereof and modifications thereto) have been delivered to Buyer prior to the date hereof. Except as set forth in Section 4.15 of the Disclosure Statement, no consent to the consummation of the transactions contemplated by this Agreement is required from the lessor of any such real property.

The scheduling of real property serves to support the buyer's due diligence efforts by identifying each property owned or leased by the target or any subsidiary. In requesting disclosure of leases, consideration should be given to the dollar threshold in annual rental payments that identifies a lease that the target must disclose. For smaller targets, it may be appropriate to include no threshold at all, requiring the disclosure of all leases of real property.

This representation is also designed to elicit disclosure of both (i) obligations for periodic payments or capital commitments that have been incurred by the target or any subsidiary, and (ii) those leases where landlord consents may be required to avoid lease terminations by virtue of the

acquisition. Rental commitments and agreements to purchase will have an impact on the cash flow requirements of the target but may not have been apparent to the buyer from a review of the target's financial statements.

The buyer should require the annual lease payment information in order to prepare a cash flow analysis. In addition, this disclosure will aid a buyer who is trying to determine the financeability of the target's and subsidiaries' real estate and the necessity of obtaining appraisals of the real estate to assist its financing efforts.

Section 4.16 Fixed Assets; Leased Assets.

(i) Section 4.16(i) of the Disclosure Statement sets forth a complete and accurate list or description of all equipment, machinery and other items of tangible personal property which the Target or any Subsidiary owns or leases, has agreed (or has an option) to purchase, sell or lease, or may be obligated to purchase, sell or lease having a book value of _____ Dollars ($_____) or more or requiring annual rental payments in excess of _____ Dollars ($ _____), specifying in the case of leases, the name of the lessor, licensor or other grantor, the description of the property covered thereby, the basic annual rental and other amounts paid or payable with respect thereto and a summary of the other terms thereof. True copies of all leases for such assets with aggregate rental payments individually in excess of _____ Dollars ($ _____) (including all amendments thereto and modifications thereof) have been delivered to Buyer prior to the date hereof. The book value of all such assets owned or leased by the Target and its Subsidiaries not included on such list does not, in the aggregate, exceed _____ Dollars ($ _____) at the date hereof.

(ii) Except as set forth in Section 4.16(ii) of the Disclosure Statement, no consent to the consummation of the transactions contemplated by this Agreement is required from the lessor, licensor or other grantor of any such tangible personal property.

As with the representation relating to real estate in Section 4.15, this representation elicits disclosure of each item of tangible personal property owned or leased by the target or any subsidiary that has a value or annual cost in excess of a given dollar threshold. Unlike the real property representation, where the buyer may reasonably request and be interested in information on each piece of real property owned by the target or any subsidiary, requesting disclosure of every item of tangible personal property absent a dollar threshold would impose an unreasonable burden on the seller and would subject the seller to the risk of misrepresentation in the event an asset were inadvertently omitted.

This risk will motivate the seller to negotiate for a higher dollar threshold. A buyer may determine that it can live with a dollar threshold on

the book value of owned assets but must require a lower amount in respect of lease obligations since the latter will have a direct impact on cash flow projections. The buyer, in any event, should base its threshold on the individual value of assets that it deems relevant to any financing that may be necessary for it to finance the purchase price.

Section 4.17. Title and Related Matters.

(i) Subject to the exceptions contained in the second sentence of this Section 4.17, the Target or a Subsidiary has, and immediately after giving effect to the transactions contemplated hereby will have, good and marketable title (or, in jurisdictions where title insurance policies insuring good and marketable title are not available, good and indefeasible title, or good and merchantable title or some quality of title substantially equivalent thereto) to or a valid leasehold interest in (a) all of the properties and assets reflected in the Most Recent Balance Sheet or acquired after the date of the appropriate Most Recent Balance Sheet by the Target or a Subsidiary, (b) all properties or assets which are subject to operating leases as defined in Financial Accounting Standards Board Statement No. 13 and are not reflected in the Most Recent Balance Sheet, and (c) all other properties and assets owned or utilized by the Target or any Subsidiary in the conduct of their respective businesses. All properties and assets referred to in the preceding sentence are presently owned or held by the Target or a Subsidiary, and at and immediately after the Closing Date, will be held by the Target or a Subsidiary, free and clear of all title defects or objections, mortgages, liens, pledges, charges, security interests, options to purchase or other encumbrances of any kind or character, except: (v) liens for current taxes not yet due and payable; (w) liens, imperfections of title and easements which do not, either individually or in the aggregate, materially detract from the value of, or interfere with the present use of, the properties subject thereto or affected thereby, or otherwise materially impair the operations of the entity which owns, leases or utilizes such property or materially impair the use of such property by such entity; (x) mortgages and liens securing debt which is reflected as a liability on the Most Recent Balance Sheet; (y) mechanics', carriers', workmen's, repairmen's and other similar liens arising or incurred in the ordinary course of business; and (z) as set forth in Section 4.17(i) of the Disclosure Statement.

(ii) All the plants, structures, facilities, machinery, equipment, automobiles, trucks, tools and other properties and assets owned or leased by the Target and the Subsidiaries, including but not limited to such as are reflected in the Most Recent Balance Sheet or acquired after the respective dates of the Most Recent Balance Sheet by the Target or a Subsidiary are structurally sound with no defects known to Seller and in good operating condition and repair (except for routine immaterial maintenance in the ordinary course of business) and usable in a manner consistent with their current use.

(iii) All leases pursuant to which the Target and the Subsidiaries lease (as

lessee) real and/or personal property are valid and enforceable by the Target or a Subsidiary in accordance with their respective terms; other than with respect to property which has been sublet by the Target or the Subsidiaries as noted on Section 4.17(iii) of the Disclosure Statement, the Target or a Subsidiary has been in peaceable possession since the commencement of the original term of each such lease; except for the tenancies in respect of property being sublet, as specified in the second clause of this sentence, there are no tenancies or other possessory interests with respect to any real or personal property owned by the Target or any Subsidiary; all rents due under, or other amounts required to be paid by the terms of, each such lease have been paid; and there is not under any of such leases, to Seller's knowledge, any default (or event which, with the giving of notice, the passage of time or both, would constitute a default), waiver or postponement of any of the Target's or any Subsidiary's obligations thereunder.

(iv) Except as stated in Section 4.17(iv) of the Disclosure Statement, none of the real property owned or leased by the Target or any Subsidiary is subject to any governmental decree or order to be sold and there is no condemnation or eminent domain proceeding pending, or, to the best of Seller's knowledge, threatened, against any real property owned or leased by the Target or any Subsidiary or any part thereof, and neither Target nor any Subsidiary has made a commitment or received any notice, oral or written, of the desire of any public authority or any entity to take or use the real property owned or leased by the Target or any Subsidiary or any part thereof, whether temporarily or permanently, for easements, rights-of-way, or other public or quasi-public purposes, or for any other purpose whatsoever, nor is there any proceeding pending, or threatened in writing or by publication, or, to the best knowledge of the Seller, threatened, which could adversely affect, as to any portion of any parcel of the real property owned or leased by the Target or any Subsidiary, the zoning classification in effect on the date hereof. On the Closing Date, the real property owned or leased by the Target and its Subsidiaries shall be free and clear of any management, leasing, maintenance, security or service obligations other than utilities and except those incurred in the ordinary course of business.

(v) All rights-of-way, easements, licenses, permits and authorizations in any manner related to the location or operation of the business of the Target and the Subsidiaries are in good standing, valid and enforceable in all material respects in accordance with their respective terms. Except as stated in Section 4.17(v) of the Disclosure Statement, neither the Target nor any Subsidiary is in violation of any, and each has complied with all, applicable zoning, building or other codes, statutes, regulations, ordinances, notices and orders of any governmental agency with respect to the occupancy, use, maintenance, condition and operation of the real property owned or leased by the Target and its Subsidiaries or any material portion of any parcel thereof, and the use of any improvements for all purposes for which the real property owned or leased by the Target and its Subsidiaries is being used on the date hereof will not violate any

> such code, statute, regulation, ordinance, notice or order. The Target and the Subsidiaries possess and shall maintain in effect all licenses, certificates of occupancy, permits and authorizations required to operate and maintain the real property owned or leased by the Target and its Subsidiaries for all uses for which the real property owned or leased by the Target and its Subsidiaries is operated on the date hereof. Except as stated in Section 4.17(v) of the Disclosure Statement, no equipment installed or located in any part of the real property owned or leased by the Target and its Subsidiaries violates any law, ordinance, order, regulation or requirement of any governmental authority which violation would have an adverse effect on the real property owned or leased by the Target or any Subsidiary or any portion of any parcel thereof.

Title to the property owned by the target and its subsidiaries is important for the purpose of verifying the value and financeability of the assets acquired. It is useful to include within the scope of the title representations assets leased under operating leases as these assets will generally not be disclosed on a balance sheet and may represent significant value if the target's rental payments are below market rates, especially if the target's leasehold interest is mortgageable.

An acquisition lender advancing funds on a secured basis will require the buyer to make extensive representations regarding the quality of its title to the assets securing the loan. The buyer should therefore attempt to obtain as much comfort on the existence of liens and encumbrances from the seller as possible. Not only is it important to elicit in the Disclosure Statement all liens that might have an impact on the buyer's ability to obtain sufficient financing, but the buyer must also carefully review the liens disclosed and assess the degree to which the liens impair financeability of the assets of the target and its subsidiaries. Close scrutiny may reveal the existence of liens that limit marketability and prevent the buyer from providing its lender with a first priority security interest. Once these liens have been identified, the buyer may wish to require as its condition to closing that certain liens be discharged.

As an alternative to having the seller schedule existing liens (as is the approach in the second sentence of paragraph (i)), the buyer could permit an exception for "liens, imperfections of title and easements which do not, either individually or in the aggregate, materially detract from the value of, or interfere with the present value of, the properties subject thereto or affected thereby, or otherwise materially impair the operations of the entity which owns, leases or utilizes such property or materially impair the use of such property by such entity." In addition, the materiality standard might be made more definite by referring to a lien or imposition in excess of a

specified dollar amount. However, although a materiality exception may provide sufficient protection to the buyer vis-à-vis the seller, a lender may find it unacceptable. The buyer employing the exception must be willing to take on the risk that a lender may, through certain loan representations and covenants, require the discharge of liens that are not material to either the seller or the buyer.

The representations in paragraphs (ii) and (iii) are intended to assure the buyer that the assets to be acquired are in good operating condition and that the target's and subsidiaries' leases are enforceable and not in default.

Paragraphs (iv) and (v) attempt to verify that no violations or proceedings exist that might prevent the buyer from using the real estate acquired as it had been used in the past by the target and the subsidiaries. The seller may seek to limit the statement about existing violations by imposing a materiality standard. A buyer might well concede this point; a useful compromise position might be to require the representation that any violation would not result in an award of damages, or require expenditures to remedy the violation, in excess of a specified dollar amount.

Section 4.18. Intellectual Property.

(i) Section 4.18(i) of the Disclosure Statement sets forth a complete and accurate list, including, where applicable, the date of registration or expiration, serial or registration number or patent number, of all United States (including the individual states and territories of the United States) and foreign registered trademarks, service marks and trade names; unregistered trademarks, service marks and trade names; trademark, service mark and trade name applications; product designations; designs; unexpired patents; pending and filed patent applications; current and active invention disclosures; inventions on which disclosures are to be prepared; trade secrets; registered copyrights; and unregistered copyrights (collectively, the "Intellectual Property"), which the Target or any Subsidiary owns or licenses, has agreed (or has an option) to purchase, sell or license, or may be obligated to purchase, sell or license. With respect to each of the foregoing items, there is listed on Section 4.18(i) of the Disclosure Statement (a) the extent of the interest of the Target and its Subsidiaries therein; (b) the jurisdictions in or by which each such patent, trademark, service mark, trade name, copyright and license has been registered, filed or issued; (c) each agreement and all other documents evidencing the interest of the Target and its Subsidiaries therein, including, but not limited to, license agreements; (d) the extent of the interest of any third party therein, including, but not limited to, any security interest or licenses; and (e) each agreement and all other documents evidencing the interest of any third party therein.

(ii) Except as set forth in Section 4.18(ii) of the Disclosure Statement, the right, title or interest of the Target and its Subsidiaries in each item of Intellectual Property is free and clear of material adverse Liens.

(iii) Except as set forth in Section 4.18(iii) of the Disclosure Statement, the Target and its Subsidiaries have all right, title and interest in all inventions, trade secrets, proprietary information and have all other intellectual property rights necessary in any material respect for the non-infringing manufacture, use or sale, as the case may be, of all of the products, components of products and services which the Target or any Subsidiary manufactures, uses or sells in their business as currently conducted or which the Target or any Subsidiary contemplated manufacturing, using or selling in connection with the preparation of the Projected Financial Statements.

(iv) Except as set forth in Section 4.18(iv) of the Disclosure Statement, the Target and its Subsidiaries have all right, title and interest in all trademarks, service marks, trade names and product designations necessary for the non-infringing use of all such marks and trade names which the Target or any Subsidiary uses in their business as currently conducted or which the Target or any Subsidiary contemplated using in connection with the preparation of the Projected Financial Statements.

(v) Except as set forth in Section 4.18(v) of the Disclosure Statement, the Target and its Subsidiaries have all right, title and interest in all material copyrights necessary for the non-infringing publication, reproduction, preparation of derivative works, distribution, public performance, public display and importation of all copyrighted works which the Target or any Subsidiary in their business as currently conducted or as contemplated in connection with the preparation of the Projected Financial Statements, publishes, reproduces, prepares or has prepared a derivative of, distributes, publicly performs, publicly displays or imports.

(vi) Except as set forth in Section 4.18(vi) of the Disclosure Statement, neither the Target nor any of the Subsidiaries has, whether directly, contributorily or by inducement, within any time period as to which liability of the Target or the Subsidiaries is not barred by statute, infringed any patent, trademark, service mark, trade name or copyright or misappropriated any intellectual property of another, or received from another any notice, charge, claim or other assertion in respect thereto or committed any actions of unfair competition.

(vii) Except as set forth in Section 4.18(vii) of the Disclosure Statement, neither the Target nor any of the Subsidiaries has sent or otherwise communicated to another person any notice, charge, claim or other assertion of, or has any knowledge of, present, impending or threatened patent, trademark, service mark, trade name or copyright infringement by such other person, or misappropriation of any intellectual property of the Target or any of the Subsidiaries by such other person or any acts of unfair competition by such other person.

(viii) No product, license, patent, process, method, substance, design, part or other material presently being sold or contemplated to be sold or employed by the Target or any Subsidiary infringes on any rights owned or held by any other person; (b) no claim, litigation or other proceeding is pending or threatened against the Target or any Subsidiary contesting the right of such entity to

sell or use any such product, license, patent, process, method, substance, design, part or other material and no such claim is impliedly threatened by an offer to license from a third party under a claim of use; and (c) no patent, formulation, invention, device, application or principle nor any statute, law, rule, regulation, standard or code, exists or is pending or proposed that would have a Material Adverse Effect.

(ix) No filing or recording fees, stamp or transfer taxes or other fees, costs or taxes of any kind are payable by the Target or any Subsidiary in respect of the Intellectual Property and no such filing or recording fees, stamp taxes or other fees, costs or taxes of any kind will be payable by the Target, any Subsidiary or Buyer in connection with the Merger except as set forth in Section 4.18(ix) of the Disclosure Statement.

The intellectual property representation requires the disclosure of all intellectual property that the target or any subsidiary uses in its business and is designed to assure the buyer that the intellectual property, or the target's or its subsidiaries' use thereof, does not infringe upon the rights of third parties. The representation has been drafted to cover any intellectual property rights that may exist or are pending that would adversely affect the target or its subsidiaries. This representation may be extremely important if, for example, the value of the target's business is largely dependent upon its possession of a particular patent or its ability to market its product under a particular trademark.

Subparagraph (ix) is intended to elicit information as to filing or transfer fees that might be incurred in connection with the transaction. Where the target and its subsidiaries have extensive foreign intellectual property holdings, these fees can be of sufficient magnitude that the buyer may desire to attempt to obligate the seller to pay a portion of these costs.

Section 4.19. Assets Necessary to the Business. Except as set forth in Section 4.19 of the Disclosure Statement, the Target and the Subsidiaries collectively own or lease, directly or indirectly, all of the assets and properties, and are parties to all licenses and other agreements, in each case which are presently being used or are reasonably necessary to carry on the businesses and operations of the Target and the Subsidiaries as presently conducted, and none of the stockholders of the Target, the Seller nor any of their affiliates (other than any of the Target and the Subsidiary) owns any assets or properties which are being used to carry on the business or operations of the Target and the Subsidiaries as presently conducted.

Notwithstanding all of the other representations made by the seller about the specific assets, liabilities, and other agreements, rights, and

obligations that the target and its subsidiaries may have, a buyer has no way of knowing that it is getting everything that it needs to operate the business of the target and its subsidiaries as presently conducted without this broad representation. This type of representation is critical if the buyer is purchasing a company by means of an asset acquisition or a business that has been operated as a division of another company. If, for example, certain equipment or services necessary to the business of the target or its subsidiaries were provided by the seller or its affiliates, the buyer would be unable to operate the business without replacing such equipment or services, most likely at a cost that far exceeds the cost at which they were provided by the seller or its affiliates.

Section 4.20. Additional Contracts. In addition to the other items set forth in the Disclosure Statement attached hereto pursuant to the other provisions of this Agreement, Section 4.20 of the Disclosure Statement identifies as of the date hereof the following:

(i) each agreement to which the Target or any Subsidiary is a party which involves or may involve aggregate annual future payments (whether in payment of a debt, as a result of a guarantee or indemnification, for goods or services, or otherwise) by the Target or any Subsidiary of _____ Dollars ($ _____) or more;

(ii) each outstanding commitment of the Target or any Subsidiary to make capital expenditures, capital additions or capital improvements in excess of _____ Dollars ($ _____);

(iii) any contract for the employment of any officer or employee or former officer or employee of the Target or any Subsidiary (other than, with respect to any employee, contracts which are terminable without liability upon notice of 30 days or less and do not provide for any further payments following such termination) pursuant to which payments in excess of _____ Dollars ($ _____) may be required to be made at any time following the date hereof;

(iv) any stock option or stock appreciation rights plan or arrangement of the Target or any Subsidiary;

(v) any mortgage or other form of secured indebtedness of the Target or any Subsidiary;

(vi) any unsecured debentures, notes or installment obligations of the Target or any Subsidiary, the unpaid balance of which exceeds _____ Dollars ($ _____) in the aggregate except trade payables incurred in the ordinary course of business;

(vii) any guaranty of any obligation of the Target or any Subsidiary for borrowings or otherwise, excluding endorsements made for collection, guaranties made or letters of credit given in the ordinary course of business, and other

guaranties which in the aggregate do not exceed _____ Dollars ($ _____);

(viii) any agreement of the Target or any Subsidiary, including options, for the purchase, sale, disposition or lease of any of its assets (other than inventory) having a book value of more than _____ Dollars ($ _____) for any single asset or _____ Dollars ($ _____) in the aggregate or for the sale of inventory other than in the ordinary course of business;

(ix) any contract to which the Target or any Subsidiary is a party pursuant to which the Target or any Subsidiary is or may be obligated to make payments, contingent or otherwise, exceeding _____ Dollars ($_____) in the aggregate, on account of or arising out of the prior acquisition of businesses, or all or substantially all of the assets or stock, of other companies or any division thereof;

(x) any contract with any labor union of which the Target or any Subsidiary is a party;

(xi) any contract or proposed contract, including but not limited to assignments, licenses, transfers of exclusive rights, "work for hire" agreements, special commissions, employment contracts, purchase orders, sales orders, mortgages and security agreements, to which the Target or any Subsidiary is a party and which (A) contains a grant or other transfer, whether present, retroactive, prospective or contingent, by the Target or any Subsidiary, of any rights in any invention, trade secret, proprietary information, trademark, service mark, trade name, copyright or other intellectual property by whatever name designated, without regard to whether such invention, trade secret, proprietary information, trademark, service mark, trade name, copyright, material object or other intellectual property was in existence at the time such contract was made, or (B) contains a promise made by the Target or by any Subsidiary to pay any lump sum or royalty or other payment or consideration in respect to the acquisition, practice or use of any rights in any invention, trade secret, proprietary information, trademark, service mark, trade name, copyright, material object in which an original work of authorship was first fixed or other intellectual property by whatever name designated and without regard to whether such lump sum, royalty payment or other consideration was ever made or received;

(xii) any contract with the Seller or any officer, director or employee of the Target or any Subsidiary of the Seller (A) involving at least _____ Dollars ($ _____) in aggregate payments over the entire term thereof or more than $_____ Dollars in any 12-month period or (B) the terms of which are not arms-length; or

(xiii) any other contract, agreement or other instrument which the Target or any Subsidiary is a party not entered into in the ordinary course of business which is material to the financial, business, earnings, prospects or condition of the Target or the Subsidiaries and not excluded by reason of the provisions of clauses (i) through (xii), inclusive, of this subsection.

Except as otherwise agreed to by the parties as set forth in Section 4.20 of the Disclosure Statement, true and complete copies of all contracts, agreements and other instruments referred to in Section 4.20 of the Disclosure Statement have heretofore been delivered, or will be delivered at least ten business days prior to Closing, to Buyer by the Seller. All such contracts, agreements and other instruments are enforceable by the Target or the Subsidiaries which is (are) a party thereto in accordance with their terms except as to enforceability thereof may be affected by applicable bankruptcy, reorganization, insolvency, moratorium or other similar laws now or hereafter in effect, or by general equity principles.

This is an information-gathering representation that is designed to identify all the important contractual relationships of the target and its subsidiaries. Depending upon the type of deal being negotiated, a seller may be reluctant to make this representation because of the inordinate amount of work required to satisfy the disclosure obligation. The seller may instead tell the buyer that it is welcome to review all the contracts and other agreements at the offices of the seller. However, like any other representation that is founded on access as opposed to identification, the buyer takes responsibility at its own peril. Therefore, a prudent buyer will demand that the seller identify all such documents and, if need be, offer to assist in the seller's preparation of the Disclosure Statement.

The amount of the dollar thresholds in this representation are deal-specific and the same considerations previously discussed are appropriate here.

Section 4.21. Customers and Suppliers. Section 4.21 of the Disclosure Statement sets forth (i) a true and correct list of (A) the ten largest customers of the Target and each of the Subsidiaries in terms of sales during the fiscal year ended [fill in date of most recent fiscal year end] and (B) the ten largest customers of the Target and each of the Subsidiaries in terms of sales during the three (3) months ended [fill in the most recent quarter end], showing the approximate total sales to each such customer during the fiscal year ended [fill in date of most recent fiscal year end] and the three (3) months ended [fill in most recent quarter end]; (ii) a true and correct list of (A) the ten largest suppliers of the Target and each of the Subsidiaries in terms of purchases during the fiscal year ended [fill in date of most recent fiscal year end], and (B) the ten largest suppliers of the Target and each of the Subsidiaries on a consolidated basis in terms of purchases during the three (3) months ended [fill in most recent quarter end], showing the approximate total purchases from each such supplier during the fiscal year ended [fill in date of most recent fiscal year end], and the three (3) months ended [fill in most recent quarter end], respectively. Except to the extent set forth in Section 4.21 of the Disclosure Statement, there has not

been any material adverse change in the business relationship of the Target or any Subsidiary with any customer or supplier named in the Disclosure Statement. Except for the customers and suppliers named in Section 4.21 of the Disclosure Statement, neither the Target nor any Subsidiary had any customer who accounted for more than 5 of its sales during the period from [insert appropriate period of 12 to 18 months prior to date of Agreement], or any supplier from whom it purchased more than 5 of the goods or services purchased by it during such period.

Depending upon the nature of the target's and the subsidiaries' businesses, the buyer may agree to require disclosure of the largest customers and suppliers on "a consolidated basis." The principal reason for this representation is to identify the dependence of the business on a single or small group of customers or suppliers.

Section 4.22. Competing Lines of Business. Except as set forth in Section 4.22 of the Disclosure Statement, no affiliate of the Seller owns, directly or indirectly, any interest in (excepting not more than 5 stockholdings for investment purposes in securities of publicly held and traded companies), or is an officer, director, employee or consultant of, or otherwise receives remuneration from, any person which is, or is engaged in business as, a competitor, lessor, lessee, customer or supplier of the Target or any Subsidiary.

In certain situations, it may appear unnecessary to require a seller to enter into some sort of noncompete agreement because of the nature of the seller's business. However, it still may be useful for the buyer to assure itself that there are no hidden companies that the seller operates or controls that compete with the target or a subsidiary. The protection afforded by this representation is limited; the seller may be able to adversely affect the business of the target or a subsidiary in light of the seller's inside knowledge or simply because it has greater resources. The buyer should be forewarned that, despite its receipt of this representation, a seller may remain a competitor given the practicalities of a particular situation.

Section 4.23. Restrictive Covenants. Except as set forth in Section 4.23 of the Disclosure Statement, neither Target nor any Subsidiary is a party to any agreement, contract or covenant limiting the freedom of the Target or any Subsidiary from competing in any line of business or with any person or other entity in any geographic area.

A buyer must be aware of agreements that constrain the operation of the target and its subsidiaries. Many buyers purchase targets with the expectation that the business of the target can be expanded geographically. In some cases, the buyer may be relying on this expectation to the point of

including such expansion in its projections. Therefore, the buyer should carefully review any agreements that are disclosed as a result of this representation.

Section 4.24. Books and Records.

(i) The books of account and other financial records of the Target and its Subsidiaries are in all material respects complete and correct, and have been maintained in accordance with good business practices.

(ii) The minute books of the Target and its Subsidiaries, as previously made available to the Buyer and its counsel, contain accurate records of all meetings and accurately reflect all other material corporate action of the stockholders and directors and any committees of the Board of Directors of the Target and its Subsidiaries.

(iii) The Buyer has been or will be prior to the Closing Date, afforded access to all such records referred to in subparagraphs (i) and (ii) above.

Section 4.25. Bank Accounts. Section 4.25 of the Disclosure Statement contains a true and correct list of the names of each bank, savings and loan or other financial institution, in which the Target or its Subsidiaries has an account, including cash contribution accounts, or safe deposit boxes, and the names of all persons authorized to draw thereon or to have access thereto.

Sections 4.24 and 4.25 above are representations that confirm the accuracy of information usually furnished to the buyer in connection with its due diligence efforts.

Section 4.26. Employee Benefit Plans; Labor Relations.

(i) The term "Employee Plan" shall mean any pension, retirement, profit-sharing, deferred compensation, bonus or other incentive plan, any medical, vision, dental or other health plan, any life insurance plan, or any other employee benefit plan, including, without limitation, any "employee benefit plan" as defined in Section 3(3) of the Employee Retirement Income Security Act of 1974, as amended ("ERISA") and any employee benefit plan covering any employees of the Target or any Controlled Entity in any foreign country or territory (a "Foreign Plan"), to which the Target or any Controlled Entity contributes or is a party or is bound and under which employees of the Target or any Controlled Entity are eligible to participate or derive a benefit, except any government-sponsored program or government-required benefit. Section 4.26(i) of the Disclosure Statement lists each Employee Plan and identifies each Employee Plan (other than a Foreign Plan) which, as of the date hereof, is a defined benefit plan as defined in Section 3(35) of ERISA (a "Defined Benefit Plan") or is a multi-employer plan within the meaning of Section 3(37) of ERISA (a "Multi-Employer Plan"). In the case of each Defined Benefit Plan, the unfunded accrued liabilities of such plan as of [insert date], determined on

an ongoing plan basis by the actuaries for such plan using the actuarial methods and assumptions used in the latest actuarial valuation of the plan, do not exceed the assets of the plan. Section 4.26(i) of the Disclosure Statement identifies each of the Employee Plans which purports to be a qualified plan under Section 401(a) of the Code (as defined below). In the case of each Multi-Employer Plan, Section 4.26(i) of the Disclosure Statement sets forth the Target or Controlled Entity contributions made to such Plan for the 12 months ended on the last day of its most recent fiscal year. In the case of each Foreign Plan, Section 4.26(i) of the Disclosure Statement sets forth the Target or Controlled Entity contributions made to such Plan for the last plan year ending prior to the date of this Agreement. The Target has delivered, or will deliver prior to the Closing, to Buyer the following documents as in effect on the date hereof: (a) true, correct and complete copies of any Employee Plan, other than a Foreign Plan, including all amendments thereto, which is an employee pension benefit or welfare benefit plan (within the meaning of Sections 3(1) or 3(2) of ERISA), and, in the case of any unwritten Employee Plans, descriptions thereof, (b) with respect to any plans or plan amendments described in the foregoing clause (a), (1) the most recent determination letter issued by the Internal Revenue Service (the "IRS") after September 1, 1974, if any, (2) all trust agreements or other funding agreements, including insurance contracts, (3) with respect to each Defined Benefit Plan, all notices of intent to terminate any such Employee Plan and all notices of reportable events with respect to any such Employee Plan as to which the PBGC has not waived the thirty (30) day notice requirement, (4) the most recent actuarial valuations, annual reports, summary plan descriptions, summaries of material modifications and summary annual reports, if any, and (5) a true, correct and complete summary of the benefits provided under each Foreign Plan, together with the most recent actuarial valuation of financial information relative thereto.

(ii) As of the date hereof:

(a) Each of the Employee Plans that purports to be qualified under Section 401(a) of the Internal Revenue Code, as amended (the "Code") is qualified as of the Closing Date and any trusts under such plans are exempt from income tax under Section 501(a) of the Code. The retroactive cure period with respect to any plan amendments not yet submitted to the IRS has not expired. The Employee Plans each comply in all material respects with all other applicable laws (including, without limitation, ERISA, the Age Discrimination in Employment Act, the Americans with Disabilities Act, the Family Leave Act, and the Tax Increase Prevention and Reconciliation Act of 2005) of the United States and any applicable collective bargaining agreement. Other than claims for benefits submitted by participants or beneficiaries or appeals from denial thereof, there is no litigation, legal action, suit, investigation, claim, counterclaim or proceeding pending or threatened against any Employee Plan.

(b) With respect to any Employee Plan, no prohibited transaction (within the meaning of Section 406 of ERISA and/or Section 4975 of the Code) exists which could subject the Target or any Controlled Entity to any material liability or civil penalty assessed pursuant to Section 502(i) of ERISA or a material tax imposed by Section 4975 of the Code. Neither the Seller nor the Target, nor any Controlled Entity, nor any administrator or fiduciary of any Employee Plan (or agent of any of the foregoing) has engaged in any transaction or acted or failed to act in a manner which is likely to subject the Target or any Controlled Entity to any liability for a breach of fiduciary or other duty under ERISA or any other applicable United States law. The transactions contemplated by this Agreement and the Related Instruments will not be, or cause any, prohibited action.

(c) No Defined Benefit Plan has been terminated or partially terminated after September 1, 1974.

(d) No plan termination liability to the Pension Benefit Guaranty Corporation ("PBGC") or withdrawal liability to any Multi-Employer Plan that is material in the aggregate has been or is expected to be incurred with respect to any Employee Plan or with respect to any employee benefit plan sponsored by any entity under common control (within the meaning of Section 414 of the Code) with the Target or a Controlled Entity by reason of any action taken by the Seller, the Target or any Controlled Entity prior to the Closing Date. The PBGC has not instituted, and is not expected to institute, any proceedings to terminate any Employee Plan. Except as described in Section 4.26(ii)(d) of the Disclosure Statement, there has been no reportable event since [insert date] (within the meaning of Section 4043(b) of ERISA and the regulations thereunder) with respect to any Employee Plan, and there exists no condition or set of circumstances which makes the termination of any Employee Plan by the PBGC likely.

(e) As of the date hereof, as to each Employee Benefit Plan, all filings required by ERISA and the Code have been timely filed and all notices and disclosures to participants required by ERISA or the Code have been timely provided.

(iii) Except as indicated in Section 4.26(iii) of the Disclosure Statement, the Target and each Controlled Entity has made full and timely payment of all amounts required under the terms of each of the Employee Plans that are employee pension benefit plans, including the Multi-Employer Plans, to have been paid as contributions to such plans for the last plan year ended prior to the date of this Agreement and all prior plan years. No accumulated funding deficiency (as defined in Section 302 of ERISA and Section 412 of the Code), whether or not waived, exists with respect to any Employee Plan (other than a Foreign Plan) as of the end of such plan year, provided contributions owed with respect to such plan year are timely paid. Further, the Target and each

Controlled Entity has made or shall make full and timely payment of or has accrued or shall accrue all amounts which are required under the terms of the Employee Plans to be paid as a contribution to each such Employee Plan that is an employee pension benefit plan with respect to the period from the end of the last plan year ending before the date of this Agreement to the Closing Date in accordance with [insert covenant cross reference] hereof.

(iv) No state of facts exists with respect to a Foreign Plan, the effect of which would have a material adverse effect on the business, assets, earnings, financial condition or prospects of the Target and the Controlled Entities taken as a whole.

(v) All contributions made to or accrued with respect to all Employee Plans are deductible under Section 404 or 162 of the Code. No amounts, nor any assets of any Employee Plan are subject to tax as unrelated business taxable income under Sections 511, 512 or 419A of the Code.

(vi) No facts exist which will result in a material increase in premium costs of Employee Plans for which benefits are insured or a material increase in benefit costs of Employee Plans which provide self-insured benefits.

(vii) No Employee Plan provides medical, disability, life or other benefits to retired former employees.

(viii) Except as described in Section 4.26(v) of the Disclosure Statement, no union has been recognized as a representative of any or all of the Target's or any Subsidiary's employees. There are no agreements with, or pending petitions for recognition of, a labor union or association as the exclusive bargaining agent for any or all of the Target's or any Subsidiary's employees; no such petitions have been pending at any time within two (2) years of the date of this Agreement and, to the best of the Seller's knowledge, there has not been any organizing effort by any union or other group seeking to represent any employees of the Target or any Subsidiary as their exclusive bargaining agent at any time within two (2) years of the date of this Agreement; and there are no labor strikes, work stoppages or other troubles, other than routine grievance matters, now pending, or, to the best of Seller's knowledge, threatened, against the Target or any Subsidiary, nor have there been any such labor strikes, work stoppages or other labor troubles, other than routine grievance matters, at any time within two (2) years of the date of this Agreement.

This particular representation is extremely important in situations in which the target or any subsidiary has a substantial number of employees. Over the past few years, potential liability with respect to employee benefits and related plans has increased dramatically. Therefore, it is important for the buyer to know that the employee plans maintained by the target or any subsidiary are in compliance with existing regulations and are adequately funded. (For a further discussion of employee benefits, see Chapter 9.)

> ***Section 4.27. Litigation.*** Except as set forth in Section 4.27 of the Disclosure Statement, there is no action, suit, proceeding or investigation pending or, to the best knowledge after due inquiry of Seller and the Target, threatened, which would be likely to have a Material Adverse Effect; there is no reasonable basis known to the Seller or the Target for any such action that may result in any such effect and that is probable of assertion; and the Target, or any Subsidiary is not in default in respect of any judgment, order, writ, injunction or decree of any court or any federal, state, local or other governmental department, commission, board, bureau, agency or instrumentality which would be likely to have a Material Adverse Effect.

Generally, a seller will have no problem disclosing to the buyer the existence of any pending or threatened action against the target or a subsidiary that would have Material Adverse Effect. The part of this representation that is more difficult for the seller to make relates to whether the seller has a reasonable basis to know of any action that may result in a Material Adverse Effect. Although there may be no claim pending or action threatened, the buyer wants to know whether the seller, target, or subsidiary has taken any action that would result in a Material Adverse Effect. For example, if immediately prior to the signing of the acquisition agreement the target were to willfully breach a contract essential to its business, the other party to the contract, unaware of the breach, would not yet have filed a claim. Without this particular representation, the seller would not have to disclose this event. Not surprisingly, the seller is often unwilling to evaluate which of its actions may result in a claim that would have a Material Adverse Effect, or make warranties based on its evaluation. The seller may argue that routine corporate actions could result in a Material Adverse Effect, or the seller may express unwillingness to take on liability for the knowledge of each of its directors, officers, and employees. As with other representations, the issue is risk allocation. A smart buyer will soften this representation to appease the seller but will nonetheless seek disclosure, since the seller should be aware of an action taken that would or may constitute a Material Adverse Effect and can always choose to disclose it rather than guess as to its outcome.

> ***Section 4.28. Compliance with Laws.***
>
> (i) The Target and the Subsidiaries comply with, and have made all filings required pursuant to, all federal, state, municipal or local constitutional provisions, laws, ordinances, rules, regulations and orders in connection with the conduct of their businesses as now conducted.
>
> (ii) The Target and the Subsidiaries have all governmental licenses, permits and authorizations necessary for the conduct of their respective businesses as

currently conducted (the "Permits"), and all such Permits are in full force and effect, and no violations exist in respect of any such Permits, and no proceeding is pending or, to the knowledge of the Seller, threatened, to revoke or limit any thereof. Except as otherwise disclosed in Section 4.28(ii) of the Disclosure Statement, all such Permits are set forth on the Disclosure Statement.

(iii) Except as set forth in Section 4.28(iii) of the Disclosure Statement, neither the Target nor any Subsidiary has received notice of violation or of any alleged or potential violation of any such constitutional provisions, laws, ordinances, rules, regulations or orders, cured or not, within the last five years or any injunction or governmental order or decree.

(iv) Except as set forth in Section 4.28(iv) of the Disclosure Statement, there are no present or past Environmental Conditions in any way relating to the business of the Target or any Subsidiary. For purposes of this Agreement, "Environmental Condition" means (a) the introduction into the environment of any pollution, including without limitation any contaminant, irritant, or pollutant or other toxic or hazardous substance (whether or not such pollution constituted at the time thereof a violation of any federal, state or local law, ordinance or governmental rule or regulation) as a result of any spill, discharge, leak, emission, escape, injection, dumping or release of any kind whatsoever of any substance or exposure of any type in any work places or to any medium, including without limitation air, land, surface waters or ground waters, or from any generation, transportation, treatment, discharge, storage or disposal of waste materials, raw materials, hazardous materials, toxic materials or products of any kind or from the storage, use or handling of any hazardous or toxic materials or other substances, as a result of which the Target or any Subsidiary has or may become liable to any person or by reason of which any of the assets of the Target or any Subsidiary may suffer or be subjected to any Lien, or (b) any noncompliance with any federal, state or local environmental law, rule, regulation or order as a result of or in connection with any of the foregoing.

The buyer might limit the representation contained in paragraph (ii) by excepting "any such licenses, permits and authorizations the failure to obtain which will not have a Material Adverse Effect."

Similarly the buyer might agree to limit the scope of subparagraph (iii) by adding to the five-year limitation the phrase "which would be reasonably likely to result in any liability for penalties or damages exceeding _____Dollars ($ _____) in the aggregate."

The environmental representation in paragraph (iv) is extremely important in light of the tremendous cost that can be incurred in correcting environmental problems. As a result of significant legislative and judicial developments over the past two decades, unwary buyers may find themselves saddled with obligations to clean up environmental problems

caused by their predecessors. Such problems can range from removing asbestos in buildings to expensive groundwater purification programs made necessary by leaks from underground storage tanks.

> ***Section 4.29. Non-Contravention; Consents.*** Except as set forth in Section 4.29 of the Disclosure Statement, the execution, delivery and performance of this Agreement and the Related Instruments and the consummation of any of the transactions contemplated hereby and thereby by the Seller and the Target do not and will not:
>
> (i) violate any provisions of Seller's or Target's certificate of incorporation or bylaws;
>
> (ii) violate, or result with the passage of time in the violation of, any provision of, or result in the acceleration of or entitle any party to accelerate (whether after the giving of notice or lapse of time or both) any obligation under, or result in the creation or imposition of any lien, charge, pledge, security interest or other encumbrance upon any of the properties of Target or any Subsidiary pursuant to any provision of, any mortgage, lien, lease, agreement, permit, indenture, license, instrument, law, order, arbitration award, judgment or decree to which the Seller, Target or any Subsidiary is a party or by which it or any of its properties are bound, the effect of all of which violations, accelerations, creations and impositions would result, in the aggregate, in subjecting the Target or the Subsidiaries to liabilities in excess of _____ Dollars ($ _____);
>
> (iii) violate any law, order, judgment or decree to which the Target or any Subsidiary is subject;
>
> (iv) violate or conflict with any other restriction of any kind or character to which Target or any Subsidiary is subject, or by which any of their assets may be bound, the effect of all of which violations or conflicts would result, in the aggregate, in subjecting Target or the Subsidiaries to aggregate liabilities in excess of _____Dollars ($ _____);
>
> (v) constitute an event permitting termination of an agreement to which Target or any Subsidiary is subject, if in any such circumstance, individually or in the aggregate with all other such events, could have a Material Adverse Effect; or
>
> (vi) require a consent, license, permit, notice, application, qualification, waiver or other action of any kind, authorization, order or approval of, or filing or registration with, any governmental commission, board, regulatory, or administrative agencies or authorities or other regulatory body.

This representation is quite useful in that it clearly lays out the various items that should be of concern to the buyer in its operation of the business after the consummation of the transactions contemplated by the acquisition agreement. The utility of the representation lies in the ability

it gives the buyer to address each adverse consequence of the transaction before the deal is closed. For example, many agreements provide for their termination in the event that there is a change of control of the target or a subsidiary, as the case may be. Advance notice of the number and nature of these agreements gives the buyer the opportunity to put replacement contracts in place. In addition, the disclosure of certain consents may prompt the buyer to condition its obligation to close upon the success of the seller in obtaining such consents.

The buyer should give careful consideration to the amount of the dollar thresholds, as items beneath the threshold will not be disclosed and may result in dollar-for-dollar liability to the surviving corporation.

> ***Section 4.30. Unlawful Payments.*** Neither the Target nor any Subsidiary, nor to the best of the Target's knowledge any officer or director of the Target nor any officer or director of any Subsidiary, nor any employee, agent or representative, of the Target or any Subsidiary has made, directly or indirectly, with respect to the business of the Target or such Subsidiary, any illegal political contributions, payments from corporate funds not recorded on the books and records of the Target or such Subsidiary, payments from corporate funds that were falsely recorded on the books and records of the Target or such Subsidiary, payments from corporate funds to governmental officials in their individual capacities for the purpose of affecting their action or the action of the government they represent to obtain favorable treatment in securing business or licenses or to obtain special concessions or illegal payments from corporate funds to obtain or retain business.

The purpose of this representation is to identify whether the target or any subsidiary has made any payments that violate laws, such as the Foreign Corrupt Practices Act, or any payments that are not accurately reflected on the target's or subsidiaries' books and records. In addition, disclosure of these payments might reveal the tenuous nature of certain aspects of the target's or its subsidiaries' business, or the necessity for continuing such payments in order to obtain favorable treatment.

> ***Section 4.31. Brokers and Finders.*** Neither the Seller, Target or any Subsidiary nor any stockholder, officer, director or agent of the Seller, the Target or any Subsidiary has incurred on behalf of Seller, the Target or any Subsidiary any liability to any broker, finder or agent for any brokerage fees, finders' fees or commissions with respect to the transactions contemplated by this Agreement, except to [name of broker or finder]. Such fees and commissions will be paid by Seller.

This representation protects the buyer against obligations of the target or any subsidiary to pay certain fees in connection with the acquisition.

Buyer and seller may agree to share some of these fees but the buyer certainly doesn't want to be obligated to pay any fees of which it is not aware or that are not included in its calculation of the purchase price. As discussed in Chapter 2, these liabilities can be incurred even though no formal written agreement has been executed.

Section 4.32. Absence of Certain Changes or Events. Except as reflected in Section 4.32 of the Disclosure Statement or as specifically set forth herein, since the date of the Most Recent Balance Sheet neither Target nor any Subsidiary has

(i) conducted its business other than in the ordinary course of business;

(ii) issued or sold, or contracted to sell, any of its stock, notes, bonds or other securities, or any option to purchase the same, or entered into any agreement with respect thereto;

(iii) amended its certificate of incorporation or bylaws;

(iv) had or made any capital expenditures or commitments for the acquisition or construction of any property, plant or equipment in excess of _____Dollars ($_____) individually and _____Dollars ($ _____) in the aggregate;

(v) entered into any transaction inconsistent in any material respect with the past practices of its business or has conducted its business in any manner materially inconsistent with its past practices;

(vi) incurred (A) any damage, destruction or similar loss in an aggregate amount exceeding _____ Dollars ($_____) and which is covered by insurance or (B) any damage, destruction or loss in an aggregate amount exceeding _____Dollars ($ _____) and which is not covered by insurance;

(vii) suffered any loss or, to the best knowledge of the Seller, Target and the Subsidiaries, any prospective loss, of any dealer, customer or supplier or altered any contractual arrangement with any dealer or supplier, the loss or alteration of which would (or would, when added to all other such losses or alterations) have a Material Adverse Effect;

(viii) incurred any material liability or obligation (absolute or contingent) or made any material expenditure, other than such as may have been incurred or made in the ordinary course of business and other than capital expenditures described in clause (iv) of this subsection;

(ix) suffered any material adverse change in the business, operations, earnings, properties, liabilities, prospects, assets or financial condition or otherwise of the Target or any Subsidiary and no event which would have Material Adverse Effect has occurred;

(x) declared, set aside or paid any dividend or other distribution (whether in cash, shares, property or any combination thereof) in respect of the capital stock of the Target or any Subsidiary;

(xi) redeemed, repurchased, or otherwise acquired any of its capital stock or securities convertible into or exchangeable for its capital stock or entered into any agreement to do so;

(xii) except as reflected on the Most Recent Balance Sheet and covered by an adequate reserve therefor, made any sale of accounts receivable or any accrual of liabilities not in the ordinary course of business or written off any notes or accounts receivable or portions thereof as uncollectible;

(xiii) purchased or disposed of, or contracted to purchase or dispose of, or granted or received an option to purchase or sell, any properties or assets having a value greater than _____Dollars ($ _____) for any single asset, or greater than _____Dollars ($ _____) in the aggregate;

(xiv) except for normal annual increases or increases resulting from the application of existing formulas under existing plans, agreements or policies relating to employee compensation, made any increase in the rate of compensation payable or to become payable to the Target's or any Subsidiary's officers or employees or any increase in the amounts paid or payable to such officers or employees under any bonus, insurance, pension or other benefit plan, or any arrangements therefor made for or with any of said officers or employees;

(xv) adopted, or amended, any collective bargaining, bonus, profit-sharing, compensation, stock option, pension, retirement, deferred compensation or other plan, agreement, trust, fund or arrangement for the benefit of employees;

(xvi) made any change in any material accounting principle, material accounting procedure or material accounting practice, if any, followed by the Target or any Subsidiary or in the method of applying such principle, procedure or practice [except as required by a change in generally accepted accounting principles in the country of domicile];

(xvii) made any provision for markdowns or shrinkage with respect to inventories other than in the ordinary course of business and consistent with past practices or any write-down of the value of inventory by the Target or any Subsidiary of more than _____Dollars ($ _____) in the aggregate;

(xviii) discharged any lien or paid any obligation or liability (whether absolute, accrued, contingent or otherwise) other than current liabilities shown on the Most Recent Balance Sheet, and current liabilities incurred thereafter;

(xix) mortgaged, pledged or subjected to any lien, except liens specifically excepted from the provisions of Section 4.17 hereof, any properties or assets, real, personal or mixed, tangible or intangible, of Target or any Subsidiary;

(xx) experienced any material shortage of raw materials or supplies;

(xxi) made any gifts or sold, transferred or exchanged any property for less than the fair value thereof; or

(xxii) made or entered into any agreement or understanding to do any of the foregoing.

In order to bring down the financial condition of the target and its subsidiaries from the date of the Most Recent Balance Sheet, the buyer should have the seller represent the lack of certain events since such date. Because there are no financial statements covering the period between the date of the Most Recent Balance Sheet and the Closing Date, it is important for the buyer to understand the operation of the business during this period. In addition, the buyer should require the seller to covenant that it will not breach this representation on or prior to the Closing Date (see Section 6.1). Included in Section 4.32 are representations regarding matters which, although not specifically related to the financial statements, provide vital information about the ongoing business of the target. For example, the representation requires the disclosure of any material shortage of raw materials or supplies. A buyer must, of course, tailor this representation to the business of its target.

Section 4.33. Accuracy of Information Furnished. No representation or warranty by the Seller or Target contained in this Agreement, the Disclosure Statement or in respect of the exhibits, schedules, lists or other documents delivered to Buyer by the Seller and referred to herein, and no statement contained in any certificate furnished or to be furnished by or on behalf of the Seller or Target pursuant hereto, or in connection with the transactions contemplated hereby, contains, or will contain as of the date such representation or warranty is made or such certificate is or will be furnished, any untrue statement of a material fact, or omits, or will omit to state as of the date such representation or warranty is made or such certificate is or will be furnished, any material fact which is necessary to make the statements contained herein or therein not misleading. To the best knowledge of the Seller, the Target and the Subsidiaries, there is no fact which could have a Material Adverse Effect on the Target or any Subsidiary which the Seller has not prior to or on the date hereof disclosed to Buyer in writing.

The buyer will request this representation to provide assurance that the information upon which the buyer has based its evaluation of the target and its subsidiaries is accurate and complete. This representation is typically referred to as a "10b-5 representation" because the language closely parallels Rule 10b-5 promulgated by the Securities and Exchange Commission (SEC).

Similar to the representation made in Section 4.6 with respect to undisclosed liabilities, the last sentence in this representation shifts to the seller the responsibility of providing any information of which the buyer should be aware. The seller, although typically reluctant to make this

representation, may derive some comfort from the fact that it has already told the buyer everything it could possibly know about the target and the subsidiaries in the preceding representations.

> ***Section 4.34. Reports Filed with the Securities and Exchange Commission.*** Buyer has been furnished with accurate and complete copies of each annual report on Form 10-K that Target has filed with the Securities and Exchange Commission, all other reports or documents, including all amendments and supplements thereto, required to be filed by the Seller pursuant to Section 13(a) or 15(d) of the Securities Exchange Act since the filing of the most recent annual report on Form 10-K and its most recent annual report to its stockholders. Such reports do not contain any material false statements or any misstatements of any material fact and do not omit to state any fact necessary to make the statements set forth therein not misleading in any material respect.

This representation is applicable only to targets that are publicly traded corporations required to file reports with the SEC. The buyer must assure itself that the target has discharged its obligations to file reports with the SEC, and that the statements contained in the target's filings are true and are not misleading. Failure to obtain this representation may expose the buyer to significant post-closing liabilities, as the target may be the object of stockholders' suits or SEC enforcement actions.

> ***Section 4.35. Investment Purpose.*** The Seller's acquisition of the [describe securities of Buyer to be purchased by Seller] is made for its own account for investment purposes only and not with a view to the resale or distribution thereof. The Seller agrees that it will not sell, assign or otherwise transfer or pledge the [describe securities of Buyer to be purchased by Seller] or any interest therein except in compliance with the transfer restrictions set forth on such securities.

When the seller has agreed to accept securities of the buyer in partial payment of the purchase price for the acquisition, the buyer should require certain investment representations from the seller. The representations of the seller are intended to provide the basis for characterizing the sale of securities to the seller as a private placement, thereby exempting the securities from registration under the Securities Act of 1933 and applicable state securities laws. However, this representation is not meant to satisfy all the requirements for exemption under the securities laws, especially in cases where there are more than a handful of persons receiving these securities.

Section 4.36. Dealership and Franchises.

(i) Section 4.36(i) of the Disclosure Statement contains a list of (a) those franchisees or dealers who or which, as of the date of this Agreement, were authorized by the Seller to operate stores under the name "_____," or other similar name associating such franchisee or dealer with the Seller (the "Franchisees"), (b) those Franchisees whose relationship with the Seller, the Target or any Subsidiary has been terminated within one year prior to the date hereof and (c) those persons who have become Franchisees within one year prior to the date hereof. Such list is true, correct and complete and includes the expiration date of each existing Franchise Agreement. The Seller has given Buyer an opportunity to review true and correct copies of each of the agreements between it, the Target or any Subsidiary and each Franchisee. Except as stated in Section 4.36(i) of the Disclosure Statement, each agreement between the Seller, the Target or any Subsidiary and each Franchisee (A) has been duly and validly authorized, executed and delivered by, and is the valid and binding obligation of, such Franchisee, enforceable against such Franchisee in accordance with its terms, except as may be limited by applicable bankruptcy, reorganization, insolvency, moratorium or other similar laws or by legal or equitable principles relating to or limiting creditors' rights generally, and (B) does not violate any law or regulation applicable thereto, and (C) does not conflict with the provisions of any other agreement.

(ii) Except as set forth in Section 4.36(ii) of the Disclosure Statement, there is not, under any agreement between the Seller, the Target or any Subsidiary and any Franchisee, any existing default or event which with notice or lapse of time, or both, would constitute an event of default and which has or would be reasonably likely to have a Material Adverse Effect. The execution and delivery of this Agreement and the performance of the transactions contemplated hereby will not result in any event of default under any agreement between the Seller, the Target or any Subsidiary and any Franchisee.

(iii) Except as set forth in Section 4.36(iii) of the Disclosure Statement, each Franchisee was offered his, her or its franchise in accordance with all applicable laws and regulations, including, without limitation, the regulations of the Federal Trade Commission, and any state and/or local agencies regulating the sale of franchised businesses. The Seller has not offered any person or entity a franchise since [insert a date 18 months prior to date of Agreement].

Where the target has entered into franchise or distributorship arrangements in the conduct of its business, the buyer will want to obtain specific disclosures about the terms of these arrangements. This representation is designed to require the seller to disclose the health of its contractual relations with its franchisees and distributors. A statement certifying compliance with Federal Trade Commission (FTC) regulations is important, as the target may be liable for any failure to comply with FTC disclosure requirements.

ARTICLE V: REPRESENTATIONS AND WARRANTIES OF THE BUYER

The Buyer represents and warrants to the Seller and the Target as follows:

Section 5.1. Organization. The Buyer is a corporation duly organized, validly existing and in good standing under the laws of the jurisdiction of its incorporation. The Buyer has delivered to the Seller true and correct copies of its Certificate of Incorporation and Bylaws.

Section 5.2. Authorization. The execution, delivery and performance of this Agreement and any instruments or agreements contemplated herein to be executed, delivered and performed by the Buyer (including without limitation, [list important agreements to be executed by Buyer on or before Closing]) (the "Buyer's Related Instruments"), and the consummation of the transactions contemplated hereby and thereby, have been duly adopted and approved by the Board of Directors and the stockholders, of the Buyer. The Buyer has all requisite power and authority to execute, deliver and perform this Agreement and the Buyer's Related Instruments and to consummate the transactions contemplated hereby and in the Buyer's Related Instruments. This Agreement has been and as of the Closing Date, each of the Buyer's Related Instruments will be, duly and validly authorized, executed and delivered by the Buyer. This Agreement is and the Buyer's Related Agreements are or will be, as of the Closing Date, the valid and binding obligation of the Buyer, enforceable against the Buyer in accordance with their respective terms.

Section 5.3. Non-Contravention; Consents. Except as set forth in Section 5.3 of the Disclosure Statement, the execution and delivery of this Agreement and the Related Instruments and the consummation of any of the transactions contemplated hereby and thereby by the Buyer do not and will not:

(i) violate any provisions of the Buyer's certificate of incorporation or bylaws;

(ii) violate, or result with the passage of time in the violation of, any provision of, or result in the acceleration of or entitle any party to accelerate (whether after the giving of notice or lapse of time or both) any obligation under, or result in the creation or imposition of any lien, charge, pledge, security interest or other encumbrance upon any of the properties of the Buyer pursuant to any provision of, any mortgage, lien, lease, agreement, permit, indenture, license, instrument, law, order, arbitration award, judgment or decree to which the Buyer is a party or by which it or any of its properties are bound, the effect of all of which violations, accelerations, creations and impositions would result, in the aggregate, in subjecting the Buyer to liabilities in excess of _____Dollars ($_____);

(iii) violate any law, order, judgment or decree to which the Buyer is subject;

(iv) violate or conflict with any other restriction of any kind or character to which the Buyer is subject, or by which any of their assets may be bound, the

effect of all of which violations or conflicts would result, in the aggregate, in subjecting the Buyer to aggregate liabilities in excess of _____Dollars ($ _____); or

(v) require any consent, license, permit, notice, application, qualification, waiver or other action of any kind, authorization, order or approval of, or filing or registration with, any governmental commission, board, regulatory, or administrative agencies or authorities or other regulatory body.

Section 5.4. Litigation. There is no action, suit, proceeding or investigation pending, or, to the best of the Buyer's knowledge, threatened, against or related to the Buyer or its respective properties or business which would be reasonably likely to adversely affect or restrict the Buyer's ability to consummate the transactions contemplated hereby or in the Related Instruments; and there is no reasonable basis known to the Buyer for any such action that may result in such effect and is probable of assertion.

Section 5.5. Brokers and Finders. Neither the Buyer nor any stockholder, officer, director or agent of the Buyer has incurred on behalf of the Buyer any liability to any broker, finder or agent for any brokerage fees, finders' fees or commissions with respect to the transactions contemplated by this Agreement, except to [name of broker or finder], whose fees will be paid by the Buyer.

Section 5.6. Business. The Buyer has not engaged in any activities other than those incident to its organization or as contemplated by the terms of this Agreement.

Section 5.7. Accuracy of Information Furnished. No representation or warranty by the Buyer contained in this Agreement, the Disclosure Statement or in respect of the exhibits, schedules, lists or other documents delivered to the Seller by the Buyer and referred to herein, and no statement contained in any certificate furnished or to be furnished by or on behalf of the Buyer pursuant hereto, or in connection with the transactions contemplated hereby, contains, or will contain as of the date such representation or warranty is made or such certificate is or will be furnished, any untrue statement of a material fact, or omits, or will omit to state as of the date such representation or warranty is made or such certificate is or will be furnished, any material fact which is necessary to make the statements contained herein or therein not misleading.

The representations and warranties of the buyer generally parallel the representations made by the seller and target in Article IV. However, there is no need for the buyer, as the acquirer, to make the vast number of representations and warranties required of the seller and target, because it is the businesses and assets of the seller that are being purchased and in respect of which most representations and warranties therefore apply.

In some instances, the buyer may accomplish its acquisition of the target by utilizing a shell company as the acquirer. If properly structured, this strategy may permit the parties to avoid filing a pre-merger notification under the Hart–Scott–Rodino Antitrust Improvements Act of 1974. The representation made in Section 5.6 above regarding the scope of the business of the buyer is useful to the seller in that it assures the seller that there should be few contractual constraints on the shell company to consummate the acquisition.

In circumstances where the buyer is not a shell company, it may be appropriate for the seller to include additional representations about the buyer. For example, a representation relating to the buyer's financial statements and the absence of certain changes or events since the date of such financial statements might assure the seller of the buyer's ability to consummate the transaction.

ARTICLE VI: COVENANTS OF SELLER AND TARGET

> ***Section 6.1. Conduct of Business.*** Except as set forth in Section 6.1 of the Disclosure Statement or required to consummate the transactions contemplated hereby, from and after the execution and delivery of this Agreement and until the Closing Date, the Seller shall cause the Target and each of the Subsidiaries (a) to use its best efforts to preserve the respective present business organizations of the Target and the Subsidiaries substantially intact; (b) to maintain in effect all foreign, federal, state and local approvals, permits, licenses, qualifications and authorizations which are required to carry on their respective businesses as now being conducted; (c) to use their best efforts to maintain their respective relationships with and preserve the goodwill of, employees, agents, distributors, franchisees, licensees, customers, suppliers and others having business dealings with them; and (d) without the prior written consent of the Buyer, to take any action which would result in a breach of any of the representations set forth in Section 4.32 hereof.

The "conduct of business" covenant is used by a buyer to ensure that the seller will not do, or cause to be done, anything that would (a) alter the business being purchased, (b) diminish the value of such business to the buyer, or (c) create for the buyer an unanticipated liability or problem with respect to the business it is acquiring. This is important because the buyer has presumably negotiated an acceptable purchase price for the target based on the operations and performance of the business as it presently exists. If the seller were to allow necessary permits or licenses, or business

relationships with distributors, employees, or franchisees to lapse, the value of the business could be diminished. If not restricted by such a covenant, the seller could render the buyer's valuation meaningless by taking some action outside of the ordinary course of business that impairs the financial position of the target or the value of the target to the buyer. One issue that often arises is how to define the actions that are in the ordinary course of business. Since most agreements fail to include a definition of this phrase, the buyer should acquaint itself with applicable case law in order to be aware of its usage in the jurisdiction governing the acquisition agreement.

In negotiating this representation, the seller should be certain that, between the signing of the agreement and the closing date, it need not obtain the buyer's consent for anything other than items that would not normally occur in the ordinary course of business of the target or its subsidiaries. Subsection (d) incorporates all of the items represented in Section 4.32 and consequently may require the seller to obtain the buyer's consent for actions to be taken by the target or any subsidiary that are extremely important to the continued operation of the business. A seller would likely request that the buyer agree not to unreasonably withhold its consent in order for the seller to take such actions. Although this language may seem innocuous, it can in certain circumstances have consequences that the buyer did not intend at the time. As state courts have not consistently interpreted the standard of reasonableness, the buyer may be unable to reconcile its business judgments with local case precedent. A common strategy is for a buyer to require unmodified consent in its first draft, and then, if the seller requests it, add the reasonableness standard as a bargaining point or show of good faith.

> ***Section 6.2. Pre-Closing Activities.*** Prior to the Closing Date, the Seller shall cause the Target, with the cooperation of the Buyer where appropriate, and the Target shall and shall cause each Subsidiary to use their best efforts to obtain any consent, authorization or approval of, or exemption by, any governmental authority or agency or other third party, including without limitation, their landlords and lenders and those persons (other than the Target or a Subsidiary) who are parties to the agreements described in Section 4.29 of the Disclosure Statement required to be obtained or made by them in connection with the transactions contemplated by this Agreement and the Related Instruments or the taking of any action in connection with the consummation thereof, including without limitation, any consent, authorization or approval necessary to waive any default under any of the agreements described in Section 4.29 of the Disclosure Statement.

Once the buyer is made aware of the various consents necessary to consummate the acquisition by means of the seller's disclosure in Section 4.29, the buyer typically will attempt to require the seller to use its best efforts to obtain such consents. The seller, who has an interest in getting the deal done, should agree to accommodate the buyer, but only to the extent it is reasonable for the seller to do so under the circumstances. It should make clear that "best efforts" do not extend to spending money.

> ***Section 6.3. Proposals; Disclosure.*** Prior to the Closing Date, the Target and the Seller (i) will not, directly or indirectly, whether through any of their officers, employees, representatives or otherwise, solicit or encourage any written inquiries or proposals for the acquisition of stock, or all or substantially all of the assets or the business or any portion thereof of the Target or any Subsidiary and (ii) will promptly advise the Buyer orally and in writing of any inquiry or proposal for the acquisition of any stock, or all or substantially all of the assets or business or any portion thereof of the Target or any Subsidiary occurring on or after the date hereof.

This covenant is designed (a) to prevent the seller from shopping for a better deal during the period between signing of the acquisition agreement and the Closing Date, and (b) to keep the buyer apprised of any unsolicited inquiries. From the buyer's point of view, the seller has made a commitment to sell to the buyer and should be concentrating all of its efforts toward a closing with the buyer rather than continuing to court other would-be suitors. In addition, the acquisition agreement represents a binding contract, and the buyer has made a commitment to purchase provided that all conditions to closing are satisfied. The buyer should have the benefit of having made such a commitment as well as the risk of a deterioration in the target's business in the ordinary course of events. One benefit of ownership is the opportunity to sell at a profit. The *Pennzoil v. Texaco* case has highly publicized the fact that this benefit belongs to a potential buyer once a contractual commitment between the seller and buyer has been put in place.

> ***Section 6.4. Additional Financial Statements.*** Prior to the Closing Date, the Target shall furnish to the Buyer as soon as practicable but in no event later than _____ days after the close of each quarterly period or _____ days after the close of each monthly period (i) for each successive quarterly period ending after the date of the Most Recent Balance Sheet, an unaudited consolidated quarterly balance sheet and related statements of income, stockholders' equity and changes in financial position of the Target and its Subsidiaries and (ii) for each successive monthly period ending

after the date of the Most Recent Balance Sheet, an unaudited consolidated monthly balance sheet and related monthly statements of income, stockholders' equity and changes in financial position of the Target and its Subsidiaries. Such financial statements shall be complete, accurate and correct and present fairly the financial condition of the Target and the Subsidiaries, both individually and taken as a whole, as of the end of each such quarterly or monthly period, as the case may be, and shall present fairly the results of operations for each of the quarterly or monthly periods then ended, in accordance with generally accepted accounting principles consistently applied except for the footnotes thereto, normal year-end adjustments consistent with past practices or as contemplated by this Agreement.

Section 6.5. Additional Summaries of Accounts Receivable. Prior to the Closing Date, the Target will deliver to the Buyer, as soon as practicable but in no event later than _____ days after the close of the appropriate monthly period hereinafter referred to, for each successive monthly period after the date of the Most Recent Balance Sheet a true and correct summary of all accounts receivable of the Target and the Subsidiaries as at the end of each such monthly period.

Sections 6.4 and 6.5 permit the buyer to monitor the operations of the business after the execution of the acquisition agreement by reviewing monthly and quarterly financial statements furnished by the seller. This can be extremely important to the buyer, especially if the financial statements reveal a material adverse change in the business. In this event, the buyer would not be obligated to close, since a customary condition to its obligation to close is the absence of any material adverse changes in the business. For a further discussion of material adverse change, see Section 9.6.

Section 6.6. Investigation by Buyer. The Seller and Target shall, and the Target shall cause its Subsidiaries to, afford to the officers and authorized representatives of the Buyer free and full access, during normal business hours and upon reasonable prior notice, to the offices, plants, properties, books and records of the Target and its Subsidiaries in order that the Buyer may have full opportunity to make such investigations of the business, operations, assets, properties and legal and financial condition of the Target and its Subsidiaries as the Buyer deems reasonably necessary or desirable; and the officers of the Seller, the Target and its Subsidiaries shall furnish the Buyer with such additional financial and operating data and other information relating to the business operations, assets, properties and legal and financial condition of the Target and its Subsidiaries as the Buyer shall from time to time reasonably request. Prior to the Closing Date, or at all times if this Agreement shall be terminated, the Buyer shall, except as may be

otherwise required by applicable law, hold confidential all information obtained pursuant to this Section 6.6 with respect to the Target and its Subsidiaries and, if this Agreement shall be terminated, shall return to the Target and its Subsidiaries all such information as shall be in documentary form and shall not use any information obtained pursuant to this Section 6.6 in any manner that would have a material adverse consequence to the Target or its Subsidiaries.

The representations, warranties and agreements of the Seller, the Target and its Subsidiaries set forth in this Agreement shall be effective regardless of any investigation that the Buyer has undertaken or failed to undertake.

The "investigation" covenant ensures that the seller will cooperate with the buyer by granting access and logistical support for the buyer's due diligence review of the target and its subsidiaries. It is important for the buyer to include the last paragraph of this covenant so that the seller cannot attempt to prevent the buyer from taking action against the seller as a result of a material breach of the seller's or target's representations by alleging that, since the buyer discovered or could have discovered the breach during its investigation of the target and its subsidiaries, the seller should be relieved of any responsibility for such misrepresentations.

Section 6.7. Notification. The Seller shall give prompt notice to the Buyer of (i) any notice of, or other communication received by the Seller, the Target or any Subsidiary subsequent to the date of this Agreement and prior to the Closing Date, relating to a default or event which with notice or lapse of time or both would become a default, or which would cause any warranty or representation of the Seller or the Target to be untrue or misleading in any material respect, under this Agreement, or any other material contract, agreement or instrument to which the Target or any Subsidiary is a party, by which it or any of its property is bound or to which it or any of its property is subject, (ii) any notice or other communication from any third party alleging that the consent of such third party is or may be required in connection with the transactions contemplated by this Agreement, (iii) any material adverse change in the business, operations, earnings, prospects, assets or financial condition of the Target or its Subsidiaries, or (iv) any information received by the Seller or Target prior to the Closing Date relating to the operations of the Buyer which, to the best knowledge of the Seller or Target, constitutes (or would be reasonably likely to constitute) or indicates (or would be reasonably likely to indicate) a breach of any representation, warranty or covenant made by the Buyer herein or in any other document relating to the transactions contemplated hereby.

The "notice" covenant places on the seller the onus of notifying the buyer of any potential material breaches of the seller's representations and

warranties. Upon such notification, the buyer has the option of asserting a breach and abandoning the deal on the grounds that the conditions to closing are not met. However, a buyer does not have a right to walk from the deal if the breach can be cured by the seller prior to the closing.

> ***Section 6.8. Access to Records.*** After the Closing, the Buyer shall be entitled to reasonable access to the business and tax records of the Seller relating to the Target and its Subsidiaries for proper business purposes, including the preparation of tax returns. In connection with any such purpose, the Seller agrees to cooperate with the Buyer in the communication of information contained in such records and the handling of examinations, appeals and litigations.

This covenant may be important where many of the records of the target and its subsidiaries are consolidated with those of the seller. It is impossible in such circumstances for the seller to turn over to the buyer such records, since they may also relate to other companies owned by the seller.

> ***Section 6.9. Stockholders' Meeting.*** The Target, acting through its Board of Directors shall, as soon as practicable and in accordance with its Articles of Incorporation and By-Laws and applicable law:
>
> (1) prepare and distribute proxy materials (the "Proxy Statement") in compliance with applicable law for, and duly call, give notice of, convene and hold, a special meeting (the "Special Meeting") of its stockholders as soon as practicable after the date hereof but not later than [insert the date] for the purposes of considering and voting upon this Agreement in accordance with the [name of business code for Target's state of incorporation] Code;
>
> (2) include in the Proxy Statement (as hereinafter defined) the recommendation of the Board that stockholders of the Target vote in favor of the approval and adoption of this Agreement; and
>
> (3) use its best efforts (a) to obtain and furnish the information required to be included by it in the Proxy Statement, (b) to file a preliminary version of the Proxy Statement with the Securities and Exchange Commission ("SEC") not later than [insert number of days] after the receipt by the Target of its audited financial statement for the year ended [insert year], furnish copies thereof to the Buyer and, after consultation with the Buyer, respond promptly to any comments made by the SEC with respect to the Proxy Statement and any preliminary version thereof, (c) to cause the Proxy Statement to be mailed to its stockholders as early as practicable after the date hereof but no later than [insert number of days], and (d) to obtain the necessary approval of this Agreement by its stockholders. Notwithstanding any consultation with the Buyer in connection with the Proxy Statement, neither the Buyer nor any of its officers, directors, employees or affiliates shall incur any liability to the Target or its stockholders with respect thereto, except with respect to any information

contained in the Proxy Statement which any of them has furnished, or confirmed the accuracy of, in writing to the Target.

(4) amend, supplement or revise the Proxy Statement as may from time to time be necessary in order to insure that the Proxy Statement does not contain any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or omits to state any material fact necessary in order to make the statements therein not false or misleading. Prior to submitting any such amendment, supplement or revision of the Proxy Statement to the stockholders of the Target, such amendment, supplement or revision shall be submitted to the Buyer for its approval. Notwithstanding such approval, neither the Buyer nor any of its officers, directors, employees or affiliates shall incur any liability to the Target or its stockholders with respect thereto, except with respect to any information contained in such amendment, supplement or revision which any of them has furnished, or confirmed the accuracy of, in writing to the Target.

In an acquisition of a target whose equity securities are publicly traded, it is essential that the target comply with all relevant regulations, especially those promulgated by the Securities and Exchange Commission dealing with proxies and required stockholders' meetings. Failure to comply with these regulations can expose the target to stockholder suits or regulatory enforcement actions. The buyer is also desirous of placing an affirmative obligation on the target to solicit proxies and to obtain stockholder approval.

In some circumstances, the buyer may require the seller to deliver a cold comfort letter from the seller's or target's accountants at closing confirming the financial information in the proxy statement. The purpose of this requirement is to reduce the potential for error in the financial information presented in the proxy statement and thereby reduce the chance that a stockholder may prevail in a suit against the surviving corporation.

Section 6.10. Dissenting Stockholders; Notice. The Target will promptly advise the Buyer of each notice given or demand made by a dissenting Target stockholder pursuant to [cite relevant section of business law in state where Target is incorporated].

No buyer wants to close a transaction in which a large percentage of the target's stockholders are seeking appraisal rights. If such stockholders were to be awarded a price per share in excess of the price paid by the buyer, it could expose the surviving corporation to an inordinate amount of liability. Therefore, as covered in Section 9.10 and the discussion that

follows, in order for a buyer to exercise its right not to consummate the transaction pursuant to Section 9.10, it must be aware of any dissenting stockholders of the target.

ARTICLE VII: COVENANTS OF THE BUYER

> The Buyer shall give prompt notice to the Seller of (i) any notice of, or other communication received by the Buyer subsequent to the date of this Agreement and prior to the Closing Date, relating to a default or event which with notice or lapse of time or both would become a default, or which would cause any warranty, or representation of the Buyer to be untrue or misleading in any material respect, under this Agreement, or any other material contract, agreement or instrument to which the Buyer is a party, by which it or any of its property is bound or to which it or any of its property is subject, (ii) any notice or other communication from any third party alleging that the consent of such third party is or may be required in connection with the transactions contemplated by this Agreement, or (iii) any information received by the Buyer prior to the Closing Date relating to the operations of the Seller, the Target or its Subsidiaries which, to the best knowledge of the Buyer, constitutes (or would constitute) or indicates (or would indicate) a breach of any representation, warranty or covenant made by the Seller or Target herein or in any other document relating to the transactions contemplated hereby.

Similar to the representations, the seller's covenants usually far outnumber the covenants of the buyer. Typically, a seller would at a minimum require a buyer to give the same "notice" that it is required to give. One useful device (which is advantageous to both buyer and seller) is the requirement that each notify the other in the event that the first party is aware of the other's breach of a particular representation, warranty, or covenant. The utility of this obligation, especially for the seller, is that neither side has a distinct advantage over the other post-closing by reason of a breach that was known about prior to the closing.

ARTICLE VIII: COVENANTS OF BUYER, TARGET AND SELLER

> ***Section 8.1. Governmental Filings.*** The Buyer, the Target and the Seller shall cooperate with each other in filing any necessary applications, reports or other documents with any federal or state agencies, authorities or bodies (domestic and foreign) having jurisdiction with respect to the Merger, and in seeking

necessary consultation with and prompt favorable action by any such agencies, authorities or bodies. Without limiting the generality of the foregoing, the Buyer, the Target and the Seller shall as soon as practicable, and in any event within fifteen (15) days, after the date hereof, make the necessary filings under the Hart–Scott–Rodino Antitrust Improvements Act of 1976 (the "Hart–Scott–Rodino Act") and shall cooperate in attempting to secure early termination of the applicable waiting period.

This covenant requires the buyer, target, and seller to work together in making any governmental filing or application. The buyer and the seller should use a general covenant of this type and then specify the particular filings that must be made (Hart–Scott–Rodino Act filings with respect to a merger, SEC filings, state government filings, and so on).

Section 8.2. Publicity. The Buyer, the Target and the Seller will consult with each other before making any public announcements with respect to the Merger or the Related Instruments or the transactions contemplated hereby or thereby, and any public announcements shall be made only at such time and in such manner as the Seller and the Buyer shall mutually agree, except that either party shall be free to make such public announcements as it shall reasonably deem necessary to comply with foreign, federal or state laws.

The buyer and the seller must be aware of each other's plans with respect to publicity surrounding the acquisition of a target so as to be able to coordinate their efforts. It can be extremely harmful to the transaction or one of the parties to the transaction if there are conflicting reports or misleading statements. For example, conflicting reports in the press can disrupt management of the target or may even damage the ongoing business. More importantly, where one or both of the entities involved are public companies, liability can arise from premature press reports that might be alleged to have been made to manipulate the market or mislead stockholders and investors. When possible, the buyer and seller should issue joint press releases or, at least, carefully review releases before they are distributed.

ARTICLE IX: CONDITIONS TO OBLIGATIONS OF THE BUYER

The obligations of the Buyer to consummate this Agreement, and the transactions to be consummated by the Buyer hereunder on the Closing Date, shall be subject to the satisfaction, prior to or concurrently with the Closing, of each of the conditions set forth in this Article IX; such conditions may be waived in writing in whole or in part by the Buyer to the extent permitted by applicable law.

> ***Section 9.1. Compliance with Agreement.*** The Seller and the Target shall have complied with and performed the terms, conditions, acts, undertakings, covenants and obligations required by this Agreement to be complied with and performed by each of them on or before the Closing Date; and the Buyer shall have received from the Seller at the Closing a certificate, dated the Closing Date and signed by the President or a Vice President of the Seller to such effect.

This condition gives the buyer the opportunity to abandon the acquisition if the seller or the target has failed to perform its obligations under the acquisition agreement. Although this condition is less critical than the bring-down of representations and warranties to the closing date that appears in Section 9.2, it provides the buyer a valuable "out" if the seller or the target has breached a covenant that is essential to the buyer's valuation of the target. For example, the duty of the target to endeavor to obtain all regulatory approvals necessary for the transaction would usually arise from a covenant made to the buyer in the acquisition agreement, as would the obligation of the target to conduct business only in the ordinary and usual course. Because failure to perform under these covenants may compromise the value of the target, the buyer must ensure its right to abandon the transaction in these circumstances.

The requirement for an officer's certificate is based upon the belief that prior to any officer's execution of such a certificate, the officer will investigate to ascertain its accuracy, and the certificate can be drafted to include a representation to that effect.

This condition can be drafted without a materiality standard. However, sellers typically demand that the materiality qualifier be incorporated. This position is a reasonable one given the broad language of both the condition itself and the covenants and other agreements to which it refers. Consequently, the buyer should be prepared to accept "performance in all material respects of the terms" of the agreement as adequate protection of its interests. A similar qualifier appears in the condition set forth in Section 9.2 below.

> ***Section 9.2. Representations and Warranties True as of Closing Date.*** All representations and warranties of the Seller and the Target set forth in this Agreement shall be true and correct in all material respects on and as of the Closing Date with the same force and effect as though such representations and warranties had been made on and as of the Closing Date and the Buyer shall have received from the Seller at the Closing a certificate, dated the Closing Date and signed by the President or a Vice President of the Seller to such effect.

The importance of this bring-down condition was discussed in detail in this chapter. A bring-down of the representations and warranties to the closing date is, from the buyer's perspective, insurance that the target it acquires is the target for which it bid and upon which it conducted due diligence.

Section 9.3. Third Party Orders and Consents.

(i) The Seller and the Buyer shall have fully complied with the applicable provisions of the Hart–Scott–Rodino Act and any and all applicable waiting periods thereunder shall have expired, or an opinion, reasonably acceptable to the Buyer, that no such filing is required shall have been delivered to the Buyer.
(ii) All consents and approvals listed in Section 4.29 of the Disclosure Statement hereto shall have been obtained, and the Seller and the Buyer shall have been furnished with appropriate evidence, reasonably satisfactory to them and their respective counsel, of the granting of such consents and approvals.

This condition enables the buyer to abandon a transaction if all necessary consents are not obtained before closing. Failure to obtain the consent of the target's lenders, for example, may prejudice the pricing of the acquisition or its financeability because consummation of the transaction may entitle the lenders to accelerate their debts or impose a lien on the property of the target. Failure to obtain necessary governmental consent to an acquisition may preclude the buyer from operating the business of the target as previously operated.

The seller should attempt to limit this condition to governmental consents necessary in order to consummate the transactions contemplated by the acquisition agreement. The seller could reasonably maintain that any debt instruments that are accelerated by their terms should be refinanced by the buyer. If this limitation is accepted, the obligation of the buyer to close the deal should not be conditioned upon the consent of the holders of such debt. Clearly, the buyer and the seller must agree on exactly what consents must be obtained prior to the closing.

Section 9.4. Corporate Action. The Buyer shall have received:

(i) a copy of the resolution or resolutions duly adopted by the Board of Directors of the Seller and the Target and by the stockholders of the Target authorizing the execution, delivery and performance of this Agreement and the Related Instruments by the Seller and the Target, and authorizing all other necessary or proper corporate action to enable the Seller and the Target to comply with the terms of this Agreement, certified in each case by the Secretary or an Assistant Secretary of the Seller or the Target as the case may be; and

(ii) a certificate of the Secretary or an Assistant Secretary of each of the Seller and the Target, dated the Closing Date, as to the incumbency and

signatures of the officers of the Seller and the Target, respectively, executing this Agreement and the Related Instruments and any other documents in connection with the transactions contemplated by this Agreement or the Related Instruments.

A further protection for the Buyer that the acquisition agreement and related documents are properly authorized and delivered is a review of the resolutions authorizing such documents.

Section 9.5. Opinion of the Seller's and Target's Counsel. At the Closing, the Seller shall furnish the Buyer and the banks and/or other financial institutions providing financing for the Merger (the "Acquisition Lenders") with an opinion, dated the Closing Date, of [name of Seller's counsel], in form and substance satisfactory to the Buyer and its counsel and the Acquisition Lenders and counsel to the Acquisition Lenders, to the effect that:

(i) Target (a) is a corporation duly organized, validly existing and in good standing under the laws of its state of incorporation, (b) is duly qualified or licensed to transact business as a foreign corporation and is in good standing in each jurisdiction in which the properties owned or leased by it or the nature of the business conducted by it makes such qualification or licensing necessary, except in those jurisdictions where the failure to be so qualified or licensed and in good standing will not, individually or in the aggregate, have a Material Adverse Effect, and (c) has full power and authority to carry on its business as it is now being conducted and to own the properties and assets it now owns;

(ii) Target has full power and authority to execute, deliver and perform the Agreement and the Related Instruments and to consummate the transactions contemplated hereby and by the Related Instruments; and the execution, delivery and performance of the Agreement and the Related Instruments and the consummation of the transactions contemplated by the Agreement and the Related Instruments have been duly authorized by all requisite action on the part of the Target;

(iii) the Seller is a corporation duly organized, validly existing and in good standing under the laws of its state of incorporation and has full power and authority to execute, deliver and perform the Agreement and the Related Instruments and to consummate the transactions contemplated by the Agreement and the Related Instruments; and the execution, delivery and performance of the Agreement and the Related Instruments and the consummation of the transactions contemplated by the Agreement and the Related Instruments have been duly authorized by all requisite action on the part of the Seller;

(iv) each of the Subsidiaries (a) is a corporation duly organized, validly existing and in good standing under the laws of its jurisdiction of organization, (b) is duly qualified or licensed to transact business and is in good standing in each jurisdiction in which the properties owned or leased by it or the nature of the business conducted by it makes such qualification or licensing necessary,

except in those jurisdictions where the failure to be so qualified or licensed and in good standing will not, individually or in the aggregate, have a Material Adverse Effect and (c) has full power and authority to carry on its business as it is now being conducted and to own the properties and assets it now owns;

(v) the authorized, issued and outstanding equity capital of the Target and each Subsidiary consists solely of (a) in the case of the Target, _____shares of Common Stock, of which _____shares are issued and outstanding and _____shares of Preferred Stock, of which _____shares are issued and outstanding and (b) in the case of each Subsidiary, as set forth in Section 4.3 of the Disclosure Statement (the "Subsidiary Stock"). All outstanding shares of the Target Common Stock and the Subsidiary Stock have been duly and validly authorized and issued and are fully paid, nonassessable and free of preemptive rights and based upon an examination of the organizational documents, minute books, stock registers and other similar records of the Target, all of such shares are owned of record and beneficially by (a) the Seller, in the case of the Target and (b) as set forth in Section 4.1 of the Disclosure Statement, in the case of each Subsidiary, in each case free and clear of all claims, liens, mortgages, charges, security interests, encumbrances and other restrictions or limitations of any kind whatsoever, and there are no outstanding options, warrants, calls, convertible securities or other rights relating to unissued shares of capital stock of Target or any Subsidiary;

(vi) the Agreement and the Related Instruments have been executed and delivered by each of the Seller and the Target and constitutes the legal, valid and binding obligations of each of the Seller and the Target, enforceable against each in accordance with their respective terms, except (a) as such enforcement may be subject to fraudulent conveyance, bankruptcy, insolvency, reorganization, moratorium or other similar laws now or hereafter in effect, or by legal or equitable principles, relating to or limiting creditors' rights generally and (b) that the remedy of specific performance and injunctive and other forms of equitable relief are subject to certain equitable defenses and to the discretion of the court before which any proceeding therefor may be brought;

(vii) neither the execution, delivery and performance of the Agreement or the Related Instruments by the Seller or the Target, nor the consummation of the transactions contemplated hereby or thereby will violate any provision of the Certificate of Incorporation or Bylaws of the Seller or the Target or of any of the Subsidiaries or, to the best knowledge of such counsel after due inquiry, will violate, conflict with, or constitute a default under, or cause the acceleration of maturity of any debt or obligation pursuant to, or result in the creation or imposition of any security interest, lien or other encumbrance upon any property or assets of the Target or any of the Subsidiaries under, any contract, commitment, agreement, trust, understanding, arrangement or restriction of any kind to which the Target or any of the Subsidiaries is a party or by which the Target or any of the Subsidiaries is bound or violate any statute or law, or

any judgment, decree, order, regulation or rule of any court or governmental authority;

(viii) to the best knowledge of such counsel, none of the Target, the Seller nor any Subsidiary is engaged in or threatened with any legal action or other proceeding or has incurred or been charged with or is under investigation with respect to any violation of any law or administrative regulation which if adversely determined might, in such counsel's opinion, materially adversely affect or impair (a) the business or condition, financial or otherwise, of the Target or any of the Subsidiaries except as specifically disclosed in the Agreement or the Disclosure Statement or (b) the ability of the Target and/or the Seller to consummate the transactions contemplated by the Agreement or the Related Instruments;

(ix) no filing, declaration or registration with, or any permit, authorization, license, consent or approval of, any governmental or regulatory authority is required in connection with the execution, delivery and performance of the Agreement or the Related Instruments by the Seller and the Target or the consummation of the transactions contemplated by the Agreement or the Related Instruments, except as expressly disclosed in this Agreement, all of which have been duly and validly obtained;

(x) no facts have come to the attention of such counsel that cause such counsel to believe that any information provided to the Buyer in writing by or on behalf of the Seller or the Target contained any untrue statement of a material fact or omitted to state any material fact necessary to make the statements therein, in light of the circumstances under which they were made, not misleading, except that counsel may also state that it has not independently verified the accuracy, completeness or fairness of such information, and the limitations inherent in the examination made by it and the knowledge available to it are such that it is unable to assume, and does not assume, any responsibility for the accuracy, completeness or fairness of such information.

As to any matter contained in such opinion which involves the laws of a jurisdiction other than the United States or the State of [state in which such counsel is licensed to practice], such counsel may rely upon opinions of local counsel of established reputation reasonably satisfactory to the Buyer, which opinions shall expressly state that they may be relied upon by the Buyer and the Acquisition Lenders. Such counsel may also expressly rely as to matters of fact upon certificates furnished by appropriate officers of the Seller, the Target and any Subsidiary, or appropriate governmental officials.

Typically, the seller and the target will require an opinion from the buyer's counsel (see Section 10.6) that mirrors many of the provisions included in the opinion given by seller's counsel. Although these opinions may be heavily negotiated by the counsel who must render them, they are useful for a variety of reasons. First, legal opinions serve as a due diligence device and force counsel to closely examine the important aspects

of the transaction. Second, counsel's reluctance to deliver an opinion regarding a particular issue raises a red flag, permitting the parties to reexamine that aspect of the transaction. Third, the opinion gives the party to which it is addressed legal recourse against counsel delivering the opinion. In this regard, the buyer may be asked to accept the opinion of general counsel to the seller or target. The buyer should resist this request since the buyer's recourse against the general counsel of the target may be tantamount to recourse against the surviving corporation. In contrast, outside counsel's opinion provides recourse against an independent source, one that may be more diligent in its efforts and less biased in its evaluation as a result of its potential liability and relative "distance" from the seller's management.

In some circumstances, the buyer may be required to accept the opinion of general counsel with respect to certain matters relating to the law of a jurisdiction where it would be impractical or inordinately expensive to retain outside counsel. In addition, outside counsel frequently relies on a backup opinion from the general counsel of the target with respect to matters that pertain to the business of the target in general. For example, general counsel would probably provide a backup opinion with respect to whether the target is qualified as a foreign corporation in each jurisdiction in which the properties owned or leased by it or the nature of the business conducted by it makes such qualification or licensure necessary.

The opinion also may be used as a negotiating tool in the earlier phases of the transaction; counsel's unwillingness to opine that no governmental consent is required in connection with the contemplated transactions or to the enforceability of particular documents may cause the parties to revamp the structure of the transaction.

One opinion that counsel is often reluctant to deliver is expressed in clause (x) on the preceding page. Only rarely will counsel accept such a high level of responsibility. If the acquisition involves a public company, counsel may agree to opine to the accuracy of the proxy statement if counsel oversaw its preparation. Otherwise, despite the buyer's legitimate concern with the accuracy of information provided by the seller, the target, and the subsidiaries, it will not have the comfort of counsel's opinion on the matter. If a party is extremely concerned about the withholding of information or the accuracy thereof, it may be able to persuade the seller's counsel to include clause (x) at the end of its opinion letter without giving it the benefit of being a legal opinion.

Section 9.6. No Material Adverse Change. No material adverse change in the business, operations, earnings, prospects, assets or financial condition of the Target or any Subsidiary and no event which would have such an effect shall have occurred.

As discussed, a customary condition to the buyer's obligation to close the transaction is that the target has not suffered any adverse change prior to the closing. The seller should attempt to limit this condition to the target and its subsidiaries taken as a whole since the buyer is not buying the target and its subsidiaries piecemeal. The seller should also focus on the phrase "business, operations, earnings, prospects, assets or financial condition" because, in some instances, the buyer may not have bargained for a certain earnings stream or the prospects of the target. For example, in a transaction based on the net assets of the target, a seller who has not made any projections as to the growth of the business of the target could argue that the target's "earnings" and "prospects" are irrelevant and should be deleted from this condition since the deal was not priced on a multiple of earnings or discounted cash flow. This appears plausible, since the buyer has based its investment decision only on the value of the net assets. However, most buyers will resist this approach, alleging that future earnings were an important factor in the investment decision.

Conversely, where the buyer has relied on projections, it should specifically include the projections in this condition as a yardstick for measuring the prospects of the target.

What constitutes a material adverse change is unclear and varies from circumstance to circumstance. It's easy to identify an obvious one, such as the single line target that has lost the only supplier of raw materials for the manufacture of its product. But the loss of a customer whose purchase of goods from the target constitutes 5 percent of the target's overall revenues is a less clear-cut situation. The usual vagueness of this condition gives the buyer the opportunity to get out of the deal, even in circumstances where the change is of uncertain harm to the target, because the seller is usually disinclined to bring suit on the basis that no material adverse change has occurred. Of course, the buyer must have some real basis for its belief that a material adverse change has occurred. Usually, the seller and buyer attempt to restructure the transaction in light of any material adverse change.

Section 9.7. Litigation. At the Closing, there shall be no effective injunction, writ or preliminary restraining order or any order of any nature issued by a

court or governmental agency of competent jurisdiction restraining or prohibiting the consummation of the transactions provided for herein or any of them or limiting in any manner the Buyer's right to control the Target and the Subsidiaries or any aspect of their businesses or requiring the sale or other disposition of any of the operations of the Target or any Subsidiary or making the consummation of the Merger or the transactions contemplated by this Agreement and the Related Instruments unduly burdensome to the Target or any Subsidiary, and immediately prior to the Closing Date no proceeding or lawsuit shall have been commenced and be pending or be threatened by any governmental or regulatory agency or any other person with respect to the transactions contemplated by this Agreement or the Related Instruments which the Buyer, in good faith and with the advice of counsel, believes is likely to result in any of the foregoing or which seeks the payment of substantial damages by the Target, any Subsidiary or the Buyer.

The utility of this condition is self-explanatory. It is usually triggered in circumstances in which the acquisition is either unfriendly and a potential suitor has brought suit to enjoin the consummation of the transaction contemplated by the acquisition agreement, or a governmental agency has attempted to enjoin the transaction because of antitrust or other governmental concerns.

Section 9.8. Financing.

(i) The Buyer shall have received the financing proceeds pursuant to, and on substantially the same terms and conditions as those contained in, the commitment letter from [name of Acquisition Lender].

(ii) The final documentation of such financing arrangements referred to in the commitment letter from [name of Acquisition Lender] shall in all respects be reasonably satisfactory in form and substance to the Buyer.

This "financing out" is discussed in Chapter 4. The version included here is appropriate if the buyer has obtained financing commitments before signing the acquisition agreement. Another method, which is appropriate if the parties have agreed that the buyer must finance the transaction within a certain period of time, is to build in a provision enabling the parties to terminate the acquisition agreement if commitment letters are not obtained or the deal is not closed by a specific date.

Section 9.9. Title Insurance. [Insert name of title company], or any other reputable title company reasonably satisfactory to the Buyer (the "Title Company") shall have issued owners', lessees' and mortgagees' title insurance policies (or unconditional commitments therefor) with respect to, and in the amount of the fair market value of, the real property and the leased real

property listed in Section 4.15 of the Disclosure Statement and located in the United States, the United States territories and possessions and Canada, on the current edition of the A.L.T.A. Form B, Rev. 1970 (or Loan Policy Form, in the case of mortgagees' title insurance) insuring title, with all standard and general exceptions deleted or endorsed over so as to afford full "extended form coverage," except for the lien of taxes not yet due and payable, and with no further exceptions not reasonably satisfactory to the Buyer. It is hereby agreed that if, in order to delete, or endorse over, standard form or general exceptions so as to afford to owners, lessees or lenders "extended form coverage," the Title Company requires standard form seller's affidavits, the conditions set forth in this Section 9.10 shall be satisfied by an authorized officer of the Seller giving such affidavit. The Buyer shall have received unconditional title insurance commitments reflecting the foregoing matters at least ten (10) days prior to Closing.

This condition provides the buyer comfort that the real property owned or leased by the target is free from defects in title and, consequently, may be used to secure acquisition financing. The seller may demand that this condition be effective only to the extent that Acquisition Lenders require title insurance. On the other hand, the buyer may strengthen the condition to make the existence of a title defect that compromises the business of the target a sufficient basis for abandoning the transaction. To the extent that title insurance is unavailable and the real property is an integral part of the business of the target, this condition gives the buyer the opportunity to renegotiate the price of the acquisition or to walk away from the deal.

Section 9.10. Dissenting Stockholders. Holders of not more than [insert percentage] of the Target's Common Stock shall have elected dissenter's rights as provided in Section [ ] of the [business code of Target's state of incorporation] Code, and the Target shall have taken all action with respect to the rights of dissenting stockholders required of it pursuant to such Code.

In an acquisition of a target with numerous stockholders, a buyer should attempt to limit its exposure to liability in the event that the stockholders of the target achieve a higher price for the value of their shares than that paid by the buyer through an appraisal proceeding brought by such stockholders post-closing. The seller should obviously negotiate a percentage high enough to prevent the buyer from abandoning the deal without good cause, and the buyer should be willing to accept some level of risk. The exact percentage of holders seeking appraisal rights in this condition depends on the circumstances.

ARTICLE X: CONDITIONS TO OBLIGATIONS OF THE SELLER AND TARGET

The obligations of the Seller and the Target to consummate this Agreement, and the transactions to be consummated by the Seller hereunder on the Closing Date, shall be subject to the satisfaction, with the Closing, of each of the conditions set forth in this Article X; which conditions may be waived in writing in whole or in part by the Seller to the extent permitted by applicable law.

Section 10.1. Compliance with Agreement. The Buyer shall have complied with and performed in all material respects the terms, conditions, acts, undertakings, covenants and obligations required by this Agreement to be complied with and performed by it on or before the Closing Date; and the Seller shall have received from the Buyer at the Closing a certificate, dated the Closing Date and signed by the President or a Vice President of the Buyer to such effect.

Section 10.2. Representations and Warranties True as of Closing Date. All representations and warranties of the Buyer set forth in this Agreement shall be true and correct in all material respects on and as of the Closing Date with the same force and effect as though such representations and warranties had been made on and as of the Closing Date and the Seller shall have received from the Buyer at the Closing a certificate, dated the Closing Date and signed by the President or a Vice President of the Buyer to such effect.

Section 10.3. Third Party Orders and Consents.

(i) The Seller and the Buyer shall have fully complied with the applicable provisions of the Hart–Scott–Rodino Act and any and all applicable waiting periods thereunder shall have expired, or an opinion, reasonably acceptable to the Seller, that no such filing is required shall have been delivered to the Seller.

(ii) All consents and approvals listed in Section 4.29 of the Disclosure Statement shall have been obtained, and the Seller and the Buyer shall have been furnished with appropriate evidence, reasonably satisfactory to them and their respective counsel, of the granting of such consents and approvals, and such consents and approvals remain in full force and effect on the Closing Date.

Section 10.4. Corporate Action. The Seller shall have received:

(i) a copy of the resolution or resolutions duly adopted by the Board of Directors of the Buyer and by the stockholders of the Buyer authorizing the execution, delivery and performance of this Agreement and the Related Instruments by the Buyer, and authorizing all other necessary or proper corporate action to enable the Buyer to comply with the terms of this Agreement and the Related Instruments, certified in each case by the Secretary or an Assistant Secretary of the Buyer; and

(ii) a certificate of the Secretary or an Assistant Secretary of the Buyer, dated the Closing Date, as to the incumbency and signatures of the officers of the Buyer executing this Agreement and the Related Instruments and any other

documents in connection with the transactions contemplated by this Agreement and the Related Instruments.

Section 10.5. Opinion of the Buyer's Counsel. At the Closing, the Buyer shall furnish the Seller with an opinion, dated the Closing Date, of [name of Buyer's outside counsel], in form and substance reasonably satisfactory to the Seller and its counsel, to the effect that:

(i) the Buyer is a corporation duly organized, validly existing and in good standing under the laws of the state of its incorporation;

(ii) the Buyer has the power and authority to execute, deliver and perform the Agreement and the Related Instruments and to consummate the transactions contemplated by the Agreement and the Related Instruments; and the execution, delivery and performance of the Agreement and the Related Instruments and the consummation of the transactions contemplated by the Agreement and the Related Instruments have been duly authorized by all requisite action on the part of the Buyer;

(iii) this Agreement and the Related Instruments have been executed and delivered by the Buyer and is the legal, valid and binding obligation of the Buyer, enforceable against the Buyer in accordance with their respective terms, except (a) as such enforcement may be subject to fraudulent conveyance, bankruptcy, insolvency, reorganization, moratorium or other similar laws now or hereafter in effect, or by legal or equitable principles, relating to or limiting creditors' rights and (b) that the remedy of specific performance and injunctive and other forms of equitable relief are subject to certain equitable defenses and to the discretion of the court before which any proceeding therefor may be brought;

(iv) neither the execution, delivery and performance of the Agreement and the Related Instruments by the Buyer, nor the consummation of the transactions contemplated by the Agreement and the Related Instruments will violate any provision of the Certificate of Incorporation or Bylaws of the Buyer, or to the best knowledge of such counsel, will violate, conflict with, or constitute a default under, or cause the acceleration of maturity of any debt or obligation pursuant to, or result in the creation or imposition of any security interest, lien or other encumbrance upon any property or assets of the Buyer, any contract, commitment, agreement, trust, understanding, arrangement or restriction of any kind to which the Buyer is a party or by which the Buyer is bound or violate any statute or law, or any judgment, decree, order, regulation or rule of any court or governmental authority;

(v) to the best knowledge of such counsel, the Buyer is not engaged in or threatened with any legal action or other proceeding nor has it incurred or been charged with, nor is it under investigation with respect to, any violation of any law or administrative regulation which if adversely determined might, in such counsel's opinion, materially adversely affect or impair the ability of the Buyer to consummate the transactions contemplated hereby;

(vi) no filing, declaration or registration with, or any permit, authorization, license, consent or approval of, any governmental or regulatory authority is required in connection with the execution, delivery and performance of the Agreement and the Related Instruments by the Buyer or the consummation of the transactions contemplated by the Agreement and the Related Instruments, except as expressly disclosed in the Agreement or the Disclosure Statement, all of which have been duly and validly obtained;

(vii) no facts have come to the attention of such counsel that cause such counsel to believe that any information provided to the Seller in writing by or on behalf of the Buyer contained any untrue statement of a material fact or omitted to state any material fact necessary to make the statements therein, in light of the circumstances under which they were made, not misleading, except that counsel may also state that it has not independently verified the accuracy, completeness or fairness of such information, and the limitations inherent in the examination made by it and the knowledge available to it are such that it is unable to assume, and does not assume, any responsibility for the accuracy, completeness or fairness of such information.

As to any matter contained in such opinion which involves the laws of a jurisdiction other than the United States or the State of [state in which Buyer's counsel is licensed to practice], Buyer's counsel may rely upon opinions of local counsel of established reputation reasonably satisfactory to the Seller, which opinions shall expressly state that they may be relied upon by the Seller. Such counsel may also expressly rely as to matters of fact upon certificates furnished by appropriate officers of the Buyer, or appropriate governmental officials.

Section 10.6. Litigation. At the Closing, there shall be no effective injunction, writ or preliminary restraining order or any order of any nature issued by a court or governmental agency of competent jurisdiction restraining or prohibiting the consummation of the transactions provided for herein or any of them or limiting in any manner the Buyer's right to control the Target and the Subsidiaries or any aspect of their businesses or requiring the sale or other disposition of any of the operations of the Target or any Subsidiary or making the consummation of the Merger or the transaction contemplated by this Agreement and the Related Instruments unduly burdensome to the Target or any Subsidiary, and immediately prior to the Closing Date no proceeding or lawsuit shall have been commenced and be pending or be threatened by any governmental or regulatory agency or any other person with respect to the transactions contemplated by this Agreement or the Related Instruments which the Buyer, in good faith and with the advice of counsel, believes is likely to result in any of the foregoing or which seeks the payment of substantial damages by the Target, any Subsidiary or the Buyer.

Sections 10.1 and 10.2 afford the seller the same right to abandon the transaction as the buyer has under Sections 9.1 and 9.2. However, since the buyer enters into fewer and less expansive representations and covenants than the seller, this right is typically less valuable to the seller than it is to the buyer.

Sections 10.3, 10.4, 10.5, and 10.6 are the seller's equivalent of the bring-down, consent, and corporate action legal opinions and litigation conditions given the buyer in Sections 9.3, 9.4, 9.5, and 9.7, respectively.

ARTICLE XI: TAX MATTERS

Section 11.1. Representations, Warranties and Covenants.
The Seller and the Target each represents and warrants to the Buyer that:

(i) The Seller, the Target, and each of the Subsidiaries have filed or will file when due all federal, foreign, state and local tax returns, tax information returns, reports and estimates for all years and periods (and portions thereof) for which the due date (with extensions) is on or before the Closing Date. All such returns, reports and estimates were or will be prepared in the manner required by applicable law, and reflect or will reflect the liability for taxes of the Target or the Subsidiary filing same in all material respects and all Taxes (as defined in paragraph (v) of this Section 11.1 hereof) shown thereby to be payable and all assessments received by the Target and any Subsidiary have been paid or will be paid when due.

(ii) Section 11.1(ii) of the Disclosure Statement sets forth all jurisdictions in which the Target and the Subsidiaries have filed or will file income or franchise tax returns for each taxable period, or portion thereof, beginning on [insert date] and ending on or before the Closing Date.

(iii) The Target and each Subsidiary have withheld or will withhold amounts from their respective employees and have filed or will file all federal, foreign, state and local returns and reports with respect to employee income tax withholding and social security and unemployment Taxes for all periods (or portions thereof) ending on or before the Closing Date, in compliance with the provisions of the Internal Revenue Code, as amended and currently in effect (the "Code"), and other applicable federal, foreign, state and local laws.

(iv) The Target and the Subsidiaries have paid, or have provided a sufficient reserve on the Most Recent Balance Sheet for the payment of, all federal, state, local, and foreign Taxes with respect to all periods, or portions thereof, ending on or before the date of the Most Recent Balance Sheet.

(v) "Taxes" or "Tax" means all net income, capital gains, gross income, gross receipts, sales, use, ad valorem, franchise, profits, license, withholding,

payroll, employment, excise, severance, stamp, occupation, premium, property, or windfall profit taxes, customs duties, or other taxes, fees, assessments, or charges of any kind whatsoever, together with any interest and any penalties, additions to tax, or additional amounts imposed by any taxing authority ("Taxing Authority") upon the Target or any Subsidiary.

(vi) The consolidated federal income tax returns of the Target through the taxable year ended _____, have been examined by the United States Internal Revenue Service (the "IRS") or closed by applicable statutes of limitations, and any deficiencies or assessments, including interest and penalties thereon, claimed or made as a result of such examinations in respect of the Target and any of the Subsidiaries whose results of operations are includible for such years in the consolidated federal income tax returns of the Target have been paid or provided for.

(vii) Except as set forth in Section 11.1(vii) of the Disclosure Statement, there are no material claims or investigations by any Taxing Authority pending or to the best of the knowledge of Seller threatened against the Target or any Subsidiary for any past due Taxes; and there has been no waiver of any applicable statute of limitations or extension of the time for the assessment of any Tax against the Target or any Subsidiary except as set forth on Section 11.1(vii) of the Disclosure Statement.

(viii) Neither the Target nor any Subsidiary has made, signed or filed, nor will it make, sign or file any consent under Section 341(f) of the Code with respect to any taxable period ending on or before the Closing Date.

(ix) No event has occurred or will occur on or prior to the Closing Date that would require indemnification by the Target or any Subsidiary of any tax lessor under any agreements relating to tax leases executed under Section 168(f)(8) of the Internal Revenue Code or by Seller as to assets of the Target or any Subsidiary.

(x) Any and all consolidated federal income tax (or similar) agreements executed between the Target or a Subsidiary and the Seller, or any other member of the Seller's consolidated group that relate to any payments or liability therefor by or to the Target or a Subsidiary with respect to its federal income and other Taxes and that are continuing in effect will terminate as of the Closing Date, and notwithstanding any provisions contained in such agreements, and on the Closing Date, the Target and the Subsidiaries shall be relieved of all liability and obligation thereunder.

Section 11.2. Payment of Tax Liabilities.

(i) Subject to indemnification by the Seller under Section 11.3(i) hereof, the Target shall pay or cause to be paid at the times required by the relevant Taxing Authority all unpaid separate (unconsolidated) state, local or foreign Tax liabilities, including interest and any penalties thereon, of the Target and any Subsidiary for all periods, or portions thereof, ended on or before the Closing Date.

(ii) The Seller shall pay at the times required by the relevant Taxing Authority

all unpaid federal or combined foreign, state or local Tax liabilities, including interest and any penalties thereon, attributable to the Target and the Subsidiaries for all periods, or portions thereof, with respect to which the Target and the Subsidiaries are included in a combined return.

Section 11.3. Indemnification.

(i) The Seller agrees to indemnify, defend and hold the Buyer, the Target and the Subsidiaries harmless against and from (a) all unpaid federal or combined foreign, state or local Tax liabilities of the Target and any Subsidiary for all periods, or portions thereof, ended on or before the Closing Date, together with any penalties and interest attributable to such liabilities, and (b) all unpaid separate (unconsolidated) state, local or foreign Tax liabilities of the Target and any Subsidiary for all periods, or portions thereof, ended on or before the Closing Date, together with any penalties and interest attributable to such liabilities. The amount of the Seller's obligation under this Section 11.3 shall be reduced by the value of any net Tax benefit ("Net Tax Benefit") realized by the Target and/or any Subsidiary by reason of a Tax deduction or loss, basis adjustment, and/or shifting of income, deductions, gains, losses and/or credits. For this purpose, the value of a Net Tax Benefit shall be determined by the accountant of the Target, using reasonable assumptions and methods of valuation.

(ii) The Seller shall indemnify and hold the Buyer, the Target, the Surviving Corporation and each Subsidiary harmless against any loss, liability, damage or expense (including reasonable attorneys' fees) arising out of or resulting from any inaccuracy or misrepresentation in or breach of any of the warranties, representations, covenants or agreements made by the Seller or the Target in this Article XI.

(iii) The Buyer, the Target, the Surviving Corporation and the Subsidiaries shall indemnify and hold the Seller harmless against any loss, liability, damage or expense (including reasonable attorneys' fees) arising out of or resulting from any inaccuracy or misrepresentation in or breach of any of the warranties, representations, covenants or agreements made by the Buyer in this Article XI.

(iv) The Seller and the Buyer shall satisfy their obligations to each other for indemnification hereunder by check or cash within sixty (60) days after written notice thereof from the other respective party.

(v) The Buyer, the Target and each Subsidiary, on the one hand, and the Seller, on the other hand, hereby agree that in the event a claim is made by one party to this Agreement against the other party, the party making the claim shall furnish to the other party all books, records and other information reasonably requested by such other party that relate to such claims.

Section 11.4. Post-Closing Obligations.

(i) The Seller shall include the results of operations of the Target and the Subsidiaries for the period ending on the Closing Date in its consolidated

federal income tax return and in any consolidated or combined foreign, state or local income Tax return required to be filed by Seller after the Closing Date; and Seller will pay all federal, state, local and foreign income Taxes (including interest and penalties relating thereto) due for the periods covered by such returns with respect to the Target and each Subsidiary.

(ii) The Buyer shall cause the Target and the Subsidiaries to include the results of their respective operations in any separate (unconsolidated) state, foreign or local income Tax return for any taxable year beginning before and ending on or after the Closing Date. Subject to indemnification by the Seller under Section 11.3 hereof, the Buyer shall pay, or cause to be paid, all state, foreign or local income Taxes (including interest and penalties relating thereto) shown as due on any such return with respect to the Target or any Subsidiary.

(iii) All refunds or credits of Taxes paid by the Seller with respect to the Target or the Subsidiaries for periods ending on or prior to the Closing Date shall be the property of the Seller (except for refunds attributable to the carryback of any credits, losses or deductions arising out of the operation of the Target or the Subsidiaries after the Closing Date), and the Buyer shall forward to or reimburse the Seller for such refunds or credits (except as aforesaid) as soon as practicable after receipt thereof. Any refunds or credits of foreign, federal, state or local income Taxes, paid by the Buyer, the Target, the Surviving Corporation or any Subsidiary in accordance with the provisions of Section 11.4(ii) hereof with respect to the Target or any Subsidiary shall be the property of Buyer, the Target or the Subsidiary, as the case may be, and the Seller shall forward or reimburse the Buyer, the Target, or the Subsidiary for any such refunds or credits as soon as practicable after receipt thereof.

(iv) Any losses, credits or other Tax items of the Target or a Subsidiary, including, but not limited to, net operating losses, capital losses, business, foreign and other tax credits (the "Tax Attributes"), which may be attributable to the operation of the business of the Target or a Subsidiary after the Closing Date, including any carrybacks of such Tax Attributes to any period ending on or before the Closing Date, and any refunds of Taxes attributable thereto, shall belong to the Target. To the extent the Tax Attributes are carried back to the Seller's returns under applicable Treasury Regulations, the Seller will file appropriate refund claims upon receipt from the Target of information to be included in such claims. Any refunds attributable to such refund claims received by the Seller shall be received by the Seller solely as agent for the Target and the Seller shall pay over such refunds to the Target immediately upon receipt thereof. The out-of-pocket expenses incurred by the Seller in filing any such refund claim shall be borne by the Target.

(v) To the extent that any election or other action by the Seller or an audit by the IRS or relevant state revenue agency for taxable years ending on or before the Closing Date results in an increase in the federal, state or foreign income Tax liability of the Target or any Subsidiary for a taxable year ending after the

Closing Date, the Seller shall promptly pay the amount of such increase to the Buyer, provided, however, that the Seller shall not be required to make such payment until it receives from the Target reasonable evidence that the increased liability of the Target (or a Subsidiary, as the case may be) is due and payable and provided further that in the event that a subsequent audit by the IRS or relevant state revenue agency of the Buyer, the Target or any Subsidiary results in a reduction or elimination of such increase that resulted in any payment made under this paragraph, the Buyer shall promptly refund such payment or portion thereof, as the case may be, together with interest thereon at the prime rate from the date of such payment through the date of such refund.

(vi) If requested by the Buyer, the Seller shall make or cause the Target, with respect to the Subsidiaries, to make a deemed dividend election as of [_____], the first day of the Target's most recent taxable year, pursuant to consolidated return Treas. Regs. 1.1502-32(f)(2) and, with respect to such Subsidiaries, a consent dividend with respect to the period commencing on [_____], the first day of the Target's most recent taxable year, through the Closing Date pursuant to Section 565 of the Code. The Seller shall also cause the Target and any Subsidiary, to the extent not inconsistent with the requirements of the preceding sentence, to not have an excess loss account, as defined in Treas. Regs. 1.1502-32(e)(1), in the stock of any domestic subsidiary at the Closing Date.

(vii) At the reasonable request of the Buyer, the Seller will furnish to the Buyer, to the extent prepared or available and without representation or warranty, copies of (i) studies on the earnings and profits of the Target and each Subsidiary made pursuant to Treas. Regs. 1.1502-33 and (ii) computations pursuant to Treas. Regs. 1.1502-32 of actual investment adjustments with respect to the stock of, or any ownership interest in, the Target and each Subsidiary through the Closing Date.

(viii) Subsequent to the filing of the Seller's consolidated federal income tax return which includes the taxable period ending on the Closing Date, the Seller shall determine, under the Seller's policy, consistently applied, and pursuant to Treas. Reg. 1.1502-79, the portion of any net operating loss or capital loss carryover, charitable contribution carryover, or business and other credit carryovers, not availed of in the Seller's consolidated federal income tax returns that are allocable to the Target and each domestic subsidiary of the Target when each such corporation ceased to be a member of the Seller's consolidated group.

(ix) In the event that (a) the Target or a Subsidiary pays any separate (unconsolidated) state, local or foreign tax liability, including interest and penalty thereon, pursuant to Section 11.2(i) hereof and (b) the Target is indemnified against such payment by the Seller under Section 11.3(i), then the Seller shall reimburse the Target or the Subsidiary in the following manner: Any reimbursement payment required to be made by Seller to the Target or a Subsidiary pursuant to this Section 11.4(ix) shall be made no later than thirty (30) days

after receipt by the Seller of (x) a notice or demand for payments, (y) a copy of the complete return or report to be filed with the Taxing Authority, and (z) copies of all supporting workpapers or other appropriate assurances showing that the Tax liability less the value of any Net Tax Benefit, as provided in Section 11.3(i), has been correctly computed and apportioned to the Seller.

Section 11.5. Further Assurances and Assistance. From time to time prior to and after the Closing, the Seller and the Buyer will, without further consideration, (i) execute and deliver such documents as the other may reasonably request in order to consummate more effectively the transactions contemplated by this Agreement and (ii) provide such assistance and records as the other may reasonably request in connection with any tax return, tax investigation or audit, judicial or administrative proceeding or other similar matter relating to the Target or any of its Subsidiaries.

There are at least two approaches for dealing with the concerns of the seller and the buyer as to who should control the tax audit. Sections 11.6 and 11.7 are examples of each approach. The first approach is quite straightforward and eliminates any involvement by the buyer provided that the seller completely indemnifies the target from any tax liability relating thereto. The second approach gives the buyer the right to control the tax contest in situations in which the buyer has greater exposure than the seller. The advantages of each of these approaches are discussed in connection with the control of proceedings in the indemnity provisions in Article XII.

Section 11.6. Audit Matters. The Seller will be responsible for and have the right to control, at the Seller's expense, the audit of any Tax return relating to periods ended on or prior to the day of Closing. The Buyer will have the right, directly or through its designated representatives, to approve any settlement, provided, however, that the Seller may settle an audit on any terms by providing the Target with full indemnification against any Tax liability as a result thereof, in form and substance satisfactory to the Buyer.

Section 11.7. Certain Tax Claims for Which Seller May Be Liable.

(i) If a claim is made by any Taxing Authority or, if during the course of an examination by a Taxing Authority, it appears that the examining agent will propose adjustments that will result in a claim (a "Proposed Claim") with respect to the Target or a Subsidiary (the "Target Group"), the party to this Agreement that has the legal right to settle or compromise such Proposed Claim under applicable law (the "Controlling Party") shall notify in writing ("Notice") the other party to this Agreement that may incur any liability in respect of such Proposed Claim under this Article XI (the "Noncontrolling Party") within ten (10) business days of the date of such Proposed Claim. If

the Controlling Party is a member of the Target Group, Notice shall be given to the Seller; if the Seller is the Controlling Party, Notice shall be given only to the Target. In the case of any such Proposed Claim, the Controlling Party shall not agree to such Proposed Claim or make payment thereof for at least sixty (60) days (or such shorter period as may be required by applicable law) after the giving of Notice with respect thereto. The Controlling Party need not give Notice of a Proposed Claim if the Controlling Party assumes liability for it. The failure to give Notice as provided hereunder shall not affect a Noncontrolling Party's liabilities under this Article XI unless such failure materially prejudices the ability of the Noncontrolling Party to defend against such Proposed Claim or to seek a refund of amounts paid in regard of such Proposed Claim.

(ii) As to a Tax that would result from a Proposed Claim for which the Controlling Party or the Noncontrolling Party would be solely liable under this Article XI hereof, the party that would be solely liable shall have the right, at its sole cost, to resist the Proposed Claim and if any Tax is paid, to seek the recovery of any such tax ("Tax Contest"). Such party may contest such Tax Contest by any and all appropriate proceedings, whether involving amended tax returns, claims for refund, administrative proceedings, litigation, appeals or otherwise, and in connection therewith, the other party will execute and deliver, or cause to be executed and delivered, to the party conducting the Tax Contest or its designees all instruments (including without limitation powers of attorney) reasonably requested by the party conducting the Tax Contest in order to implement the provisions of this paragraph.

(iii) As to a Tax for which the Noncontrolling Party is liable for a portion hereunder ("Joint Tax"), either the Controlling Party or the Noncontrolling Party shall have the right to institute or maintain a Tax Contest with respect thereto, subject to the provisions of Section 11.7(ii) hereof, as further modified by the following:

(a) If the asserted liability of the Controlling Party hereunder is equal to fifty percent (50) or more of the Proposed Claim, the Controlling Party may elect to conduct all proceedings of the Tax Contest as to such Joint Tax or to tender the conduct of all proceedings to the Noncontrolling Party.

(b) If the asserted liability of the Controlling Party hereunder is less than fifty percent (50) of the Proposed Claim, the Controlling Party shall tender the conduct of all proceedings of the Tax Contest to the Noncontrolling Party.

(c) If the conduct of all proceedings of the Tax Contest is tendered to the Noncontrolling Party and it declines to conduct such proceedings, then the Controlling Party (unless it elects to settle or not to contest as provided below) will conduct such proceedings. All costs of the Tax Contest will be shared as between the Controlling Party and the Noncontrolling Party in the ratio in which the Joint Tax is ultimately assessed.

(d) If the party conducting the Tax Contest (the "Manager") wishes to concede a Joint Tax or wishes and is able to compromise a Joint Tax and so notifies the other, the other party must either concede or agree to such compromise, as appropriate, or else agree to bear any portion of the Manager's tax liability in excess of the conceded or compromised amount. The party not wishing to concede or compromise will then assume responsibility for the conduct of the proceedings relating to the Tax Contest, and shall bear all costs of the Tax Contest thereafter incurred.

(iv) The "costs" of a Tax Contest means all out-of-pocket costs incurred by the Manager during the period it is acting as the Manager and any reasonable costs incurred by the other party for other than routine services or materials requested by the Manager in connection with such Tax Contest.

(v) The Target and the Seller will cooperate fully with each other in connection with any audit examinations of the Target by any Taxing Authority or any Tax Contests, including, without limitation, the furnishing or making available of records, books of account, or other materials necessary or helpful for the defense against the assertions of any Taxing Authority as to any income tax returns (consolidated or otherwise) of the Target and the Subsidiaries.

(vi) The Seller shall not agree to a settlement of any such Tax liabilities which would adversely affect any member of the Target Group in any taxable period ending after the Closing Date to any material extent (including, without limitation, the imposition of income tax deficiencies or the reduction of asset basis or cost adjustments) without the Target's prior written consent, which consent shall not be unreasonably withheld, unless the Seller indemnifies the Target Group against the effects of any such settlement. The Target shall not resolve, settle or contest any tax issue with respect to the Target which would have an adverse material effect on the Seller without the Seller's prior written consent, which consent shall not be unreasonably withheld, unless the Target indemnifies the Seller against the effects of any such settlement.

Many nontax lawyers merely skim the tax section of an acquisition agreement, since they find it extremely esoteric. Although this may be unavoidable, the importance of tax provisions should not be minimized or overlooked. Article XI is used in connection with the acquisition of a target whose federal income tax returns are filed as part of the consolidated tax return of the seller. Although pre-closing federal tax liabilities of the target will be automatically included in the seller's consolidated return, the target will itself have liability to various other taxing authorities for periods prior to the closing. Therefore, since the target will file a tax return after Closing that covers a portion of the period prior to closing, the agreement should require the seller to pay any taxes for periods prior to the closing that may be due to various taxing authorities. This is logical, as the

seller reaped the benefits of the target's income during this period. It is also necessary for the seller and the buyer to coordinate the filing of tax returns post-closing as well as the handling of tax refunds or credits.

When agreeing to indemnify the target for the target's tax liability covering periods prior to the closing, the seller should require its indemnity obligation to be reduced by the amount of any offsetting tax benefits realized by the target by reason of pre-closing tax liability. (See Section 11.3(i).) This is at least theoretically a fair result, since the buyer should not be expected to get a windfall from the indemnity provisions. The principal, and fairly valid, argument against such a provision is that the actual determination of an offsetting tax benefit can be quite difficult in practice.

The representations and warranties set forth in Section 11.1 assure the buyer that it should not be faced with unanticipated tax liabilities of any kind.

In situations in which the target is not a member of the seller's consolidated group, much of Article XI may be unnecessary, and the buyer should instead require a representation by the seller in Article IV as follows:

> ***Tax Matters.*** For purposes of this Agreement "Taxes" or "Tax" means all net income, capital gains, gross income, gross receipts, sales, use, ad valorem, franchise, profits, license, withholding, payroll, employment, excise, severance, stamp, occupation, premium, property, or windfall profit taxes, customs duties, or other taxes, fees, assessments, or charges of any kind whatsoever, together with any interest and any penalties, additions to tax, or additional amounts imposed by any taxing authority ("Taxing Authority") upon the Target or the Subsidiary.
>
> (i) Except as set forth in Section _____of the Disclosure Statement, the Target and the Subsidiary have filed or will file when due all federal, foreign, state, and local tax returns, tax information returns, reports, and estimates for all years and periods (and portions thereof) ending on or before the Closing Date for which any such returns, reports or estimates were due. All such returns, reports and estimates were prepared in the manner required by applicable law, and all Taxes shown thereby to be payable have been paid when due.
>
> (ii) Section _____of the Disclosure Statement sets forth all jurisdictions in which the Target and the Subsidiaries have filed or will file income or franchise tax returns for each taxable period, or portion thereof, ending on or before the Closing Date.
>
> (iii) The Target and the Subsidiaries each has withheld or will withhold amounts from its respective employees and has filed or will file all federal, foreign, state and local returns and reports with respect to employee income tax withholding and social security and unemployment Taxes for all periods (or

portions thereof) ending on or before the Closing Date, in compliance with the provisions of the Internal Revenue Code, as amended and currently in effect (the "Code"), and other applicable federal, foreign, state and local laws.

(iv) The Target and the Subsidiaries each have paid, or provided a sufficient reserve on the Balance Sheet for the payment of, all federal, state, local and foreign Taxes with respect to all periods, or portions thereof, ending on or before _____. The amount of any net operating loss for federal income tax purposes shown on the Target's federal income tax returns has been accurately and properly determined in accordance with the Code and other applicable law without giving effect to the transactions contemplated hereby.

(v) The separate and consolidated federal income tax returns of the Target and its Subsidiaries, through the taxable year ended [insert date], have been examined by the United States Internal Revenue Service (the "IRS") or closed by applicable statute of limitations, and any deficiencies or assessments, including interest and penalties thereon, claimed or made as a result of such examinations in respect of the target and any of its Subsidiaries.

(vi) Except as set forth in Section _____of the Disclosure Statement there are no material claims or investigations by any Taxing Authority pending or, to the best knowledge of the Seller and the Target, threatened, against the Target or the Subsidiaries for any past due Taxes; and there has been no waiver of any applicable statute of limitations or extension of the time for the assessment of any Tax against the Target or the Subsidiaries, except as set forth in Section _____of the Disclosure Statement.

(vii) Neither the Target nor any Subsidiary has made, signed or filed, nor will it make, sign or file any consent under Section 341(f) of the Code with respect to any taxable period ending on or before the Closing Date.

(viii) Except as set forth in Section _____of the Disclosure Statement, no event has occurred or will occur on or prior to the Closing Date that would require indemnification by the Target or the Subsidiaries of any tax lessor under any agreements relating to tax leases executed under Section 168(f)(8) of the Internal Revenue Code as to assets of the Target or its Subsidiaries.

(ix) Neither the Target nor any Subsidiary has ever been, nor is the Target or any Subsidiary currently, a party to any agreement relating to the sharing of any liability for, or payment of, Taxes with any other person or entity.

ARTICLE XII: SURVIVAL OF REPRESENTATIONS; INDEMNIFICATION

Section 12.1. Indemnification by Seller. Notwithstanding any other provision of this Agreement and subject to the terms and conditions of this Article XII, the Seller hereby agrees to indemnify, defend and hold harmless the Buyer, any

subsidiary or affiliate thereof (including the Target, the Surviving Corporation and the Subsidiaries) and their respective successors, if any, and their officers, directors and controlling persons (the "Buyer Group"), at any time after the Closing Date, from and against all demands, claims, actions or causes of action, assessments, losses, damages, liabilities, costs and expenses, including without limitation, interest, penalties and attorneys' fees and expenses, which were reasonably incurred by or imposed upon the Buyer Group or any member thereof, net of any insurance proceeds received by any member of the Buyer Group with respect thereto (all such amounts, net of insurance proceeds being hereafter referred to collectively as "Buyer Group Damages"), asserted against, resulting to, imposed upon or incurred by the Buyer Group or any member thereof, directly or indirectly, by reason of or resulting from any misrepresentation, breach of any warranty or nonperformance or breach of any covenant, obligation or agreement of the Seller or the Target or its Subsidiaries contained in or made pursuant to this Agreement, the Disclosure Statement, the Related Instruments or pursuant to any statement, certificate or other document furnished pursuant to this Agreement or the Related Instruments (collectively referred to as the "Indemnity Documents") or any facts or circumstances constituting such a breach. (A claim for indemnification under this Section 12.1 shall be referred to as the "Buyer Group Claims.")

Section 12.2. Indemnification by the Surviving Corporation. Notwithstanding any other provision of this Agreement and subject to the terms and conditions of this Article XII, the Surviving Corporation hereby agrees to indemnify, defend and hold harmless the Seller and their respective successors, if any, and their officers, directors and controlling persons (the "Seller Group"), at any time after the Closing Date, from and against all demands, claims, actions, or causes of action, assessments, losses, damages, liabilities, costs and expenses, including, without limitation, interest, penalties and attorneys' fees and expenses, which were reasonably incurred by or imposed upon the Seller Group or any member thereof, net of any insurance proceeds received by any member of the Seller Group with respect thereto (all such amounts, net of insurance proceeds being hereafter referred to collectively as "Seller Group Damages"), asserted against, resulting to, imposed upon or incurred by the Seller Group or any member thereof, directly or indirectly, by reason of or resulting from any misrepresentation, breach of any warranty, or nonperformance or breach of any covenant, obligation or agreement of the Buyer contained in or made pursuant to any Indemnity Document or any facts or circumstances constituting such a breach. (A claim for indemnification under this Section 12.2 shall be referred to as the "Seller Group Claims.")

The buyer group damages and seller group damages take into account any insurance proceeds that are received by the indemnified party in

order to reduce the amount of damages that can be recovered by the indemnified party. Another item that arguably should offset the amount of damages that an indemnified party can claim is the amount of any tax benefits that the surviving corporation has enjoyed as a result of such damages. The difficulty of determining the exact amount of the tax benefit that directly resulted from the damages almost always causes the buyer and seller to overlook this potential windfall.

Section 12.3. Materiality. For purposes of determining whether an event described in Section 12.1 or 12.2 has occurred, any requirement in any representation, warranty, covenant or agreement contained in any Indemnity Document that an event or fact be material, meet a certain minimum dollar threshold or have a Material Adverse Effect, which is a condition to such event or fact constituting a misrepresentation or a breach of such warranty, covenant or agreement (a "Materiality Condition"), shall be ignored, if the aggregate Buyer Group Damages or Seller Group Damages, as the case may be, resulting from all such breaches and misrepresentations (determined by ignoring all Materiality Conditions) exceeds the amount of the Basket (as defined in Section 12.5). Notwithstanding the foregoing, an event described in Section 12.1 or 12.2 (other than a claim for indemnification under Article XI) that would otherwise give rise to a claim for Buyer Group Damages or Seller Group Damages, as the case may be, shall not be deemed to have occurred unless the Buyer Group Damages or Seller Group Damages, as the case may be, resulting from the single misrepresentation or breach of warranty, covenant or agreement that constitute such event exceeds Dollars, provided that for the purposes of this sentence, all claims for Buyer Group Damages or Seller Group Damages, as the case may be, arising out of the same facts or events causing any such breach shall be treated as a single claim.

Section 12.4. Survival of Indemnification. The right to make a claim for indemnification under this Agreement shall survive the Closing Date for a period of twenty-four (24) months except that a claim for indemnification under (a) Section 4.4 of this Agreement or based upon any misrepresentation or breach of a warranty which was actually known to be untrue by the indemnifying party when made or asserted or to any willful breach of a covenant, shall continue to survive indefinitely, (b) Article XI shall continue to survive until the latest to occur of (i) the date twenty-four (24) months after the Closing Date, (ii) the expiration date of the statute of limitations applicable to any indemnified liability for Taxes, and extensions or waivers thereof and (iii) ninety (90) days after the final determination of any such Tax liability, including the final administrative and/or judicial determination thereof, and thereafter no party shall have a right to seek indemnification under this Agreement unless a notice

of claim setting forth the facts upon which the claim for indemnification is based, and if possible, a reasonable estimate of the amount of the claim, is delivered to the indemnifying party prior to the expiration of the right to make a claim as provided in this Section 12.4. This Section 12.4 shall have no effect upon any other obligation of the parties hereto, whether to be performed before or after the Closing Date. It shall not be a condition to the indemnification with respect to such claim that the loss or liability upon which the claim would be based actually be realized or incurred prior to the date that the indemnifying party is no longer obligated to indemnify the indemnified party pursuant to this Article XII.

The length of time that the seller's indemnification obligations survive the closing date is often heavily negotiated, and its outcome is largely dependent upon the nature of the transaction and the strength of the parties' respective bargaining positions. The buyer should require the seller to indemnify the title to the securities to be purchased by it for an indefinite period of time. For indemnification relating to tax liability, the buyer should require the seller to indemnify the surviving corporation until the target can no longer suffer any loss. In some cases, the buyer may require the seller to indemnify certain items, such as an environmental or product liability concern, beyond the general indemnification period.

Section 12.5. Limitation on Claims and Damages.

(i) No amount shall be payable in indemnification under this Article XII, unless (a) in the case of the Seller, the aggregate amount of Buyer Group Damages in respect of which the Seller would be liable under this Article XII, or (b) in the case of the Surviving Corporation, the aggregate amount of Seller Group Damages in respect of which the Surviving Corporation would be liable under this Article XII, exceeds in the aggregate _____ Dollars ($ _____) (the "Basket"); provided, however, the Basket shall not apply to (a) any Buyer Group Claim or Seller Group Claim, as the case may be, based upon any misrepresentation or breach of a warranty which was actually known to be untrue by the indemnifying party when made or asserted or to any willful breach of a covenant or (b) any claim for indemnity under Article XI. In the event that the Buyer Group Damages or Seller Group Damages exceeds the Basket, the indemnified party shall be entitled to seek indemnification for the full amount of the Buyer Group Damages or Seller Group Damages, as the case may be.

(ii) The maximum amount of Buyer Group Damages for which the Seller may be liable under this Article XII shall be an amount equal to _____ _____ Dollars ($ _____).

(iii) A party shall not be liable for Buyer Group Damages or Seller Group Damages, as the case may be, under this Article XII resulting from an event relating to a misrepresentation, breach of any warranty or nonperformance or breach of any covenant by the indemnifying party if the indemnifying party can establish that the party seeking indemnification had actual knowledge on or before the Closing Date of such event.

(iv) In any case where an indemnified party recovers from third parties all or any part of any amount paid to it by an indemnifying party pursuant to this Article XII, such indemnified party shall promptly pay over to the indemnifying party the amount so recovered (after deducting therefrom the full amount of the expenses incurred by it in procuring such recovery and any additional amounts owed to the indemnified party by the indemnifying party under this Agreement), but not in excess of any amount previously so paid by the indemnifying party.

(v) The indemnified party shall be obligated to prosecute diligently and in good faith any claim for Buyer Group Damages or Seller Group Damages, as the case may be, with any applicable insurer prior to collecting or indemnification payment under this Article XII. However, an indemnified party shall be entitled to collect an indemnification payment under this Article XII if such indemnified party has not received reimbursement from an applicable insurer within one year after it has given such insurer written notice of its claim. In such event, the indemnified party shall assign to the indemnifying party its rights against such insurer.

(vi) Except in the case of fraud and other than as set forth in Article XI or Section 12.5(vii) hereof, the indemnification and terms thereof provided for in this Article XII shall be the exclusive remedy available to any indemnified party against any indemnifying party for any damages arising directly or indirectly from any misrepresentation, breach of any warranty or nonperformance or breach of any covenant, obligation or agreement pursuant to the Indemnity Documents.

(vii) Nothing in this Article XII or in Article XI shall be construed to limit the non-monetary equitable remedies of any party hereto in respect of any breach by any other party of any covenant or other agreement of such other party contained in or made pursuant to the Indemnity Documents required to be performed after the Closing Date.

The seller, who usually has the most at stake under the indemnification provisions, should require the surviving corporation to pursue collection from an insurance company for the redress of buyer group damages if the insurance policy arguably covers the buyer group damages. In addition, with respect to the covenants in Section 6.7 and Article VII, the seller should not be liable for any buyer group damages if the buyer was aware of the seller's misrepresentation or breach prior to the closing date.

A seller should always attempt to limit its exposure for indemnification. As a practical matter, the seller should not be liable for any amount in excess of the purchase price paid for the target. During negotiations of this ceiling, every argument conceivable is put on the table for consideration. However, its outcome, like that of any other highly controversial provision, rests with the party holding the trump card.

Section 12.6. Claims by Third Parties. The obligations and liabilities of an indemnifying party under any provision of this Agreement with respect to claims relating to third parties shall be subject to the following terms and conditions:

(i) Whenever any indemnified party shall have received notice that a Buyer Group Claim or a Seller Group Claim, as the case may be, has been asserted or threatened against such indemnified party, which, if valid, would subject the indemnifying party to an indemnity obligation under this Agreement, the indemnified party shall promptly notify the indemnifying party of such claim in the manner described in Section 12.4; provided, however, that the failure of the indemnified party to give timely notice hereunder shall not relieve the indemnifying party of its indemnification obligations under this Agreement unless, and only to the extent that, such failure caused the Buyer Group Damages or the Seller Group Damages, as the case may be, for which the indemnifying party is obligated to be greater than they would have been had the indemnified party given timely notice.

(ii) The indemnifying party or its designee will have the right, but not the obligation, to assume the defense of any claim described in Section 12.6(i); provided, however, if there is a reasonable probability that a Buyer Group Claim may materially and adversely affect the Surviving Corporation or any other member of the Buyer Group despite the indemnity of the Seller, the Surviving Corporation or such member of the Buyer Group shall have the right at its option to defend, at its own cost and expense, and to compromise or settle such Buyer Group Claim which compromise or settlement shall be made only with the written consent of the Seller, such consent not to be unreasonably withheld. If the indemnifying party fails to assume the defense of such claim within 15 days after receipt of notice of a claim pursuant to Section 12.6(i), the indemnified party against which such claim has been asserted will (upon delivering notice to such effect to the indemnifying party) have the right to undertake, at the indemnifying party's cost and expense, the defense, compromise or settlement of such claim on behalf of and for the account and risk of the indemnifying party, subject to the right of the indemnifying party to assume the defense of such claim at any time prior to settlement, compromise or final determination thereof and provided, however, that the indemnified party shall not enter into any such compromise or settlement without the written consent of the indemnifying party. In the event the indemnified party assumes defense of the claim,

the indemnified party will keep the indemnifying party reasonably informed of the progress of any such defense, compromise or settlement. The indemnifying party shall not be liable for any settlement of any action effected without its consent, but if settled with the consent of the indemnifying party or if there be a final judgment beyond review or appeal, for the plaintiff in any such action, the indemnifying party agrees to indemnify and hold harmless an indemnified party from and against any loss or liability by reason of such settlement or judgment. Any party who does not undertake the defense of a claim may, at its own expense, retain such additional attorneys and other advisors as it shall deem necessary, which attorneys and advisors will be permitted by the party undertaking such defense, and its attorneys, to observe the defense of such claim.

(iii) Any member of the Buyer Group shall give the Seller at least thirty (30) days' prior written notice before such member shall waive the provisions of any statute of limitations as such provisions may apply to the assessment of taxes payable by the Surviving Corporation or any Subsidiary for any taxable year or period (or portion thereof) ending on or prior to the Closing Date.

An area that can be extremely sensitive is control of a proceeding relating to a claim that is the subject of indemnification. If the indemnifying party refuses to acknowledge its obligation to indemnify a claim, then it should certainly have no right to control the proceeding. However, where the indemnifying party has accepted its obligation to indemnify for a claim, the indemnifying party will probably want to control the proceeding in order to be in command of its own destiny. If the buyer is comfortable with the creditworthiness of the seller, this should not pose a serious threat to the buyer. There are, of course, circumstances in which the buyer may want to control the proceedings notwithstanding the creditworthiness of the seller. For example, if the surviving corporation is temporarily enjoined from conducting its business as a result of the action of a third party, the buyer may feel that the seller will not move quickly enough to resolve the matter.

In some cases, the buyer and seller may have a joint interest in the outcome of a certain proceeding. For example, the proceeding may involve numerous claims against the surviving corporation, only one of which relates to a buyer group claim. One approach that may appease both the seller and buyer in this circumstance is to let the party that has the most to lose control the proceeding.

Section 12.7. Indemnity for Taxes of Indemnified Party. Each party hereto further agrees that, with respect to payment or indemnity under this Article

XII, such payment or indemnity shall include any amount necessary to hold the indemnified party harmless on an after-tax basis from all taxes required to be paid with respect to the receipt of such payment or indemnity under the laws of any Federal, state or local government or taxing authority in the United States, or under the laws of any foreign government or taxing authority or governmental subdivision of a foreign country.

In circumstances in which the indemnification payment is taxable to the indemnified party, it is common for the seller and buyer to negotiate the inclusion of a tax gross-up provision. One difficulty with this concept is that the indemnifying party may be grossing up the indemnified party for taxes that it would have been responsible for had no indemnity been necessary.

Section 12.8. Right of Offset. In the event the Seller should be required to pay monies to the Surviving Corporation pursuant to Section 12.1 or any other indemnification provision of this Agreement, the Surviving Corporation may offset the amount the Seller owes in indemnification against any outstanding principal balance of the [insert title of instrument under which the surviving corporation has continuing payment obligations].

In an acquisition in which the seller has agreed to accept, as part of the purchase price of the target, a note or other instrument that represents a payment obligation of the surviving corporation, the buyer may attempt to satisfy its right to indemnification by the seller by canceling a portion or all of such payment obligations. A creditworthy seller should resist this provision on several grounds. First, the surviving corporation should have a setoff right only after it has demonstrated, through a final determination from which no appeal can be taken, that the seller is obligated to indemnify the surviving corporation for the buyer group claim. Second, if the seller has sufficient resources, it should be able to choose whether it wants to forgive a portion of the payment obligation or simply pay cash. It is conceivable that the payment obligation may bear an interest rate well in excess of the prevailing market rate. A creditworthy seller should not lose this benefit through an offset provision.

ARTICLE XIII: NON-COMPETE

The Seller agrees that for the period of three years following the Closing Date (the "Non-Compete Period"), the Seller shall not, without the prior written consent of the Buyer, either directly or indirectly, engage in business of the type

presently conducted by the Target or any Subsidiary in the United States or any other jurisdiction in which the Target or any Subsidiary currently conducts business (the "Business"). The Seller may acquire any entity which, directly or indirectly, engages in the Business or any portion thereof (the "Acquired Entity"), if (i) the total assets and gross revenues attributable to or derived from such Business do not exceed [insert percentage] of the total assets and gross revenues of the Acquired Entity and its subsidiaries in the fiscal year immediately preceding the date of acquisition, or (ii) the Seller uses its reasonable efforts to divest itself of the Acquired Entity within a reasonable time (not to exceed six months), subject to receipt of all regulatory approvals. The Seller also agrees that, after the Closing Date, the Seller will not disclose or reveal to any person or an Acquired Entity any trade secret or other confidential or proprietary information relating to the Business, including, without limitation, any financial information relating to the Target or any Subsidiary, or any customer lists, unless readily ascertainable from public information, and the Seller confirms that after the Closing Date, such information will constitute the exclusive property of the Target and its Subsidiaries. During the Non-Compete Period, the Seller agrees not to, and to cause its affiliates not to, recruit, directly or indirectly, employees of the Target or any Subsidiary for employment with or as a consultant to the Seller or its affiliates. The Buyer and the Seller hereby agree that of the total cash consideration to be paid to the Seller at Closing, $_____ represents the consideration for the covenants of the Seller contained in this Article XIII.

Covenants not to compete can be difficult to enforce if not structured properly. The difficulty arises from a court's reluctance on public policy grounds to give force to a contractual provision restricting the ability of one of the parties to work freely in any way it chooses, even if the party being restricted has voluntarily agreed and has received consideration to be so bound. Courts have invalidated noncompetition provisions (a) that continue for too long a period of time, (b) that are too broad geographically, or (c) that are too indefinite or broad with respect to the restricted activity. Consequently, the buyer must ensure that its noncompetition clause is specific with respect to the term (typically one to five years), extends to a limited geographic area, and restricts a specific activity in the industry. For example, a court would probably accept a provision restricting the seller from selling or distributing aluminum baseball bats in the State of California for a period of two years, but would probably not accept a provision restricting the seller from selling or distributing sports equipment anywhere in the world for a period of twenty years. It is, of course, within these extremes that the enforceability of a covenant not to compete is less clear. The buyer must be cognizant of courts' rulings under the state laws

that govern the acquisition agreement and must balance the case law against its need to acquire the target without fear that the seller will acquire or establish a similar business in the same territory and attempt to lure away existing customers of the target.

The seller may also desire to modify clause (ii) above, which requires the seller's divestiture of the acquired entity within a reasonable period of time by providing that the seller is only obligated to divest the acquired entity "at a price which is economically reasonable in light of the circumstances."

ARTICLE XIV: TERMINATION

Section 14.1. Termination for Failure to Close on Time. This Agreement may be terminated upon two (2) days' written notice (i) by Buyer, on the one hand, or the Seller, on the other hand, at any time after [insert date], or (ii) by the mutual agreement of all parties at any time. In the event of such termination, this Agreement shall be abandoned without any liability or further obligation to any other party to this Agreement unless otherwise stated expressly herein. This Section 14.1 shall not apply in the event of the failure of the transactions contemplated by this Agreement to be consummated as a result of a breach by the Seller, Target or Buyer of a representation, warranty or covenant contained in this Agreement. In such event, the provisions of Section 14.2 hereof shall apply.

Section 14.2. Default; Remedies. This Section shall apply in the event that a party refuses to consummate the transactions contemplated by this Agreement or if any default under, or breach of any representation, warranty or covenant of, this Agreement on the part of a party (the "Defaulting Party") shall have occurred that results in the failure to consummate the transactions contemplated hereby. In such event, the non-Defaulting Party shall be entitled to seek and obtain specific performance pursuant to Section 14.3 or to seek and obtain money damages from the Defaulting Party plus its court costs and reasonable attorneys' fees in connection with the pursuit of its remedies hereunder.

Section 14.3. Specific Performance. In the event that any party shall fail or refuse to consummate the transactions contemplated by this Agreement or if any default under, or breach of, any representation, warranty or covenant of this Agreement on the part of any party (the "Defaulting Party") shall have occurred that results in the failure to consummate the transactions contemplated hereby, then in addition to the other remedies provided in this Article XIV, the non-Defaulting Party may seek to obtain an order of specific performance thereof against the Defaulting Party from a court of competent jurisdiction, provided that it files its request with such court within forty-five (45) days after

> it became aware of such failure, refusal, default or breach. In addition, the non-Defaulting Party shall be entitled to obtain from the Defaulting Party court costs and reasonable attorneys' fees incurred by it in enforcing its rights hereunder. As a condition to seeking specific performance hereunder, Buyer shall not be required to have tendered the [insert defined term for the total purchase price] but shall be ready, willing and able to do so.

The termination section provides both the mechanism for the termination of, and the remedies available against a nonperforming or defaulting party to, the acquisition agreement. In some cases, a seller may want to modify this section to limit liability for a willful failure to perform. Obviously, there are situations in which the buyer may be disadvantaged by the inclusion of this modifier. Therefore, like other disputed provisions, the outcome rests on the balance of power between seller and buyer.

In an acquisition requiring regulatory approval, the buyer and seller should consider extending the term of the acquisition agreement in Section 14.1 for a certain period of time in case the approval process takes longer than anticipated.

The relief of specific performance afforded the nondefaulting party in Section 14.3 is extremely difficult to enforce in a court of law. If a court can ascertain the amount of monetary damages to award the nondefaulting party, it will not generally grant specific performance.

Special consideration should be given to the termination section in connection with the acquisition of a publicly traded target. For example, an independent committee of the board of directors of the target may determine in light of the circumstances to include a fiduciary out for the target. A fiduciary out is a unilateral right of the target to terminate the acquisition agreement in the event a more favorable offer for the target is received prior to closing. The buyer should in this situation and possibly others, require a "breakup" or "topping" fee to compensate the buyer for its damages and out-of-pocket expenses. The following is an example of a "bustup" fee that covers both buyer and seller:

> ***Damages Upon Default.*** In the event that either Target or Buyer shall fail to refuse to consummate the transactions contemplated by this Agreement or if any default under, or breach of any representation (other than those contained in Section 3.5 hereof), warranty, covenant (other than those contained in hereof) or conditions of, this Agreement on the part of the Target or Buyer shall have occurred that results in the failure to consummate the transactions contemplated hereby, then (i) if Target shall be the defaulting party, Target shall pay to the Buyer Dollars ($), or (ii) if the Buyer shall be the defaulting party, then the Buyer shall pay to Target Dollars ($). In each case such payment shall be in

consideration of the expenses incurred by and efforts expended by and opportunities lost by the nondefaulting party. The parties agree that in such circumstances it would be impossible to determine the actual damages which any party may suffer and that therefore such payments shall be in lieu of any such actual damages and shall be full and complete liquidated damages and shall constitute the sole remedy in the event of such default.

ARTICLE XV: MISCELLANEOUS

Article XV contains provisions that govern the interpretation of the agreement and the taking of actions thereunder. Although the bulk of these provisions are generally not negotiated by the parties to the agreement, several sections provide valuable rights to both buyer and seller and may be subject to closer scrutiny by the parties.

Section 15.1. Definitions.

Agreement. ***See Article I.***
Buyer. ***See Article I.***
Closing. ***See Article III.***
Closing Date. ***See Article III.***
Company Capital Stock. ***See Section 4.3(i).***
Disclosure Statement. ***See Section 4.1.***
Financial Statements. ***See Section 4.5(i).***
GAAP. ***See Section 4.5(i).***
Material Adverse Effect. ***See Section 4.1(i).***
Merger. ***See Article I.***
Most Recent Balance Sheet. ***See Section 4.5(i).***
Persons. First used in Section 4.5(ii) but not defined.
Related Instruments. ***See Section 4.2.***
SEC. Defined in paragraph describing Section 4.33.
Seller. ***See Article I.***
Subsidiary. ***See Article I.***
Target. ***See Article I.***

Section 15.2. Payment of Expenses. Buyer shall pay its own expenses and the Seller and Target shall pay their own expenses incident to preparing for, entering into and carrying out this Agreement and the Related Instruments, except as otherwise provided in this Agreement and the Related Instruments.

Section 15.3. Modifications or Waivers to the Agreement. The parties may, by mutual written agreement, make any modification or amendment of this Agreement.

Section 15.4. Assignment. Neither the Buyer, Seller nor Target shall have the authority to assign its rights or obligations under this Agreement without the prior written consent of the other party, except that the Buyer may assign all or any portion of its respective rights hereunder without the prior written consent of the Seller or Target to an entity controlled by, controlling or under common control with it or to any Acquisition Lender, and the Seller, Target and the Buyer shall execute such documents as are necessary in order to effect such assignments.

Section 15.5. Burden and Benefit.

(i) This Agreement shall be binding upon and, to the extent permitted in this Agreement, shall inure to the benefit of, the parties hereto and their respective successors and assigns.

(ii) In the event of a default by the Seller or Target of any of its or their obligations hereunder, the sole and exclusive recourse and remedy of the Buyer shall be against the Seller or Target and its assets and under no circumstances shall any officer, director, stockholder or affiliate of the Seller or Target be liable in law or equity for any obligations of the Seller or Target hereunder.

(iii) In the event of a default by the Buyer of any of its obligations hereunder, the sole and exclusive recourse and remedy of the Seller or Target hereunder shall be against the Buyer and its assets, and under no circumstances shall any officer, director, stockholder or affiliate of the Buyer be liable in law or equity for any obligations of the Buyer hereunder.

(iv) It is the intent of the parties hereto that no third-party beneficiary rights be created or deemed to exist in favor of any person not a party to this Agreement, unless otherwise expressly agreed in writing by the parties.

The buyer and seller may seek to include a provision, often entitled "Burden and Benefit," limiting the rights of the seller in the event of a breach of the agreement to an action against the buyer and not against any officer, director, or controlling stockholder of the buyer. This provision, assuming the entity purchasing the target has elected to do so through a shell or thinly capitalized corporation, generally should insulate the acquiring entity from liability to the seller in the event the deal goes sour.

Section 15.6. Brokers.

(i) Each of the Seller and Target represents and warrants to the Buyer that there are no brokers or finders entitled to any brokerage or finder's fee or other commission or fee based upon arrangements made by or on behalf of the Seller or Target in connection with this Agreement or any of the transactions contemplated hereby other than the fee due [insert name of any such entity].

(ii) The Buyer represents and warrants to the Seller and the Target that no broker or finder is entitled to any brokerage or finder's fee or other commission

or fee based upon arrangements made by or on behalf of the Buyer in connection with this Agreement or any of the transactions contemplated hereby other than fees payable by it in connection with the financing of this transaction.

Section 15.7. Entire Agreement. This Agreement and the exhibits, lists and other documents referred to herein contain the entire agreement among the parties hereto with respect to the transactions contemplated hereby and supersede all prior agreements with respect thereto, whether written or oral.

Section 15.8. Governing Law. This Agreement shall be governed by and construed in accordance with the laws of the State of [insert name of state].

Section 15.9. Notices. Any notice, request, instruction or other document to be given hereunder by a party shall be in writing and delivered personally or by facsimile transmission, or by telex, or sent by registered or certified mail, postage prepaid, return receipt requested, addressed as follows:

If to the Seller: [insert name and address of Seller]
with a copy to: [insert name and address of Seller's counsel]
If to Target: [insert name and address of Target]
If to Buyer: [insert name and address of Buyer]
with a copy to: [insert name and address of Buyer's counsel]
If to the Surviving Corporation: [insert name and address of Target post-Closing]
with a copy to: [insert any other desired parties]

or to such other persons or addresses as may be designated in writing by the party to receive such notice. If mailed as aforesaid, ten days after the date of mailing shall be the date notice shall be deemed to have been received.

Section 15.10. Counterparts. This Agreement may be executed in two or more counterparts, each of which shall be an original, but all of which shall constitute but one agreement.

Section 15.11. Rights Cumulative. All rights, powers and privileges conferred hereunder upon the parties, unless otherwise provided, shall be cumulative and shall not be restricted to those given by law. Failure to exercise any power given any party hereunder or to insist upon strict compliance by any other party shall not constitute a waiver of any party's right to demand exact compliance with the terms hereof.

Section 15.12. Severability of Provisions. The parties agree that (i) the provisions of this Agreement shall be severable in the event that any of the provisions hereof are held by a court of competent jurisdiction to be invalid, void or

otherwise unenforceable, (ii) such invalid, void or otherwise unenforceable provisions shall be automatically replaced by other provisions which are as similar as possible in terms to such invalid, void or otherwise unenforceable provisions but are valid and enforceable and (iii) the remaining provisions shall remain enforceable to the fullest extent permitted by law.

The provision entitled "Severability," while addressing a purely legal issue, may have great practical impact. The section provides that, in the event particular portions of the document are found invalid, void, or otherwise unenforceable by a court interpreting the agreement, the remaining provisions shall be considered severable from the invalid provisions and shall therefore remain enforceable. This result is of particular concern when the agreement contains ancillary agreements, such as a covenant by the seller not to compete with the buyer after the acquisition. The enforceability of the agreement should not depend on the enforceability of a noncompetition agreement, and the severability provision serves to accomplish this end.

Section 15.13. Further Assurance. The Seller, the Target and the Buyer agree that at any time and from time to time after the Closing Date they will execute and deliver to any other party such further instruments or documents as may reasonably be required to give effect to the transactions contemplated hereunder.

Section 15.14. Confidential Information. The Seller, the Target and the Buyer for themselves, their directors, officers, employees, agents, representatives and partners, if any, covenant with each other that they will use all information relating to any other party, the Target or any Subsidiary acquired by any of them pursuant to the provisions of this Agreement or in the course of negotiations with or examinations of any other party only in connection with the transactions contemplated hereby and shall cause all information obtained by them pursuant to this Agreement and such negotiations and examinations, which is not publicly available, to be treated as confidential except as may otherwise be required by law or as may be necessary or appropriate in connection with the enforcement of this Agreement or any instrument or document referred to herein or contemplated hereby. In the event of termination of this Agreement, each party will cause to be delivered to the other all documents, work papers and other material obtained by it from the others, whether so obtained by it from the others, whether so obtained before or after the execution of this Agreement, and each party agrees that it shall not itself use or disclose, directly or indirectly, any information so obtained, or otherwise obtained from the other hereunder or in connection therewith, and will have all such information kept confidential and will not use such information in any way which is detrimental to any other party, provided that (i) any party may use and disclose any such

information which has been disclosed publicly (other than by such party or any affiliate of such party in breach of its obligations under this Section 15.14) and (ii) to the extent that any party or any affiliate of a party may become legally compelled to disclose any such information if it shall have used its best efforts, and shall have afforded the other parties the opportunity, to obtain an appropriate protective order, or other satisfactory assurance of confidential treatment, for the information required to be disclosed.

The confidential information section typically requires each party to keep confidential all information obtained in the course of the transaction. Because the target has already been or will shortly thereafter be the object of an intensive due diligence review when the agreement is signed, the seller is initially more concerned with disclosure issues than the buyer. The seller may take the position that all materials provided to the buyer relating to the target should be returned or destroyed in the event the parties fail to close the transaction.

Section 15.15. Writings and Disclosures. Except as otherwise provided or contemplated herein, each exhibit, schedule, writing or other disclosure described in this Agreement as having been delivered or to be delivered by one party to the other shall be identified by reference to the section of this Agreement to which it relates and shall be signed or initialed on the first page by an officer or legal counsel of the Seller and by an officer or legal counsel of the Buyer and unless so identified and signed or initialed, the party receiving the same shall not be chargeable with notice of its content.

NOTES

1. The authors wish to acknowledge the contributions of attorney Neil D. Falis, who commented on documenting the deal in *The Art of M&A Structuring: Techniques for Mitigating Financial, Legal, and Tax Risk* (New York: McGraw-Hill, 2004), and Jack Feder, the Lane & Edison attorney who wrote about acquisition agreements in the original edition of *The Art of M&A: A Merger/Acquisition/Buyout Guide* (New York: Irwin, 1989). Alexandra Lajoux served as project manager for that book. The general principles set forth in the original *Art of M&A* remain true and relevant today, and so are carried forward here in this updated text.
2. In the United States, the FASB has defined materiality for an audit in Statement of Financial Accounting Concepts No. 2, which says that "the magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or

influenced by the omission or misstatement." On September 13, 2006, the SEC issued a Staff Accounting Bulletin No. 108 with guidance to companies on quantifying financial statement misstatements. See www.sec.gov/interps/account/sab108.pdf.

The latest international standard was issued in July 2006. This was a revised International Standard on Auditing 320, *Materiality in the Identification and Evaluation of Misstatements* (ISA 320). This standard, as aptly summarized by the Canadian Institute of Chartered Accountants (cica.org) on its helpful Web site, says that materiality depends on the size and nature of an item judged in the surrounding. Materiality in the context of an audit reflects the auditor's judgment of the needs of financial statement users considering users as a group; the auditor does not have to consider the possible effects of misstatements on specific individual users, whose needs may vary widely.

3. For more on MBOs, see later parts of this chapter. See also Chapter 5.

4. Verdicts in recent cases show that it can be difficult to cancel a transaction based on material adverse impact. See for example *Frontier Oil Corp. v. Holly Corp.,* C.A. No. 20502, Court of Chancery (April 29, 2005).

5. For a good summary of this case, see E. Norman Veasey et al., "Delaware Supreme Court Affirms Chancellor's Decision of No Liability in Ovitz Case," client memorandum, Weil, Gotshal & Manges, LLP, June 16, 2006.

6. Robert Profusek and Lisa Kunkle, "Judgment Call: Directors Need to Step Back from the Activist Storm Over Golden Parachutes and Consider Their Real Purpose," *The Daily Deal,* October 3, 2005, p. 28.

7. For more on Section 83, see Chapter 5 of this book.

8. Up until this point in this book, we have tried to avoid using the word "target" to refer to the selling corporation. Although this term is commonly used in the M&A world, we find it demeaning to sellers. In the appendices to this chapter, however, we conform to common legal usage and employ this term.

CHAPTER 8
Closing

INTRODUCTION

The process described in the preceding chapters culminates in the closing. This chapter discusses the main elements of that event—a type of symphony performance in which many individual items must be synchronized carefully to produce a harmonious transaction.

THE BASICS OF CLOSING

What is a closing?

A *closing* is the event through which the parties to a transaction consummate that transaction by the execution and delivery of documentation, and, if applicable, the transfer of funds. Unless funded from internal sources by the buyer, the typical acquisition closing has two major elements: (1) the *acquisition,* or *corporate,* closing, in which the seller and the buyer effect the merger or the transfer and delivery of the stock or assets pursuant to the acquisition agreement, and the (2) *financial* closing, pursuant to which one or more lenders or other funding parties provide funding for the acquisition to the buyer, as borrower, pursuant to a specific loan agreement or other financing documentation, a portion of which is remitted to the seller in payment of the purchase price.

Is the acquisition agreement always executed prior to the closing?

Not necessarily. Sometimes, the parties will want to sign and close the corporate side of the transaction simultaneously. This most often occurs when the buyer is financing the transaction internally, when no governmental approvals are required to consummate the transaction, or when the deal must close very quickly after the parties have reached their initial meeting of the minds—for example, to take advantage of the provisions of a soon-to-expire tax law or to enable a seller to obtain the sales proceeds in time to meet a debt retirement obligation. In some instances, the parties do not intend to sign and close simultaneously, but end up doing so because they fail to reach a basic agreement until the closing date.

If the transaction is at all complex and requires governmental approval or third-party financing, the parties will most likely sign a letter of intent, negotiate and execute the acquisition agreement, and then proceed to close when the "conditions precedent to closing" (often a formally drawn document) have been met and when the financing has been made available. Government agencies may require that the parties execute the acquisition agreement prior to consideration of an application for governmental approval of the transaction. Similarly, lenders may require that the terms of a transaction be established before they commit their resources to evaluating the transaction; in particular, they will want to know what representations and warranties are being made by the seller and the remedies available to the buyer in the event of a breach thereof.

Are financing agreements usually handled in the same way?

No. Most financing agreements are entered into at the closing. Before then, however, the borrower and the lenders will have executed a commitment letter, or reached agreement on a term sheet, setting forth the basic terms of the lending arrangements.

How long does a closing take?

The closing process may last for a few hours, or for days or weeks, depending on how much negotiation is left for the finale, and on the ability of the parties to satisfy the conditions precedent to closing in a timely manner. The

period immediately before the closing is often consumed by final negotiation of the terms and conditions of the operative documents, but this is not always the case. Closings on transactions for which the terms have been negotiated and finalized prior to the closing involve review of documents and confirmation that the conditions precedent to closing have been met, followed by the execution and delivery of documents and, when appropriate, the actual receipt of funding. The simplest of closings may be effected by an exchange of documents signed in counterpart without convening the parties at a single location.

Can a closing be held if either of the parties has not yet met all the conditions to closing?

Yes. An escrow closing may occur when one or more of the necessary conditions to closing has not been met, but the parties wish to go forward subject to satisfaction of the remaining conditions. In this case, transaction documentation can be executed and entrusted to a designated escrow agent, chosen by the parties, who will break escrow and deliver the documents to the parties upon fulfillment of the outstanding conditions. An arrangement of this nature will require the negotiation and drafting of an escrow agreement among the parties; the agent must clearly set forth the terms upon which the breaking of escrow may occur, and the actions to be taken if those conditions are not fulfilled.

Alternatively, the parties may close the transaction if the party for whose benefit the unsatisfied condition was negotiated decides to waive the condition and proceed. In some cases it may be possible for the waiving party to exact some additional concession, such as an increase in the purchase price, or a pledge from the other party that it will satisfy the condition after the closing. If the unsatisfied condition is so critical that the deal would unwind were it not to be fulfilled, the prudent path is not to close, since the cost of unwinding a closed transaction or resolving the unsatisfied condition may be much higher than the cost of failing to close.

Who should attend a closing?

Each person responsible for executing a document at the closing should expect to be present at the closing offices, or to be otherwise available, from the time that the closing is scheduled to the time of actual signing. If the signatory officer is also the businessperson responsible for the transaction, he is

likely to be engaged throughout the pre-closing and closing process. If, on the other hand, the individual with signing authority is not otherwise involved in the transaction, she should be willing and able to remain available in the event that there is a delay in the closing process. Each individual sharing responsibility for the transaction should be on hand to review documents and participate in the negotiation of any final changes.

Attorneys for each of the parties to the transaction will typically be required to participate in final negotiations and preparation and review of the closing documents, including, if required, opinions of counsel.

The participation of parties at other locations may also be required, depending on the nature of the transaction. For example, a transaction involving the transfer of assets (rather than stock) will typically require that certain conveyance documents be recorded at the time of closing at the appropriate federal, state, or local recordation offices in the jurisdiction within which that property is located. For multistate acquisitions involving real and personal property, this may require filings in numerous locations. Further, counsel from each of those jurisdictions may have to render an opinion as to the effectiveness of the conveyances as a condition to closing.

If the transaction involves one or more mergers, attorneys or other appropriate persons will have to file merger certificates and other documents at the offices of the secretary of state of each jurisdiction where filing is required to effectuate such mergers. Finally, if the conveyed assets constitute security for the financing of the transaction, mortgages and other security documentation will also be recorded, and opinions of local counsel will be given in connection to these. (One important type of security document will be form UCC-1, under the Uniform Commercial Code discussed in Chapter 4). The effective coordination of all of these off-site parties is one of the more significant organizational challenges of a transactional closing.

Where should the closing take place?

The closing should occur at a location most convenient to all parties involved. In the event that a financing is involved, this is almost always the city in which the principal lender is located. The offices in which the closing takes place should offer adequate services, space, communications, word processing, and photocopying, together with sufficient secretarial (and notarial) staff, to complete the transaction documentation and otherwise consummate the deal. These facilities and services are typically found at transactional law firms that maintain offices for these specific purposes. However, the closing is often scheduled to take place at the offices of counsel to one of the parties.

In the event that a major financing is involved, it is usually held in the offices of the lender's attorneys.

The buyer should seriously consider having the corporate closing and the financing closing in separate offices, within the same city, if possible. Having two locations (or possibly more, if several pieces of large, complex financings are involved) serves the practical purpose of reducing the confusion and tension generated when many people are confined to the same quarters under stressful conditions. It also has tactical significance to the buyer. The most difficult aspect of any closing is last-minute negotiation (and renegotiation) of deal points, major and minor. Most often, it is in the buyer's best interest to keep the seller and the various lenders physically apart from each other so that the buyer can control the flow of information that each group receives and can broker a consensus on open points of common concern to the buyer's best advantage.

This can be particularly important in the area of intercreditor relationships. As closing approaches, lenders get increasingly nervous about the risks they are about to take, particularly in a highly leveraged deal, and seek to improve their position by getting more collateral to secure their loans or a piece of the equity, or by imposing tighter post-acquisition covenants. There is a definite me-too syndrome among lenders; that is, whatever concession one lender wins, the others will demand for themselves. The buyer has a better chance of neutralizing this syndrome if lenders are kept from talking to each other.

How many people should be involved in a closing?

Each party should plan to have staff adequate to cover all aspects of the transaction, from negotiating issues that exist or may arise, to performing all the mechanical tasks required to complete the transaction. Most of the tasks will be performed by attorneys and other law firm employees. The parties' accountants and various people from the business entities involved in the transaction, particularly the finance department, will also need to be on hand, or be easily reachable.

If the transaction will be financed by third parties, it is advisable that the attorneys for the buyer have separate closing teams for the corporate side of the transaction and each major piece of financing. This will be necessary if the closing is split among several physical locations. Each team should consist of the attorneys who have been primarily responsible for that aspect of the transaction since its inception and other attorneys and legal assistants as required. With adequately staffed teams in place to handle the details, the

attorney in charge of the entire matter will be freed up to offer advice on the big picture and to troubleshoot different aspects of the transaction where necessary. It is critical, however, that all attorneys and legal assistants involved in the closing be kept informed of changes that affect them. Periodic all-hands briefings are a good way to keep everyone abreast of changing events.

What are the phases of a closing?

The typical complex closing has three distinct phases: (1) the pre-closing process, (2) the closing itself, and (3) post-closing matters.

PRE-CLOSING

What happens during the pre-closing process?

During the pre-closing process: (1) the parties and their counsel distribute closing documents, including drafts of execution documents, for final review and approval prior to the scheduled date of execution and funding; (2) each party satisfies itself that all conditions to closing have been either satisfied or waived; and (3) the parties negotiate and resolve any open deal points. The size and complexity of the transaction and the number of open points, including new issues that may arise during this final phase, will determine the length of the pre-closing phase. A typical complex transaction, that is, one with layers of financing, multistate collateral, and several third-party or governmental consents, can easily involve one or two weeks of pre-closing activities.

How do the parties satisfy themselves that the conditions precedent to closing have been satisfied or waived?

With respect to closing conditions that are satisfied through the delivery of documents such as regulatory approvals, landlord waivers, estoppel certificates, and management employment agreements, the parties and their counsel will examine the pertinent documentation and determine whether it comports with the requirements of the acquisition agreement or the relevant financing agreement, as applicable.

In some cases, such as legal opinions and officers' certifications as to the accuracy of all representations and warranties as of the closing date, the

parties delivering such documents and/or their counsel will have the additional burden of satisfying themselves prior to delivery thereof that the factual and legal matters set forth in those documents are, in fact, true. For example, prior to delivering a legal opinion, counsel will review documents such as UCC lien searches, corporate resolutions, good standing certificates, and officers' certificates as to factual matters, and will verify that certain actions such as the filing of merger documents and the recording of mortgages and UCC financing statements have been completed, in order to determine that the necessary foundation for issuing the legal opinion exists.

With respect to closing conditions that are not satisfied through the delivery of documents, such as the conditions that there be no pending litigation that threatens to enjoin the consummation of the transaction, and that the target shall not have suffered a material adverse change in its business, the parties must resort to a combination of examination and analysis of documents, such as the target's most recently available financial statements, and the other due diligence investigation techniques employed from the outset of the transaction to determine that these conditions have been met.

Well in advance of the closing, the parties should prepare one or more closing checklists that set forth the steps and documentation required for closing. Compliance with the checklist and with the conditions precedent to closing set forth in the basic loan or acquisition documents will increase significantly the likelihood that the requirements for closing are met.

Previously you mentioned that at closing the seller may have to make a bring-down representation saying there are no pending lawsuits. Could you elaborate on this?

In the representation made in the acquisition agreement, which always predates the dealing signing (closing), the seller warrants that the financial statements of the company being sold represent a true and accurate picture of the company. In the new representation made at the closing, the seller must state that there has been no material adverse change in the financial condition, operations, or prospects of the target between the date of the financial statements and the date of signing.

The buyer is not required to close the transaction if any bring-down condition is not satisfied, so the condition allocates to the seller the risk of loss attributable to any adverse change during the period between signing and closing. Interim losses probably reduce the value of the target, so the bring-down condition allows the buyer to renegotiate a lower price reflecting the changes.

At the closing, a corporate officer must certify (in a certificate) that the representations and warranties are accurate in all material respects as of the closing date. Providing this certificate is a condition of closing, but it has another very important effect: it is a restatement of all the representations and warranties as of the closing date.

If the officer's certificate is not accurate, the inaccuracy will constitute a breach of a representation or warranty and may give rise to liability from buyer to seller under the indemnity section of the agreement. In the absence of an officer's certificate, a buyer might be unprotected against certain adverse events occurring between signing and closing.

For example, if a material liability arises and is discovered before closing, a closing condition will be unsatisfied, and the buyer can walk from the deal. But if it is not discovered, the parties may close because to their knowledge each closing condition—including the condition that the representation and warranty about undisclosed liabilities is true—was satisfied.

Clearly, the buyer needs more than a condition to closing to fully insulate it from undiscovered problems. Requiring the seller to represent that the closing condition is satisfied allows the buyer to treat the seller's failure to satisfy the condition as a breach of the representations. If the buyer is indemnified for losses attributable to such breaches, the buyer, by virtue of the certificate, will be protected against losses resulting from undiscovered problems.

As an aside, it is important that the officer's certificate be made solely on behalf of the corporation; it should not constitute a personal affidavit. Otherwise, the corporate officer might be personally liable to the buyer if the certificate is proved untrue, irrespective of whether the corporate officer is at fault.

How can a buyer or seller ensure that its representations and warranties are true as of the closing date?

Counsel for each party should periodically confirm with the client that nothing has occurred that makes a representation or warranty of the client untrue. Generally speaking, as soon as any significant event occurs that will make a representation or warranty untrue, such as a loss of a major customer of the seller or the filing of a lawsuit, the warranting party should inform the other parties of such occurrence so that appropriate waivers or modifications of terms can be negotiated and resolved in advance of the closing.

In addition, at least two or three days prior to the closing, counsel should review the client's representations and warranties line by line with appropriate employees and representatives of the client. Any facts that

deviate from these representations and warranties should be incorporated as exceptions to the client's closing certificate regarding the accuracy of the representations and warranties and be immediately presented to the other relevant parties for their review. If they agree to accept the certificate with such exceptions, they shall be deemed to have waived the condition to closing (although they may not have waived their claims to indemnification for breach of the representation or warranty).

What other forms do waivers take?

Waivers of conditions to closing may also be made through the acceptance of documents containing terms that differ from the previously negotiated terms, such as legal opinions that take exceptions, make assumptions, or exclude matters not originally contemplated by the parties. Where there is no previously contemplated document into which a waiver may be incorporated, the best course is to create a written waiver for the waiving party to execute.

How much renegotiation of the deal really takes place during the pre-closing phase?

A considerable amount! Therefore, the parties should be prepared for anything and everything, including the following: the filing of a lawsuit or the assessment of a tax deficiency against the seller; a change in the financial condition of the seller; an unresolved personality conflict between principals in the buying and selling companies; or a demand by lenders that the transaction between the buyer and seller be modified, that additional security be provided, that the buyers raise additional equity, or that the lenders be given an equity kicker. These unthinkable events can and do happen and may require the parties to renegotiate fundamental business issues. As a result, the buyer and seller should come to the pre-closing phase prepared to compromise where appropriate and to identify what items are nonnegotiable.

Who has the most leverage in closing week negotiations?

First of all, the convergence of the parties at the various appointed closing offices, added to the resources they have already expended in getting to this phase of the transaction, creates tremendous momentum and incentives for everyone to close. Therefore, there will be some room for compromise by each party. Nevertheless, the parties will not necessarily have equal bargaining strength simply

because both of them are fast approaching the finish line. Differences in leverage that developed through the course of prior negotiations are likely to persist during the closing week. However, there are no hard and fast rules about the degree to which the power relationships among the parties will, or will not, change.

For example, it would be logical for the buyer to assume that the sweet image of sales proceeds is dancing in the seller's head, and, as a result, the seller will bend easily to any changes requested by the lenders. But the seller, in fact, may be having second thoughts about the bargain and resist any modifications of the acquisition agreement as a way of trying to force the buyer into a position where it cannot close. Conversely, the buyer may think (or know) that it is buying the target cheaply and may therefore do whatever is necessary to achieve a quick closing.

What is a pre-closing drill?

The pre-closing drill is a dress rehearsal for the closing, preferably held no earlier than three days before closing and no later than the night prior to closing. Counsel for the parties conduct the drill; their clients and other persons will be present as needed. Each party puts all of its closing documents out on the closing room table so that the other appropriate parties can satisfy themselves that the conditions to closing embodied in those documents have been met. To the extent feasible, the parties will execute as many documents as possible in order to save time on the closing day and thereby ensure that all conditions to closing will be satisfied early enough to allow any wire transfer of funds or investment of sale proceeds to be completed on the closing day. After review of the closing documents and the closing checklist, the parties will identify tasks that must be completed before, legally and logistically, closing can be effected. However, it is not unusual to generate a schedule of minor uncompleted items and agree that they will be resolved post-closing.

In transactions involving third-party financing, lenders and their counsel may require two or more pre-closing drills; that is, one involving their own financing, one involving review of the corporate side of the transaction, and, if applicable, others involving the other financing pieces of the transaction.

CLOSING

What happens on the closing day itself?

Assuming the parties have conducted a pre-closing drill: (1) the parties and their counsel will review any documents that were revised or newly generated,

the parties will execute any previously unexecuted documents, all undated documents will be dated, any required meetings of the board of directors that have not previously been held will be held, and any changed documents or signature pages that must be submitted to local counsel prior to release of their opinions will be transmitted to them; (2) the parties will recheck all the documents lined up on the closing table against the closing checklists; and (3) when all counsel are satisfied that conditions to closing have been satisfied or waived, they will instruct their clients' respective agents to wire funds or file or record documents (simultaneously or in such order as they have agreed), as applicable, and will deem all the documents on the closing table to have been delivered in the sequence set forth in the closing checklist and other governing agreements.

In the case of a transaction involving third-party financing, what part of the deal closes first?

Typically, all transactions are deemed to take place simultaneously. Practically speaking, the lenders usually will not release the loan proceeds until they receive confirmation that the corporate portion of the transaction has been completed; that is, stock certificates or bills of sale have been delivered or merger certificates have been filed, and security and title documents have been properly recorded.

How long does it actually take to close a transaction?

Depending on the complexity of the transaction, the number of things that do not go according to plan or schedule, and the goodwill, patience, and ingenuity of the parties and their counsel in devising acceptable bridge arrangements, substitutes, or accommodations, the closing phase may be effected within a matter of an hour or two, or it may stretch over several days.

On what day should the closing take place?

Preferably any day but a Friday or a day before a holiday. The failure to achieve the closing on the scheduled day prior to a weekend or holiday puts the parties in the awkward position of having to work into or through the nonbusiness day, without the ability to transfer or invest funds until the next business day, and with the attendant disruption in the personal lives of all concerned (which can be particularly troublesome for nonprofessional staff). Depending on the point

at which the transaction slipped off schedule, any number of complications may have occurred. Title may have been transferred without funding. Issues of who owns what or who bears the risk of loss may arise. Interest may be claimed on the lost or withheld funding by the lender or the seller. Finally, the documents, especially exhibits thereto, even if prepared in an as-of form, may contain material inaccuracies caused by the passage of time that will require redating, amendment, or waiver in order to close the transaction.

What are some of the most common logistical snafus that can derail a closing?

Some of the biggest headaches result from unavailability of key businesspeople and/or failure to:

- Have local counsel on standby to review last-minute document changes
- Provide local counsel with copies of documents or other items that are conditions to release of their opinions
- Have precleared articles of merger with appropriate jurisdictions
- Have persons on standby to file or record documents, including merger documents, UCC-1s, mortgages, and terminations of UCC-1s required to be removed off-record
- Failure to have adequate support staff to make last-minute revisions in documents
- Failure to have conducted the pre-closing drill, including execution of all documents not subject to change
- Failure to have adequate legal staff at closing headquarters to negotiate final documents, including local counsel legal opinions
- Failure to obtain proper wiring instructions for funds transfers
- Failure to ascertain time periods by which wires must be sent or to make arrangements to have banks hold their wires open past normal hours
- Failure to consummate any pre-closing corporate reorganizations (such as mergers of subsidiaries into parent companies, dissolution of defunct subsidiaries, or filing of charter amendments) in a timely fashion
- Failure to have tax counsel review the final terms and documentation to ensure that tax planning objectives have not been adversely affected by last-minute restructuring or drafting

- Failure to obtain required bring-down good standing certificates or other certified documents from appropriate jurisdictions

Proper advance planning can prevent most, if not all, of these failures.

What exactly are UCC forms and where do they have to be filed?[1]

The UCC allows a creditor to notify other creditors about a debtor's assets used as collateral for a secured transaction by filing a public notice (financing statement) with a particular filing office. The place of filing is usually with the office of the secretary of state in the company's state—that is, the state of organization if the organization is registered with a state. Or it will be a state of the chief executive office (headquarters) if the organization is unregistered and has more than one place of business. Finally, it can be the state where an individual resides in the case of an individual or sole proprietor.

Filing with the office of the secretary of state is required to perfect a security interest or agricultural lien except where a filing is required with the county clerk or other office designated for the filing or recording of a mortgage on the related real property. This is also necessary if the collateral is as-extracted collateral or timber to be cut, or the financing statement is filed as a fixture filing and the collateral is goods that are or are to become fixtures.

In most cases, financing statements are filed at the close of a secured transaction. However, it is advisable to file financing statements and perform a search on the debtor to discover existing filings by other creditors before the loan closing.

WIRE TRANSFERS

What is a wire transfer of funds?

A *wire transfer of funds* is payment through a series of debits and credits transmitted via computers. A domestic wire transfer is made through the Federal Reserve System, which is divided into 12 districts throughout the United States, with each district having one main Federal Reserve Bank and a myriad of branch banks. The actual physical transfer of funds takes place on the books of the Federal Reserve Banks and branches. An international wire transfer of funds is payment through a series of debits and credits transmitted directly via telex among correspondent banks.

How is a domestic wire transfer made?

To make a wire transfer, both the buyer's and seller's banks must be members of the Federal Reserve System and maintain accounts with a Reserve Bank, or have an account with a member bank. The buyer or lender remitting funds by wire must provide to its bank the name of the seller, the name of the seller's bank, and the identity of the account to be credited, and the American Banking Association (ABA) number that identifies the seller's bank in the Federal Reserve System.

Upon the confirmation of customer funds, the originating member bank, or transferor, will notify its Reserve Bank to debit the transferor's account for credit to the member bank transferee. If the transferor and transferee maintain accounts at two separate Reserve Banks, the request for credit will be sent by the transferor's Reserve Bank to the transferee's Reserve Bank for credit to the latter. The transferee's Reserve Bank will then credit the transferee's account.

How does the originating bank confirm customer funds?

All funds to be remitted must be collected. Thus, a check deposit covering the wire transfer that has not yet cleared will delay or prevent the transfer. Essentially, the remitting bank is protecting itself from exposure on items subject to stop-payment orders until final payment is effectuated. This includes certified checks and bank checks. Often, reference is made to "immediately available funds" or "federal funds," which signifies that the funds for remittance have been collected.

When is final payment of the wire transfer effectuated?

As soon as the transferee receives notice of the credit—the *Fedwire transfer* from its Federal Reserve Bank—payment is considered final, and, except as described in the following, the seller has the right to the use of such funds.

Can a transferor revoke the request for a wire transfer of funds once the transferor has notified its Reserve Bank to debit its account?

The Reserve Bank may cease acting on the wire transfer if the transferor's request for revocation allows the Reserve Bank a reasonable opportunity to

comply with the requested revocation. If the request is received too late, the Reserve Bank may ask the transferee's Reserve Bank to ask the transferee to return the funds, if the transferor so desires. However, the Reserve Bank will only be liable for lack of good faith or failure to exercise ordinary care. Therefore, it is not responsible if the transferee refuses to return the funds.

What is the deadline for placing a wire transfer order for funds intended to be received by the seller on the same day?

Although no Reserve Bank will guarantee that it will complete a transfer of funds on the day requested, generally speaking, 3:00 P.M. is the originating bank's deadline. Moreover, the Reserve Bank may, at its discretion, process a wire transfer after its closing hour. This will usually occur in an emergency or when large sums of money are being transferred. The deadline for placing an international wire transfer order is generally 12:30 P.M.

What are the differences between the domestic and international wire transfer of funds?

With an international wire transfer, the ease and security of the Federal Reserve are not available. Hence, the transfer generally takes longer. In addition, with international wire there is a problem of provisional payment. Specifically, the bank that debits the customer's account usually reserves the right to withdraw the credit extended to the corresponding bank, if the customer's account is overdrawn in the process. This may create problems in determining when final payment is made.

What are the advantages and disadvantages to a seller in requiring payment through a wire transfer of funds?

Next to actual cash in hand, this is the best way for a seller to have use of the sale proceeds on the closing day, because the Federal Reserve Bank assumes the risk of final payment once the transferor's request is accepted by its Reserve Bank.

One potential disadvantage associated with a wire transfer concerns the nature of the account agreement the seller has with its bank. The seller's

bank may not be required to credit the seller's account immediately upon receiving Federal Reserve credit because of the account agreement. Federal law requires that the transferee *promptly* credit the beneficiary's account. However, what promptly means is not clearly specified. The seller is best advised to be familiar with the terms of its bank account agreement. Moreover, the seller could specify in the acquisition agreement that the buyer's duty to deliver funds is completed only when the seller's individual account has been credited.

Are there methods of payment, other than cash or wire transfer, that would be acceptable to sellers at a closing?

There are three types of bank-issued checks that are virtually risk-free to a seller who accepts them: (1) the certified check, (2) the cashier's check, and (3) the bank check. Each of these checks has some distinguishing feature, but all of them are designed to offer comfort to the recipient that payment will definitely be made by the designated payor bank.

Certified checks are instruments that, upon certification by the payor bank, are not subject to an order to stop payment. Under the UCC, the certifying bank becomes personally liable for failure to honor the check, and the customer is then secondarily liable.

When a bank issues a cashier's check, the bank acts as both the payor and the payee for the amount of the check. As with the certified check, a bank is deemed to have accepted a cashier's check for payment at the moment it is issued. The customer cannot stop payment on it. The seller's only risk of nonpayment is if the issuing bank becomes insolvent before payment can be made. Even in that event, if the bank is a member of the FDIC, the check will be insured up to $100,000.

A bank check does not give a seller the same degree of comfort as either a certified or cashier's check, because, unlike the certified and cashier's check, the issuing bank of a bank check has not accepted the check for payment (that is, committed to pay the stated amount upon demand) at the moment of issuance. Rather, presentment of the check is required for payment. Despite this difference, the UCC treats bank checks as cash equivalents, and the only instance in which the issuing bank can stop payment is if it is a direct party to the transaction. The only time a customer ordering a bank check can request that payment be stopped is in the case of fraud or a theft of the instrument.

POST-CLOSING

What are typical post-closing activities?

Post-closing tasks typically fall into one of two categories: document distribution and cleanup.

Document distribution requires planning. Although each of the parties to a closing generally wants to depart from the closing table with a complete stack of original closing documents for its file, this is not frequently practical. First, each of the parties has different requirements for closing documents. Some parties should not receive documents that other parties will receive, and some parties need original documents whereas others need only photocopies.

Further, some documents held or executed at other locations may be available at the time and place of closing only by telecopy, or not at all. Finally, the sheer number and volume of documents may preclude sorting and photocopying of the executed papers swiftly enough to be delivered to the parties prior to their departure from the premises.

At some point, however, each of the participants should receive a complete set of the transaction documents to which it is entitled. In some transactions, the initial distribution of originals and, as available, copies is followed by the production of a closing binder containing a complete indexed set of documents in one or more volumes. These binders may be velobound or, if the expense is approved by the clients, permanently bound in stitched covers with stamped lettering on the spine. The acquisition documents often are bound separately from the financing documents.

The final document assembly and distribution effort will be much easier if a good closing document checklist was utilized prior to closing. When completed and updated, the checklist may be turned into a closing memorandum (which may double as an index to the closing document binders), with the addition of a brief narrative chronology of the transactions taken prior to, at, and following the closing to complete the transaction. A common closing memorandum can be used even if the acquisition and financing closings occurred at different offices.

The second principal post-closing effort is the cleanup process, which involves the finalization or completion of tasks and documents that were not or could not have been completed at or prior to closing. This may include corrections or amendments to ancillary documents, the termination of pension plans, the receipt of consents and approvals not obtainable by closing, the completion and documentation of a closing date audit for balance sheet pricing adjustment

purposes, or the receipt of title insurance commitments or policies as of the closing date from jurisdictions with filing delays. In addition, where many real estate parcels in multiple jurisdictions are required to be mortgaged, or collateral is located in foreign countries, completion of recordation of mortgages and perfection of security interests are commonly put aside as post-closing matters, with a deadline for completion set for several months after the closing date.

In both cases, individuals responsible for post-closing efforts should strive to complete their tasks as soon as possible before the pressure of other matters and the passage of time make wrapping up these loose ends more difficult. A post-closing checklist similar in design to the closing checklist should be prepared, and adhered to, by the parties responsible for these activities.

PLANNING THE CLOSING

What's the best way to prepare for a closing?

Have your attorney prepare a comprehensive closing checklist well in advance of the closing—in fact, as soon as the deal begins to jell. This checklist should:

- Set forth each and every task that must be completed in order for the parties to be legally and logistically ready to consummate the transaction, and the date by which such task must be completed
- State, where applicable, the document in which the completion of the task will be embodied
- Set forth the name of one or more persons responsible for the task
- Contain a space for status notes

The closing checklist is both a road map and a progress report of the transaction. It can also be a source of embarrassment and a goad to those responsible for producing or reviewing documents whose failure to meet deadlines is documented in the status notes. Finally, it is the basis for the preparation of a closing memorandum for the transaction.

How should one schedule pre-closing tasks?

The first concern should be to deal with documents and actions of parties who either will not be at the closing, will have a limited role in the closing, or are beyond the control of the parties to the transaction.

These persons include directors and shareholders whose authorizations are required; governmental agencies without any incentive to expedite review of applications for regulatory approvals; third parties to critical agreements

who may prove recalcitrant when asked for consents, estoppel letters, solvency letters, or legal opinions; actuaries who must give up-to-date valuations of pension assets; and persons who are committed to other tasks but need to be on-call to file or record mortgages, UCC financing statements, or merger certificates upon a moment's notice.

The persons responsible for ensuring that the closing takes place on the appointed day must make an accurate assessment of how long it is likely to take to obtain a required document or to accomplish a necessary task, and, working backward from the expected closing date, attempt to develop a realistic schedule for reaching closing.

Should all the parties use the same closing checklist?

At the very least, by the time the parties arrive at the pre-closing phase, they should be working from the same closing checklist, with the following exceptions. The seller does not need those portions of the checklist dedicated to the financing of the transaction other than items related to the financing in which the seller has a role (such as delivery of reliance letters from the seller's counsel to lenders allowing them to rely on such counsel's legal opinion, and delivery of the seller's consent to assignments by the buyer to the lenders of the buyer's rights under the acquisition agreement).

The seller and the lenders do not need an expansive checklist relating to the tasks associated with the formation and capitalization of the buying group. Moreover, there may be certain tasks or documents, including side letters, that each party wishes to keep confidential within its own group. As a result, each party may have more than one closing checklist, that is, an expansive one setting forth everything about which it is concerned, and other lists that are abridged versions of the global checklist and are to be shared with one or more of the other parties. These latter lists must be developed along with the other parties so that all agree as to what activities will make everyone ready, legally and logistically, to consummate the transaction.

CONCLUDING COMMENTS

The closing of a transaction is often a last chance to check details of that transaction and to make sure all parties understand it. The closing memorandum memorializes the transactional events that have led up to closing day. The sample closing memorandum in Appendix 8A, which is from a very complex transaction, provides a useful template.

APPENDIX 8A

Sample Closing Memorandum (Including a Detailed Schedule of Closing Documents)

MERGER OF TARGET ACQUISITION CORP. INTO TARGET CO. INC.

DECEMBER 31, 2006
9:00 A.M. Eastern Standard Time

I. GENERAL

This memorandum describes the principal transactions that have occurred in connection with the acquisition (the "Acquisition") of Target Co. Inc., a Delaware corporation ("Target"), by Purchaser Holdings, Inc., a Delaware corporation ("Holdings"). Holdings; Target Acquisition Corp., a Delaware corporation and a wholly owned subsidiary of Holdings ("TAC"); and Target and Seller Holdings, Ltd., a Delaware corporation which owns all of the issued and outstanding Stock of Target ("Seller"), have entered into an Agreement of Merger, dated as of October 1, 2006 (the "Agreement"), pursuant to which TAC will be merged into Target pursuant to the Certificate of Merger.

In connection with the capitalization of Holdings to accomplish the Acquisition on the Effective Date, affiliates (the "Investor Shareholders") of Investor Corporation, a Delaware corporation ("IC"), purchased 800,000 shares of the common stock of Holdings for an aggregate amount of $4,000,000. Concurrently, IC loaned $1,000,000 on a recourse basis to certain management personnel at Target (the "Management Shareholders"). The Management Shareholders purchased 200,000 shares of the common stock of Holdings for $1,000,000 and pledged such stock to IC to secure repayment of the loan. TAC then merged into Target.

On the Effective Date, Holdings entered into a Credit Agreement with Lender Bank ("Bank") pursuant to which Holdings obtained a term loan of $40,000,000 and revolving credit loans of up to $10,000,000 (the "Credit Agreement"). Concurrently therewith, Holdings entered into a Bridge Funding Agreement with The Investment Bank Group Inc. ("Investment Bank Group")

pursuant to which Holdings obtained a bridge loan of $60,000,000 (the "Bridge Agreement"). Holdings sold warrants for 200,000 shares of its Common Stock (the "Investment Banker Warrants") to Lead Investment Banker Incorporated ("Lead Investment Banker") and its designees for $20,000.

After the Effective Date it is anticipated that Holdings and Lead Investment Banker will enter into a Securities Purchase Agreement (the "Securities Purchase Agreement") pursuant to which Holdings will return the $20,000 to Lead Investment Banker and Lead Investment Banker will return the Investment Banker Warrants to Holdings. Holdings will then sell Warrants for 200,000 shares of its Common Stock to the Purchasers named in the Securities Purchase Agreement (the "Purchasers") for $20,000 (the "Note Purchase Warrants") and deliver to the Purchasers Notes due December 31, 2011, in an aggregate principal amount of $60,000,000 and bearing interest at approximately 14 percent per annum (the "Note") for which Holdings will receive $60,000,000 cash which it will use to pay off the $60,000,000 bridge loan under the Bridge Agreement.

After the Effective Time and concurrently with the funding of the term loan, the initial revolving loans and the bridge loan, Holdings contributed to TAC the amount of $100,000,000 as a capital contribution. Seller received $100,000,000 cash less the amount of the intercompany loan to be paid after Closing, Series A Preferred Stock of Holdings having a redemption value of $10,000,000 and a Warrant entitling it to purchase 40,000 shares of the common stock of Holdings (the "Seller Warrant").

The Closing occurred on December 31, 2006 (the "Effective Date"), at 9:00 A.M. Eastern Standard Time. The merger was effective on the Effective Date at the time the Certificate of Merger was filed with the Secretary of State of Delaware (the "Effective Time").

All capitalized terms used herein which are not defined herein and which are defined in the Agreement, the Credit Agreement, the Bridge Funding Agreement, or the Securities Purchase Agreement have the respective meanings attributed to them in the Agreement, the Credit Agreement, the Bridge Funding Agreement, or the Securities Purchase Agreement.

II. TRANSACTIONS PRIOR TO THE CLOSING

The following actions were taken prior to the Closing.

1. On October 1, 2006, the Agreement among Holdings, Target, TAC, and Seller was executed and delivered.

2. On October 1, 2006, TAC, Seller, and Agent Bank (the "Escrow Agent") entered into an Escrow Agreement pursuant to which TAC deposited with the Escrow Agent One Million Dollars ($1,000,000) pursuant to Section 3.3 of the Agreement.
3. On October 1, 2006, the Board of Directors of each of Holdings and TAC approved the terms of the Merger and the Agreement and the Board of Directors of TAC approved the Escrow Agreement.
4. On October 1, 2006, the Board of Directors of each of Target and Seller approved the terms of the Merger and the Agreement and the Board of Directors of Seller approved the Escrow Agreement.
5. On October 2, 2006, Seller issued a press release announcing the Holdings, Target, Seller, and TAC agreement to the terms of the Merger and announcing the execution of the Agreement.
6. On November 16, 2006, Bank delivered to Holdings a commitment letter pursuant to which Bank agreed to provide a $40,000,000 term loan and a $10,000,000 revolving line of credit to facilitate the Acquisition and to provide working capital thereafter.
7. On November 24, 2006, Lead Investment Banker delivered to Holdings a commitment letter pursuant to which Lead Investment Banker undertook to provide a bridge loan for an aggregate amount of $60,000,000.
8. On November 24, 2006, Holdings delivered to Lead Investment Banker a retention letter pursuant to which Holdings retained Lead Investment Banker to sell the Notes and Note Purchaser Warrants.
9. On December 24, 2006, a date at least three business days before the Closing, Seller delivered to TAC pursuant to Section 4.3 of the Agreement a notice setting forth the amount of the Intercompany Loan to be paid immediately after Closing.
10. On December 28, 2006, the Board of Directors and shareholders of Holdings adopted an amendment of the certificate of incorporation of Holdings to authorize the Series A Preferred Stock.
11. On December 28, 2006, Holdings caused to be filed an Amended and Restated Certificate of Incorporation providing for 1,500 shares of Series A Preferred Stock par value $1.00 per share.
12. As of December 30, 2006, the Certificate of Merger was executed by the President of TAC and attested by the Secretary of such corporation and was executed by the President of Target and sealed and attested by the Secretary of such corporation.

13. On December 30, 2006, the Board of Directors of Holding authorized the issuance of 1,000 shares of Series A Preferred Stock to Seller with the rights designated in the Amended and Restated Certificate of Incorporation of Holdings.
14. On December 30, 2006, Seller, as sole stockholder of Target, consented to the Agreement and Certificate of Merger.
15. On December 30, 2006, Holdings, as sole stockholder of TAC, consented to the Agreement and Certificate of Merger.

III. CLOSING DOCUMENTS AND TRANSACTIONS

The following documents were delivered at or prior to the Effective Date, but all such documents are deemed delivered at the Effective Date. All documents are dated as of the Effective Date and delivered in New York, New York, unless otherwise indicated. All transactions in connection with the Closing shall be considered as accomplished concurrently, so that none shall be effective until all are effective. Executed copies (or photocopies, or conformed copies where necessary) of each document will be delivered after the Closing as follows:

one to IC
one to Holdings
one to Seller
one to Target
one to Bank
one to Lead Investment Banker

with photocopies to be distributed as follows:

one to Investment Banker Counsel (IBC)
one to Seller Counsel (SC)
one to Bank Counsel (BC)
one to Investor Corporation Counsel (ICC)

IV. SCHEDULE OF CLOSING DOCUMENTS

1. Corporate Good Standing, Articles, Bylaws, and Incumbency of Target, Its Subsidiaries, and Seller

1.01. Certificate of Incorporation and all amendments to date of Target certified by the Secretary of State of Delaware on December 3, 2006.

1.02. Certificate of the Secretary of State of Delaware, dated December 3, 2006, certifying that Target is an existing corporation and in good standing under the laws of the State of Delaware.

1.03. Telex from the Secretary of State of Delaware, dated the Effective Date, updating the information described in item 1.02 above.

1.04. Certificates of the Secretaries of State of California and New York dated December 1 and 2, 2006, respectively, certifying that Target is qualified to conduct business and is in good standing in such states.

1.05. Telexes or verbal consents from the Secretaries of State of California and New York, dated the Effective Date, updating the information described in item 1.04 above.

1.06. (a)–(b) Articles or Certificates of Incorporation or other organization documents and all amendments to date of the following Subsidiaries of Target ("Subsidiaries") certified by the appropriate authority of the governing jurisdiction:

(a) New York Target Subsidiary Ltd. (N.Y.)

(b) Delaware Target Subsidiary, Inc. (Del.)

1.07. (a)–(b) Certificates of the authorities described in item 1.06, certifying that each of the Subsidiaries is an existing corporation and in good standing.

1.08. (a)–(b) Telexes or verbal consents of the authorities described in item 1.06, dated the Effective Date, updating the information set forth in item 1.07 above.

1.09. Certificate of Incorporation and all amendments to date of Seller certified by the Secretary of State of Delaware, dated December 3, 2006.

1.10. Certificate of the Secretary of State of Delaware, dated December 3, 2006, certifying that Seller is an existing corporation and in good standing under the laws of Delaware.

1.11. Telex from the Secretary of State of Delaware, dated the Effective Date, updating the information described in item 1.10 above.

1.12. Certificate of Secretary of Target, dated the Effective Date, as to the Certificates of Incorporation and Bylaws of such corporation, the election, incumbency, and signatures of officers of such corporation, and certifying as to the resolutions of the Board of Directors and stockholders of such corporation relating to the transaction pursuant to Section 8.4 of the Agreement.

1.13. Certificate of Secretary of Seller, dated the Effective Date, as to the Certificate of Incorporation and Bylaws of such corporation,

the election, incumbency, and signatures of officers of such corporation, and certifying as to the resolutions of the Board of Directors of such corporation relating to the transaction pursuant to Section 8.4 of the Agreement.

2. Good Standing, Articles, Bylaws, and Incumbency of Holdings and TAC

2.01. Certificate of Incorporation and all amendments to date of Holdings certified by the Secretary of State of Delaware on December 21, 2006.

2.02. Certificate of the Secretary of State of Delaware, dated December 21, 2006, certifying that Holdings is an existing corporation and in good standing under the laws of the State of Delaware.

2.03. Telex of the Secretary of State of Delaware, dated the Effective Date, updating the information set forth in item 2.02 above.

2.04. Certificate of the Secretary of State of each of California and New York, dated December 22, 2006, certifying that Holdings is qualified to conduct business and is in good standing in such states.

2.05. Certificate of Incorporation and all amendments to date of TAC certified by the Secretary of State of Delaware on December 10, 2006.

2.06. Certificate of the Secretary of State of Delaware, dated December 21, 2006, certifying that TAC is an existing corporation and in good standing under the laws of the State of Delaware.

2.07. Telex of the Secretary of State of Delaware, dated the Effective Date, updating the information set forth in item 2.06 above.

2.08. Certificate of the Secretary of Holdings, dated the Effective Date, as to the Certificate of Incorporation and Bylaws of such corporation, the election, incumbency, and signatures of officers of such corporation and certifying as to the resolutions of the Board of Directors of such corporation relating to the transaction pursuant to Section 9.4 of the Agreement, Sections 5.01(e), (f), and (h) of the Credit Agreement and the Bridge Agreement.

2.09. Certificate of the Secretary of TAC, dated the Effective Date, as to the Certificate of Incorporation and Bylaws of such corporation, the election, incumbency, and signatures of officers of such corporation, and certifying as to the resolutions of the Board of Directors and stockholders of such corporation relating to the transaction pursuant to Section 9.4 of the Agreement, Sections 5.01(e), (f), and (h) of the Credit Agreement, and the Bridge Agreement.

2.10. Certificate of the Secretary of Target (the Surviving Corporation), dated the Effective Date, certifying as to the resolutions of the Board of Directors of such corporation relating to Sections 5.01(e), (f), and (h) of the Credit Agreement and the Bridge Agreement.

2.11. (a)–(b) Certificates of the Secretaries of the Subsidiaries listed in (a)–(b) of item 1.06 as to the Certificate of Incorporation and Bylaws, the election, incumbency, and signatures of officers and certifying as to resolutions of the Board of Directors of such corporations relating to Sections 5.01(e), (f), and (h) of the Credit Agreement.

3. Principal Documents

3.01. Agreement of Merger, dated as of October 1, 2006.

3.02. Certificate of Merger.

3.03. Escrow Agreement, dated October 1, 2006.

3.04. Certificate No. PA-1-1 evidencing 1,000 shares of Series A Preferred Stock of Holdings.

3.05. Seller Registration Rights Agreement.

3.06. Seller Warrant.

3.07. Credit Agreement, together with Schedules and Exhibits thereto.

3.08. Target Security Agreement, between Bank as Agent and for the Ratable Benefit of Lenders and Target.

3.09. (a)–(b) Subsidiary Security Agreement between Bank as Agent and for the Ratable Benefit of Lenders and each of the Subsidiaries listed in (a)–(b) of item 1.06.

3.10. Holdings Pledge Agreement.

3.11. Certificate No. 8 evidencing 100 shares, constituting all of the issued and outstanding shares of Target together with a stock power duly endorsed.

3.12. Target Pledge Agreement.

3.13. (a)–(b) Certificates evidencing all of the issued and outstanding shares of each of the Subsidiaries listed in item 1.06, together with stock powers or other instruments of transfer duly endorsed.

3.14. Individual Stock Pledge Agreements, executed by each of the Investor Shareholders and Management Shareholders in favor of the Bank.

3.15. Certificates evidencing all of the issued and outstanding common shares of Holdings, together with stock powers from each shareholder duly endorsed.

3.16. Mortgage.

3.17. Joinder Agreement executed by Target.

3.18. Private Placement Memorandum of December 27, 2006.

3.19. Supplement to the Private Placement Memorandum dated December 30, 2006.

3.20. Bridge Agreement.

3.21. Bridge Notes Indenture.

3.22. Senior Subordinated Bridge Note.

3.23. Bridge Note Registration Rights Agreement.

3.24. Warrants issued by Holdings to Lead Investment Banker.

3.25. Subordinated Pledge Agreement between Holdings and Investment Bank Group.

3.26. Intercreditor Agreement between Bank and Investment Bank Group.

4. Documents Relating to the Escrow Agent

4.01. Joint Written Notice executed by Seller and TAC pursuant to Section 4(a) of the Escrow Agreement to the effect that the Merger has been effected and instructing the Escrow Agent to pay the Escrow Deposit and interest accrued thereon to Target.

4.02. Receipt of Target, dated the Effective Date, for funds received from the Escrow Agent in the amount of $1,025,000.

5. Documents Relating to Compliance with Agreement of Merger

5.01. Certificate of the President of Seller, dated the Effective Date, pursuant to Sections 8.1 and 8.2 of the Agreement and as to compliance with and performance of the Agreement and as to the representations and warranties set forth in the Agreement.

5.02. Certificate of the Vice President of TAC dated the Effective Date, pursuant to Sections 9.1, 9.2, and 9.7 of the Agreement as to compliance and performance of the Agreement; the representations and warranties set forth in the Agreement; and its business, financial conditions, and operations.

5.03. Releases executed by each person holding an option to purchase common stock of Target under the Target Stock Option Plan pursuant to Section 8.9 of the Agreement.

5.04. Certificate No. 7 of Target evidencing 1,000 shares of common stock of Target issued to Seller together with such stock transfer tax stamps as may be required.

6. Documents Relating to Compliance with Credit Agreement

6.01. Certificate executed by CEO and CFO of Holdings as to representations and warranties and no event of default pursuant to Section 5.01(d) of the Credit Agreement.

6.02. (a)–(d) UCC-1 Financing Statements covering personal property and appropriate documents for perfecting security interest in U.S. intellectual property as follows:

(a) Holdings—California Secretary of State; Clerk of Los Angeles County, California; New York Department of State; and City Register of New York City;

(b) Target—California Secretary of State; Clerk of Los Angeles County, California; New York Department of State; and City Register of New York City;

(c) New York Target Subsidiary Ltd.—New York Department of State; and City Register of New York City; and

(d) Delaware Target Subsidiary Inc.—Delaware Secretary of State; Clerk of New Castle County, Delaware.

6.03. Certificate of President of Target to the effect that all indebtedness of Target has been paid or refinanced pursuant to Section 5.01(o) of the Credit Agreement.

6.04. Appointments of CT Corporation System in State of California as agent for service of process executed by CT Corporation, Holdings, Target, and the Subsidiaries pursuant to Section 5.01(s) of the Credit Agreement.

6.05. Pro Forma Closing Date Balance Sheet for Holdings and its consolidated Subsidiaries pursuant to Section 5.01(t) of the Credit Agreement.

6.06. Borrowing Base Report, dated not more than two (2) days prior to the Effective Date pursuant to Section 5.01(y) of the Credit Agreement.

6.07. Appraisal of Appraisal Co. as to fair market value and orderly liquidation value of the real and personal property of Target pursuant to Section 5.01(b) of the Credit Agreement.

6.08. Written undertakings, executed by each of Target and the Subsidiaries pursuant to Section 5.01(d) of the Credit Agreement.

6.09. Solvency letters from CFOs and accountants for Holdings and Target pursuant to Section 5.01(k) of the Credit Agreement.

6.10. Bank Credit Audit pursuant to Section 5.01(p) of the Credit Agreement.

6.11. Certificate of Borrower as to consents pursuant to Section 6.03 of the Credit Agreement.

6.12. Evidence of payment of or indemnification against tax liens: City of New York—$10,000,000; State of New York—$500.00.

7. Consents, Waivers, and Estoppel Certificates of Landlords of Target and Real Estate Matters

7.01. Consent of Lessor Ltd., lessor to New York Target Subsidiary, Ltd., with respect to the facility located at One Main Street, New York, New York.

7.02. Owners' title insurance policy with respect to the California property, dated the Effective Date, pursuant to Section 8.8 of the Agreement.

7.03. Lenders' title insurance policy with respect to the California property.

7.04. Title Insurance Questionnaire.

7.05. Estoppel Certificate.

7.06. Survey.

7.07. Indemnities of Seller to the Title Insurance Company.

7.08. Discharges of Trust Company Mortgages.

7.09. Seller Agreement regarding effluent discharge.

8. Insurance

8.01. Insurance endorsements naming Agent as additional insured or loss payee pursuant to Section 5.01(x) of the Credit Agreement.

9. Documents Relating to Compliance with Bridge Agreement

9.01. Certificate of Vice President of Holdings pursuant to Section 3.1.4 of the Bridge Agreement as to the satisfaction of certain conditions of the Bridge Agreement.

9.02. Warrant Repurchase Letter Agreement, dated the Effective Date, between Holdings and Investment Bank Group.

10. Opinions of Counsel

10.01. Opinion of SC, dated the Effective Date, addressed to Holdings, the Agent, Lead Investment Banker, and the Indenture Trustee pursuant to Section 8.5 of the Agreement, Section 5.01(mm) of the Credit Agreement, and Section 3.1.8 of the Bridge Agreement.

10.02. Opinion of ICC, dated the Effective Date, pursuant to Section 9.5 of the Agreement.

10.03. Opinion of ICC, dated the Effective Date, addressed to the Agent pursuant to Section 5.01(c) of the Credit Agreement.

10.04. Opinion of ICC, dated the Effective Date, addressed to Lead Investment Banker and the Indenture Trustee pursuant to Section 3.1.7 of the Bridge Agreement.

10.05. Opinion of California Counsel, dated the Effective Date, addressed to the Agent pursuant to Section 5.01(v) of the Credit Agreement.

10.06. Opinion of Copyright Counsel, dated the Effective Date, addressed to the Agent and Holdings as to the trademark and copyright registrations in the United States pursuant to Section 5.01(w) of the Credit Agreement.

10.07. Opinion of BC dated the Effective Date, addressed to the Lenders pursuant to Section 5.01(u) of the Credit Agreement.

11. Documents Relating to IC and Management Shareholders

11.01. Employment Agreement between Target and John Smith, President of Target.

11.02. Powers of Attorney from each Management Shareholder appointing John Smith Attorney-in-fact.

11.03. Recourse Notes in the aggregate of $1,000,000 executed by each of the Management Shareholders (originals delivered to IC).

11.04. Pledge Agreement executed by Management Shareholders in favor of IC.

11.05. Cross Receipt of IC acknowledging receipt of the notes described in 11.03 and by John Smith as Attorney-in-fact for each of the Management Shareholders acknowledging receipt of an aggregate amount of $1,000,000.

11.06. Stockholders Agreement among Holdings, Investor Shareholders, and Management Shareholders.

11.07. Agreement for Management Consulting Services between IC and Target.

11.08. IC Intercreditor Agreement by and between IC and Bank.

11.09. Letter as to Recourse Promissory Notes in favor of IC, dated the Effective Date, from IC to counsel for the Management Shareholders.

12. Funding of Holdings and TAC and Merger Payment

12.01. Cross Receipt executed by Holdings acknowledging receipt of $4,000,000, and by the Investor Shareholders acknowledging receipt of Certificate Nos. 1–4 evidencing 800,000 shares of the common stock of Holdings.

12.02. Cross Receipt executed by Holdings acknowledging receipt of $1,000,000, and by the Management Shareholders acknowledging receipt of Certificate Nos. 5–8 evidencing 200,000 shares of the common stock of Holdings.

12.03. Cross Receipt executed by Seller, dated the Effective Date, acknowledging receipt of (a) the Cash Portion of the Merger Payment in the amount of $100,000,000 determined pursuant to Section 3.2(b) of the Merger Agreement; (b) the Warrant; and (c) Certificate No. PA-1 evidencing 1,000 shares of Series A Preferred Stock, and by Holdings acknowledging receipt of (i) $10,000,000 as consideration for the issuance of the Series A Preferred Stock and (ii) a certificate evidencing 1,000 shares of Common Stock of Target.

12.04. Receipt executed by IC acknowledging receipt of $3,000,000 as a structuring fee.

13. Funding of Loan and Sale of Warrants

13.01. Term Note in the amount of $40,000,000 (original delivered to Lender).

13.02. Revolving Note in the amount of $10,000,000 (original delivered to Lender) (only $1,000,000 borrowed at Closing).

13.03. Cross Receipt of Lender acknowledging receipt of the Term Note and the Revolving Note and of Holdings acknowledging receipt of $41,000,000.

13.04. Cross Receipt of Investment Bank Group and Lead Investment Banker acknowledging receipt of the Investment Banker Warrants and Bridge Note and of Holdings acknowledging receipt of $60,000,000.

V. FILING OF CERTIFICATE OF MERGER

When all parties and their counsel were satisfied that the documents described in Section IV were complete and in order, the Certificate of Merger was filed in the office of the Secretary of State of Delaware, in accordance with the General Corporation Law of the State of Delaware.

NOTE

1. The source of this explanation is the Office of the Secretary of State, Texas, at www.sos.state.tx.us/ucc/index.shtml.

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CHAPTER 9

Postmerger Integration and Divestitures

INTRODUCTION

After the closing of an M&A transaction, many buyers and sellers feel relieved. They know the work of planning, searching, valuation, financing, structuring, and even (for the most part) due diligence is behind them. But for strategic acquirers, the closing of an M&A transaction is also an opening of a new process—combining two companies, usually in their entirety.

A typical acquisition announcement will state that one company is buying another in order to take advantage of specific resources in the other company—for example a new technology, as emphasized in Galapagos's mid-2006 acquisition of DPI.[1] Or the acquirer may seek a broad array of elements, as AT&T acknowledged when anticipating "greater financial, technical, research and development, network and marketing resources" from a merger with BellSouth that same year.[2]

But whether an acquirer is buying another company to mine a single resource or many, most acquisitions do entail a full-scale integration of all resources, processes, and responsibilities for both companies. Therefore, at the integration phase, many aspects of the acquired company having nothing to do with strategy suddenly demand attention. Acquirers who had been dreaming about teaming up for scientific breakthroughs find themselves worrying about designing a payroll system—and hundreds of similarly mundane matters. To deal with these details, comprehensive, detailed integration plans are needed.

At the same time, the company and its stakeholders need to prepare for the possibility that some company units or assets may be *sold* following an acquisition. This possibility, too, should be part of postmerger planning.

This chapter briefly explains basic concepts of postmerger integration and divestiture, and gives general guidance for the fiduciary care of key resources, processes, and responsibilities following the closing of an M&A transaction. Our explanation will be at a fairly high board-of-directors level. For close-to-the-ground managerial tools, other books in this series will be helpful.[3]

BASIC CONCEPTS OF INTEGRATION

What is M&A integration?

The term *M&A integration* refers primarily to the art of combining two or more companies—not just on paper, but in reality—after they have come under common ownership: *M&A* refers to the merger or acquisition transaction that leads to the combination, and *integration* refers to a combination of elements that enables the two companies to function as one. To practice the art of M&A integration well, one must learn by doing it—or at least learn from similar companies that have done it.

Of course, corporations aren't the only entities that get involved in mergers and divestitures. Charities, trade unions, and government agencies do as well. And mergers and acquisitions aren't the only kinds of transactions that can elicit skills in integration. Joint ventures, strategic alliances, or partial acquisitions can require some integration work as well. Finally, sometimes integrations can be extremely complex, involving the integration of multiple companies. For the most part, this chapter will emphasize standard mergers or acquisitions involving two companies, with occasional references to other applications.[4]

Don't all buyers and sellers count on postmerger integration? What would be the point of buying a company without integrating it?

Companies make acquisitions for a variety of motives, and not every one involves integration. An FTC panel report (based on a focus group with

10 executives) once counted 31 motives, ranging from expanding product lines to increasing managerial strength.[5] At the other extreme, Warren Buffett has philosophized that there is only *one* reason for M&A activity: to move investment out of cash and into assets. For many companies, there are usually a variety of motives. Expert J. Fred Weston and other scholars agree on the following 10 most common reasons why companies make acquisitions:[6]

- Achieve economies of scale by buying a customer, supplier, or competitor (operating synergy)
- Accomplish strategic goals more quickly and more successfully (strategic planning)
- Realize a return on investment by buying a company with less efficient managers and making them more efficient (differential efficiency)
- Realize a return by buying a company with inefficient managers and replacing them (inefficient management)
- Increase market share (market power)
- Lower cost of capital by smoothing cash flow and increasing debt capacity (financial synergy)
- Take advantage of a price that is low in comparison to past stock prices and/or estimated future prices, or in relation to the cost the buyer would incur if it built the company from scratch (undervaluation)[7]
- Assert control in an underperforming company with dispersed ownership (agency problems)
- Obtain a more favorable tax status (tax efficiency)[8]
- Increase the revenues or size of a company and therefore increase the pay and power of managers (managerialism)

The degree of integration necessary after an acquisition depends in part on which goals are to be met. For example, the goal of operating synergy requires more attention to integration than a change in tax status. Nonetheless, for most acquirers, some degree of integration will be necessary.

What are the benefits of integration versus separate management for an acquired company or one of its units?

If the acquirer has a strategic reason for buying the company, some form of integration will be necessary for success. If the acquirer's reason for buying a

firm is financial, however, integration may not be particularly helpful. In order to succeed as a financial acquirer, a company must have a *financial culture.* Absent such a culture, acquirers would be wise to master the art of M&A integration. (For more on strategic versus financial acquirers, see Chapter 1.)

What is the difference between a financial culture and a strategic culture when it comes to integration?

Financial acquirers have no intention of integrating the resources, operations, or technology of the acquired company into their own. These acquirers, which are typically (but not always) buyout funds, do not so much manage as *monitor* the resources they acquire.

Thus a financial culture treats each acquired company as a separate entity. In such a culture, exemplified by the buyout firm of Kohlberg Kravis Roberts & Company (KKR), the buyer tries to add value through imposing superior, top-down management strategies in a short period of time. Financial acquisitions can be fairly diverse. Although these transactions may build on the acquirers' expertise, they need not be integrated into the acquirers' operations to yield good returns.

A *strategic culture,* by contrast, treats each acquired company as a new member of its corporate family. In such a culture, exemplified by General Electric, the acquired company itself adds value to the acquiring company by integrating with the buyer's existing operations. Strategic acquisitions (commonly referred to as mergers) often involve combinations of companies in the same or related industries. Mergers within the same industry can reduce costs (usually by increasing purchasing scale or reducing the cost of payroll by laying off employees) and/or increase revenues (usually by increasing the customer base).

So far we've talked about acquisition integration. What is *reintegration*?

Reintegration has three meanings in business:

- First, reintegration can refer to consolidation in a market previously known for fragmentation. Economists, for example, talk about reintegration in the telecommunications industry as mergers today undo some of the fragmentation following the breakup of the old AT&T into Bell operating companies.

- Second, reintegration can refer to the integration of two companies that used to operate as a single company, but split apart. For example, Deloitte Touche Tohmatsu spun off Deloitte Consulting in early 2002, but reversed course in 2003 and integrated it back.[9]
- Finally, reintegration can mean cleanup integration work done years after the original acquisitions and integration. This kind of effort can be useful for companies that got on a roll with rollups, making multiple acquisitions over time, and need to rewind by making fresh starts with some of their acquired companies.

THE POSTMERGER PLAN

What is the window of time for implementing a postmerger plan?

No one has ever suggested a minimum, but a number of consulting companies have suggested maximums. Realistically, the integration can take up to a year, but the more successful initiatives are completed in six months, with the most critical phases completed in three months or, more poetically, "100 days."

What proof is there that rapid integration works better than slow integration?

Numerous studies have shown a correlation between speed of postmerger integration and success. Some of the most compelling evidence comes from research focusing on integration of specific resources, processes, or responsibilities. For example, in a recent paper, the Boston Consulting Group concluded that "the rapid and comprehensive integration of IT systems greatly enhances the chance that a merger will succeed."[10] If so, who needs proof? It stands to reason that the longer the acquirer waits to add value to the unit—presumably through some form of integration—the more expensive it will be to repay the premium paid to purchase the unit.

How successful are mergers generally after the initial windfalls? Is it true that most of them turn out to be failures?

The answer to this question depends on how you define *failure.* If you are not sure about your definition, you are not alone. In the past half century,

scholars have published hundreds of studies of postmerger financial performance, and few have defined failure—or, conversely, success—in exactly the same way.

When failure is defined in extreme terms, such as the eventual liquidation or sale of the unit, then failure rates are low—under 20 percent. When failure is defined as an inability to reach certain financial goals, such as significant growth in net income or return on equity, then reported failure rates can be high—up to 80 percent.

Overall, M&A activity does produce positive results for participants. Darden Business School Dean Robert Bruner looked into this question recently. His comprehensive review of M&A research—covering more than 100 studies—found that in general:

- Shareholders of selling firms earn large returns.
- Shareholders from buyers and sellers combined earn significant returns.
- Shareholders of buyers usually earn the required rate of return.[11]

Bruner's conclusions square with a 2003 FTC study comparing research from several major consulting firms.[12]

Based on this research, what factors contribute to successful postmerger activity—and thus what factors should be emphasized in announcing a merger?

A number of factors can contribute to success. Here is a list of some commonly cited success factors (appearing in most scholarly research articles, including those by Weston, Bruner, and others), along with some possible press-release language to use:

1. *Strategic motivation.* "Approximately 60 percent of the two companies' revenues derive from geographic markets and networks that overlap, creating the opportunity for significant network efficiencies and synergies."[13]
2. *Clear relation to core business.* "Our core business is to provide superior customer service in apparel retail. Our purchase of this well-respected apparel franchise helps build our legacy."
3. *Economic pricing.*[14] "We will pay $X for this merger. This price is based on analysis by our internal financial staff, advised by external experts in this industry."[15]

4. *Prudent cash- or debt-based financing.*[16] "The purchase price will be paid in cash. To help finance this transaction, we took out a loan at favorable lending rates based on our sound credit rating. Our cash flow will support repayment of the debt."
5. *Efficient integration planning.* "This integration will take 100 days. This memo describes the actions we will take, and the people responsible for the actions."

For a sample press release highlighting strategic motivation, see Appendix 9A.

What should be in a postmerger plan?

This varies greatly by industry and by situation. Clearly, however, there should be three elements in the postmerger plan:

- Goals of the new company
- How integration of resources, systems, and responsibilities will support those goals
- Timetable for the integration

For example, a postmerger plan for two hospitals might say that the two hospitals want to expand the range of services they provide to their local communities. Implementation details might include how the board, management, and staff will be organized; how staff will be credentialed; who will be responsible for clinical policy making; how budgeting, accounting, accounts receivable, and bond covenants will be handled; what clinical services will be changed, expanded, or cut back; and what nursing models will be used. The thorough integration plan might also include how the mission, values, and vision of the two hospitals will be merged.

Some plans never get implemented or get implemented poorly. How can postmerger planners avoid this problem?

The following 15-point M&A planning checklist can help integration planners at the senior management level see if they are on the right track:

1. Are the plans consistent with the intrinsic logic of the deal?
2. Do the plans specify how the company will pay for the deal?
3. Are there written plans to cover both the short term (less than five years) and the long term (five years or more)?

4. Do short- and long-term plans mesh?
5. Has the planning process involved both senior managers and employees most affected by the plans?
6. Do the plans take into account the operational and cultural realities of the two companies involved?
7. Have senior managers and the board of directors reviewed the plan documents?
8. Are senior managers and the board using the plans to make their decisions?
9. Are the plans supported by appropriate policies?
10. Are the plans supported by adequate resources?
11. Do the plans specify measures and milestones of progress?
12. Who will be held accountable for achieving the plans?
13. Have the plans been distributed to all appropriate parties?
14. Is there a program for communicating the plans internally?
15. Is there a program for communicating the plans externally?

The answer to each question should be *Yes!*

COMMUNICATING THE INTEGRATION PLAN

How can buyers and sellers stem the tide of rumors from various stakeholders before, during, and immediately after the deal?

Bear in mind that rumors are a symptom of a more pernicious problem: lack of information. The responsibility for the latter rests squarely with senior management.

In general, companies that plan to merge should say so publicly as soon as they have reached an agreement to combine. This announcement should go out to all the companies' stakeholders and to the general public.

This initial announcement should be the beginning of a series of regular communications through letters, memos, meetings, and any other available media about each phase of the transaction. Once the transaction is close to completion or completed and a plan is in place, both the acquirer and the acquired firm should disseminate the plan (in brief format) to all stakeholder groups, developing a special position statement for each group.

The communications process must continue for the entire period of active integration—generally up to 12 months. The best strategy is to establish, at the front end, a regular process of communications, both formal and informal. In the case of employees, for example, these would include monthly updates on the merged business. Communications should include not only a description of postmerger plans but also how and why they were made and how they will be carried out. Ideally, the affected parties will have participated in forming the plans, so the announcements will not come as great surprises.

To build stakeholder ownership of the plans, announcements should contain financial details, which ultimately measure the success or failure of new policies. The goal is to have different stakeholders buy into postmerger plans by following the transformation process, understanding its components, and checking its success.

Meanwhile, at every stage of postmerger integration, management of the new company should communicate to all stakeholders in all appropriate media, as shown in Box 9-1.

COMBINING COMPANY NAMES

When it comes to combining company names, what issues arise?

A company's name, along with the names of its brands, can constitute a significant percentage of its value. Thus one important consideration after a merger is what to do with the names of the companies. When one company buys another, it has four basic choices:

- To keep its own name (as Adobe did when it bought Macromedia). This is the most common option.
- To assume the seller's name (as Kmart did when it acquired Sears, or as NationsBank did when it acquired Bank of America). This is the least common option.
- To combine both names (in full, as in Northrop Grumman, Lockheed Martin, or Alcatel-Lucent; or via an acronym as in CIGNA—from Connecticut General and INA).
- To create an entirely *new* name (as when Great Lakes Chemical Corporation merged with Crompton Corporation to become Chemtura in 2005).[17]

BOX 9-1

Audience-Media Communications Matrix

Audiences \ **Media**	Letter	Capabilities Brochure	Special Brochure/Flyer	News Releases	Special Press Kit	Quarterly Report	Annual Report	Special Newsletter	Regular Newsletter	Promotional Item	Magazines/Bulletins	Personal Meetings	Special Event	Advertisement - Financial	Advertisement - General	Advertisement - Trade	Internal Meeting	External Group Meeting	Internet Home Page	Other	Other
Employees																					
Salesmen																					
Vendors																					
Retail Customers																					
Commercial Customers																					
Community Business People																					
Bank(s)																					
Telephone Listings																					
General Public (National)																					
General Public (Regional)																					
Special Interest Groups																					
Elected Officials																					
Local Press																					
Opinion Leaders																					
Securities Analysts																					
Brokers																					
Shareholders																					
Institutional Shareholders																					
Key Investors																					
Board of Directors																					
Advisory Directors																					
Senior Management																					
Subsidiary Officers																					
Subsidiary Non-Officials																					
Retired Employees																					
Financial Media																					
General Business Media																					
Directories																					
Rating Agencies																					
Peer Groups																					
Prospective Acquirees																					
State Regulators																					
Government Agencies																					

Courtesy of Gene Grossman, Siegel & Gale, New York

Why do most acquiring companies keep their names unchanged after a merger or acquisition?

Name changes are generally reserved for deals in which the acquired company has a reputation equal to or more prominent than the acquirer. The majority of M&A deals involve purchases of companies that are smaller and less well-known than their acquirers.

Even in a merger of equals, there is usually one company that has a stronger name value and wishes to assert that. The company may take on a new name that evokes the second merger, but that can fade in time—especially if the new entity is acquired later. The story of the BayBank name shows the gradual loss of an acquired company name. When BayBank merged with Bank of Boston in 1996, the combined entity called itself BankBoston—a small but symbolically significant concession to the elided BayBank name. In 1999, when BankBoston merged with Fleet, the new company was called FleetBoston Corporation. By 2004, the BayBank elision and name were gone: Bank of America bought FleetBoston and phased the name out forever.

What are the pros and cons of these four different approaches?

Let's look at them one by one:

- *Keeping the acquirer's name* is the simplest approach, and it is often a wise course for high-profile companies that buy low-profile companies. The chief drawback will be a sense of loss by the acquired company's employees. From plant to boardroom table, people can literally grieve the loss of what they have worked for years to build.[18] There is also a dollars-and-cents issue for the company as a whole and its owners: if the selling company has name recognition, as most companies worth buying do, the value of this trade name might be diminished, along with any trademark value it may have.
- *Adopting the seller's name* is good for acquirers that need to gain cachet from the seller's company. The chief advantages and disadvantages here are the same as in the first example, but with acquirer and seller roles reversed.
- *Putting the two names together,* with or without acronyms, has the advantage of bolstering the pride of both parties. On the other hand,

it poses the challenge of a dual identity to be understood both within and outside the company.

- *Creating an entirely new name* avoids this challenge while creating another one: what to call the new company. Of all the communication challenges facing newly combined companies, this one is paramount. (In fact, the comprehensive communications grid that appears in Box 9-1 was originally developed as a grid to announce company name changes.) In this option, the potential sense of loss is doubled. Employees from both the acquired and the acquiring company may feel a sense of abandonment.

How do buyers and sellers decide whether to use old or new names? And how do they create new names?

Sometimes the best course for naming a newly combined entity will be obvious. If a large, successful company buys a small, struggling firm in its industry, the acquirer's name should probably prevail, unchanged, especially if that acquirer has already changed its name within the past few years. Usually, however, the choice is not so easy.

Merging companies would be wise to appoint a small group of managers to look into this important question. There are basically 12 steps. (See Box 9-2, and the discussion that follows.)

Step 1: Compare Present Names with Future of Combined Company

Managers can ask themselves honestly if the existing company names—separately or in combination—adequately convey the range of the products and services the new company will offer. Is the company expanding? Is it planning to sell off noncore businesses? What qualities does the company want to project?

Step 2: Determine the Needs and Expectations of Stakeholders

Managers or their agents (designated employees or consultants) can then interview representatives of each stakeholder group to find out what they think of the businesses that are combining. This includes customers, suppliers, stockholders, bondholders, lenders, employees, and people in the communities where the companies are headquartered.

BOX 9-2

Steps for Naming a Newly Combined Company

1. Compare present names with future of company.
2. Determine needs and expectations of stakeholders.
3. Develop criteria for a new name.
4. Develop a long list of names.
5. Review/screen names to make short list.
6. Conduct preliminary legal search.
7. Evaluate linguistic and graphic attributes.
8. Select final candidates.
9. Conduct final legal search.
10. Recommend new name to board and stockholders.
11. Seek approval from board and stockholders.
12. Develop communications plan.

Step 3: Develop Criteria for a New Name

In listing criteria, managers should ensure suitability with as many facets of the company as possible. Here is a quick checklist of 10 important attributes of a name:

- *Descriptive* of the combined companies' core business?
- *Suitable* to the products, services, and (if regional) location of subsidiaries?
- *Broad* enough to suit the present while leaving room for growth in the future?
- *Acceptable* to the company's stakeholders?
- *Distinctive* rather than clichéd?
- *Memorable* rather than arcane?
- *Pronounceable* or a tongue-twister?
- *Real-sounding* or outlandish?

- *Self-explanatory* or a stretch?
- *Legally available?*

Step 4: Develop a Long List of Names

Now is the time for maximum creativity; the decision-making group may wish to include additional employees and/or outside consultants for brainstorming at this point. In generating a list of possible names, managers can use key prefixes, suffixes, and word fragments to imply general image attributes, such as "Uni" for centralization, "Max" for high-quality services, and "Ameri" for domestic orientation. The dictionary and thesaurus will be helpful here. To add to the list, a computer can be programmed to generate random names. In the end, the list should include up to several hundred names for a large, complex company. It is important to check to be sure the names aren't already used. The most sought-after names in the investment sector, for example, convey something "soaring, mighty, fast or majestic" as one source wrote. The challenge, however, is that there is currently a logjam of names. Greek gods, animals, mountain ranges, rivers, roads, and even solar systems are largely taken.[19]

Step 5: Review Names, Making a Short List

Next, managers should winnow the list down to 25 to 35 acceptable candidates. In this process, they should bear in mind that no single name can fulfill all criteria. It is up to senior management to set priorities. Managers might assign points for each desired attribute—with extra points for the attributes that matter most. They might also decide that failure on certain key points will mean automatic rejection, despite overall score.

Step 6: Conduct Preliminary Legal Search

Although the process of obtaining legal clearances can be long and frustrating, a full corporate designation must be legally cleared, registered, and protected in accordance with statutes governing its use. Depending on the size of the business and its market, a preliminary search must be conducted at the national, state, and/or local level to identify the legal availability of names on the list. (Sometimes the search must be conducted internationally, nation by nation.) It is fairly typical at this point to find that most of the names are already taken.

Step 7: Evaluate Graphic and Phonetic Attributes

In the process of narrowing down the choice, managers should begin to get a feel for what it will be like living with each of the names. At this point, they should begin to pay especially close attention to the way the name looks and sounds. The name selected must be adaptable to a variety of media, both visual and auditory. It will appear in newspapers, magazines, and on the Internet, as well as on a range of forms, stationery, and signage. It will also be heard on radio, over the telephone, and in conversation—sometimes in many languages.[20]

Step 8: Select Final Candidates

By now, a company may have about a dozen name finalists. At this point, it is time to make a final choice. One way to do this is to take two names at a time and select only one each time—a process called pairwise comparison—continuing to evaluate the attributes listed so far. At the end, only one name will survive. For a guide to pairwise comparison (a technique that can be used for many aspects of integration—not just name choices) see Appendix 9E.

Step 9: Obtain Final Legal Clearance for Use of the Name

Having selected a name, managers should ask their legal counsel to begin the paperwork for obtaining the legal right to use the name and any images associated with it, pending board and stockholder approval. As will be discussed, trademarks and service marks have value, so this is an important step.

Step 10: Seek Approval from the Board and/or Stockholders

In most situations, it will be necessary to seek approval for the name change from a board of directors and from owners. In seeking approval, managers should disclose the criteria and process they used to select the new name, and the benefits that a new name may bring.

Step 11: Create a Graphic System for the New Name

Once the name is selected and approved, it will be time to design a graphic system for it, which will include such visual elements as logos, symbols, and

typefaces for the name's expression in all foreseeable applications. Will the name consistently be linked to a specific color or symbol? Will the name appear on stationery in all capital letters or in upper and lower cases?

Step 12: Develop a Communications Plan

Managers should decide when to announce the name change, leaving adequate time for reprinting and reordering materials such as forms, stationery, and signs. After the announcement, the company should use only the new supplies. The announcement (which is sometimes coupled with the announcement of the merger itself) should be made not only through the usual channels of communication, but also in special mailings or meetings tailored to specific stakeholder concerns. The company should be sure to include information about the new name in the part of its Web site devoted to the merger. One of the FAQs (frequently asked questions) posted about Bank of America's merger with Fleet was, "What is the name of the new company?" (The response: Bank of America Corporation.)

In the end, the burden of proof will be on the new owner, who must demonstrate that the values underneath the company name and logo will survive and indeed thrive under a new banner.

INTEGRATING CULTURES

The values wrapped up in a company name could also be called a company's soul or even culture. What happens to these following a merger?

Individuals who believe people have souls can readily believe that companies do. This was the view of the late B. Kenneth West, who wrote eloquently on this subject.[21]

The embodiment of company *soul* lies in culture, which is easier to analyze and manage. Culture is a force that influences what people believe, think, and do. In an organization, it can shape:

- Attitudes/mental processes (how people feel and think)
- Behavior (what actions get performed and rewarded)
- Functions (how people do things)

- Norms (what rules get enforced)
- Structures (how the previous items get organized and repeated)
- Symbols (what images and phrases have special meaning)
- History (what stories and traditions get passed on to future generations)[22]

All of these elements tend to synchronize within a culture. So, for example, if attitudes are risk averse, so too will be the behavior, functions, norms, structures, symbols, and history.

Is it true that culture clashes cause most postmerger problems?

On the contrary, a main benefit of acquisitions is to force companies—both acquiring and acquired—to reevaluate and improve their ways of doing business.[23] Culture clashes are a thorn in the side of strategic acquisitions. Although they don't cause "death" (financial failure) in and of themselves, they can cause pain and weaken performance. Cultures often clash over risk. The more risk-averse cultures (older, more mature companies) may be praised as prudent or criticized as passive. Conversely, risk-tolerant cultures (typically belonging to smaller, newer companies) may be either branded as brash or lionized as innovative. One of the greatest challenges in any merger is to find a way to balance the two cultures.

Mergers commonly cited for cultural differences include (in reverse chronological order):[24]

- Hewlett Packard and Compaq Computer (2002)
- AOL and Time Warner (2001)[25]
- Mattel and The Learning Company (1999)[26]
- Citicorp and Travelers Group (1998)
- Daimler-Benz and Chrysler (1998)
- Walt Disney Co. and Capital Cities/ABC (1996)
- Pharmacia and Upjohn (1995)
- Quaker Oats and Snapple (1994)
- AT&T Corporation and NCR Corporation (1991)
- Sony Corporation and Columbia Pictures (1989)

In most of these cases, analysts depicted the acquirer (listed first) as being more risk averse than the acquired or merged firm.

Do extreme cultural differences doom deals to failure?

No. They merely need to be managed appropriately. Paying attention to them can help. When acquiring Compaq, HP conducted 144 focus groups and 150 interviews in 22 countries—all focused on determining cultural problems. The focus groups and interviews raised awareness of culture generally. Two years after the merger, the company reported that 78 percent of managers from both companies remained, a relatively high retention level for the industry.[27]

INTEGRATING VISION, POLICY, ETHICS, AND MISSION STATEMENTS

What happens to vision, policy, ethics, and mission statements after a merger?

First, let's look at some definitions.

Vision statements provide direction and motivation for an organization. A vision statement (sometimes called a *vision and values* statement) says, "Here is the difference we want to make in the world—the vital goal that animates us as we pursue our mission and adhere to our policies." These statements are relatively new to the corporate scene; they number in the hundreds. Some experts believe that the distribution of a vision statement should be broad, while others believe it should be strictly limited to top management.

The main goal of any *policy* statement is to ensure ethical and legal behavior. A policy statement says, "This is how we operate our business. All our employees must adhere to these rules." Almost all companies have developed policy statements for some aspects of their business.

Most major companies have comprehensive *codes of ethics.* Indeed, the Sarbanes-Oxley Act of 2002 requires all public companies to have them. Rules promulgated under Sarbanes-Oxley have defined this previously nebulous term as follows.

The final rule defines the term *code of ethics* as written standards that are reasonably designed to deter wrongdoing and to promote:

- Honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships;
- Full, fair, accurate, timely, and understandable disclosure in reports and documents that a registrant files with, or submits to, the

Commission and in other public communications made by the registrant;

- Compliance with applicable governmental laws, rules, and regulations;
- The prompt internal reporting to an appropriate person or persons identified in the code of violations of the code; and
- Accountability for adherence to the code.[28]

The primary purpose of the *mission* statement is to provide identity and focus. A mission statement says, "This is the business we are in today, as exemplified by our present products/services," and it typically has a broad audience that includes the general public as well as all company stakeholders (e.g., employees, stockholders, creditors, customers, suppliers, and local communities). About half of all companies have formal mission statements. For more about integrating responsibilities to stakeholders after a merger or acquisition, see "Integration of Key Responsibilities" later in this chapter.

Assuming that an acquirer wants to develop and disseminate new mission, policy, ethics, and/or vision statements to suit its new identity, how should it go about this?

Certainly both companies should devote part of their postmerger planning session to this question. Answers will vary according to the two companies' situations.

If the acquirer has fully developed statements that apply perfectly to the acquired company, and if the acquired company has no statement of its own, the job of integration will be easy. This will be merely a matter of educating acquired company employees in the statements of the acquirer. If, on the other hand, both companies have statements, a greater effort may be required.

First of all, management must determine who will be drafting the statements. Each mission statement should be developed by senior line managers, since mission statements pertain to lines of business, whereas policy statements (or a code of conduct) should be developed by senior legal staff.[29] The vision statement should be developed by the chief executive and board of directors, ideally based on the advice of outside experts who have a sense of the company's potential future.

Beyond this, the development of each statement should proceed step by step. The working group that is drafting the statement should obtain comparable statements and work from these, developing a content and style

appropriate to the company's circumstances. Mission and values statements tend to be expressed in a page or so, whereas policy statements—especially comprehensive, companywide codes of ethics—by their very nature, should be longer. Some become booklets—or even books.

Do you have any additional guidance on how to draft postmerger mission statements for the new company?

There are two basic possibilities here. The companies may be in completely different businesses. If so, it is best to leave their respective mission statements undisturbed at least temporarily, for the sake of continuity. Integration should not be engaged in for its own sake. If, however, the companies are in related businesses that require integration of their missions, they can and should consider drafting an entirely new mission statement for the newly combined entity.

The creation of a new mission statement should not be from a blank slate. Instead, it should be from the scratch of existing statements. First, the postmerger integration team (or its designated agent, such as a public relations manager or consultant) should inventory all formal self-descriptions the company has generated, including mission statements, policy statements, and vision statements.

Next, the team should determine the extent to which the statements have been publicized (if at all). If the statements have been widely disseminated, it would be wiser to build on them than to scrap them entirely. If, however, they have not received wide distribution, they can be used or discarded, as appropriate to the new situation.

Finally, with past statements as a base, the newly combined entities should then work to develop a new set of statements that can apply to both companies.

INTEGRATING KEY RESOURCES, PROCESSES, AND RESPONSIBILITIES

It's important to think about a company's vision and the like, but what about continuing to do *business* after a merger? How can an acquirer manage all the details involved?

First, it is important to identify each company's resources, processes, and responsibilities, and decide if they will be integrated. See Appendix 9B for a

checklist of assets featuring key resources (human, financial, tangible, and intangible/intellectual), key processes (primary processes such as management systems, support processes such as information technology, and in a class by itself, internal financial controls), and key responsibilities (commitments to various stakeholders).[30]

Then for each area to be integrated, identify:

- What needs to be done (tasks and subtasks)
- Who must do it (task owner)
- Resources needed (perquisites)
- Information needed (tactical data)
- Insight needed (strategic questions)

See Appendix 9C for an integration planning worksheet on these points, and see Appendix 9D for an integration timeline. Before using these tools, however, more guidance could be helpful. This chapter will give such guidance on how to integrate key resources, processes, and responsibilities. It will also take a closer look at compensation, a phenomenon that involves all three dimensions of company life. In conclusion, this chapter will discuss issues pertaining to postmerger divestiture.

INTEGRATING RESOURCES

Integrating Human Resources

What are some general guidelines for managing human resources after a merger?

Following a merger, acquirers need to integrate specific groups of people, such as sales teams, senior management teams, and even the board of directors. Each of these group integrations raises specific issues. It is beyond the scope of this chapter to give templates for this integration, but resources are available.[31]

When do human resources personnel typically get involved in a merger?

Traditionally, the human resources (HR) function was frozen out until the actual moment of integration. In recent years, this has changed. A 2005 survey by Mercer Human Resource Consulting indicates that only 36 percent wait

that long. Another 40 percent begin earlier, at the due diligence phase; and 24 percent begin right from the start, getting involved in the planning stage.[32]

Furthermore, when two companies merge their human resources, they also merge their HR policies, such as approaches to recruitment, retention, compensation, training and development, and (sometimes immediately) outplacement. Even if HR issues have been put off to the last minute, they will come into focus in the early postmerger period as human capital issues are getting sorted out. For a checklist of HR policies, see Box 9-3.

BOX 9-3

Acquisition Integration Plan for Human Resources Operation

Conduct integration planning kick-off meeting

HR INTEGRATION PLAN
- Standardize HR policy
- Integrate HR processes
  - Employee relations
    - Performance review and evaluation
    - Employee dispute resolution
    - Employee complaint investigation
    - Acquisition integration communication
    - Turnover reporting
    - Employee relations legal/regulatory compliance
    - EEO
    - OSHA
  - Benefits administration
    - Benefits orientation
    - Presentation of compensation/benefits at welcome party
    - Benefits conversion and enrollment
    - Medical
    - Dental
    - Benefits plan administration
    - Benefits-related legal/regulatory compliance
    - 401(k)
    - Health/welfare
    - New hire process
    - Termination process

Continued

- Compensation
  - Job mapping and redesign
  - Map acquiree and company job positions
  - Set pay scales
  - Manage changes in pay
  - Performance reviews and promotions
  - Equity/noncash compensation
  - Sales compensation
- Payroll
  - Leave accrual and administration
  - Customer service
  - Payroll administration
  - Accounting reconciliation
  - Communications with treasury
  - Pay-cycle disbursement
- Recruiting/staffing
- Facilities management
  - Office/real estate consolidation
  - Update database of site/contracts, leases
  - Assign leases to company
  - Obtain acquiree staffing projections
- Organization development/training

HR infrastructure integration

- Employee setup in HRIS
  - Establish department numbers for acquirees
  - Collect acquiree employee information
  - Input acquiree EE data in HRIS database
  - Provide acquirees with company services
  - Provide acquirees with company intranet access

HR communications plan development

HR contracts and commitments

Source: HR checklist used by a midsized U.S. telecommunications company acquiring multiple companies. Used with permission.

Benefits, compensation, and payroll are obviously important elements in the HR checklist featured here. For more on merging compensation plans, see the end of this chapter.

Integrating Financial Resources

How can an acquirer and seller combine financial resources?

This means combining them (e.g., consolidating cash reserves) and then tracking them through both accounting and controls.[33]

Combining the financial resources. A company's primary financial resources are cash, stock, and bonds. These exist in the form of bank account balances and stock and bond certificates. Immediately following the closing, acquiring managers must take possession of the acquired company's resources—transferring bank accounts, and renaming stock and bond certificates. This is a fairly straightforward matter that can be entrusted to the acquirer's chief financial officer and the CFO's team, as long as the acquiring company has adequate financial controls. Even in a merger of equals, for ease of transfer, one company should be designated for the acquirer's role in this sense.

Tracking the financial resources. The optimal value of cash, stock, and bonds, of course, is their ability to move—be spent or paid (in the case of cash), or to be exchanged (bought or sold, in the case of stocks and bonds). Movements of financial resources at any time, including following a merger, must be tracked and controlled.

- The main tool of financial tracking is financial *accounting.* Chapter 5 on structuring explains how acquisitions must be reported to conform to certain accounting practices under GAAP. For explanations of accounting issues, refer to that chapter.
- The main tool for financial controls is the set of processes known as *internal financial controls.* For more about internal financial controls, see the discussion about integration of key processes.

What does the combination of intangible resources involve?

Following a merger, intangible resources, much like financial resources, must be combined and tracked.

Combining the intangible resources. Appendix 9B lists a number of key intangibles to be considered for combination. Discussing all of them would exceed the scope of this chapter. The next sections discuss what to do about company names and brand names after a merger or acquisition. For guidance on combining other intangibles, see *The Art of M&A Integration.*[34]

Tracking intangible resources. Chapter 5 talks about the accounting issues that arise after purchasing a company that has intangibles. That chapter includes discussion of new accounting rules that make combining intangibles more complicated, yet potentially more rewarding, than in the past.

Integrating Brand Identities

What happens to brand names after a merger? Do they have to change when a company name changes?

This is a good question. Virtually every acquisition involves the purchase of at least one product or service with a recognizable name in its market segment. In some cases, the brand might be a household name nationwide or even internationally. Companies often build brands by imposing their identity (through a visual logo or by sharing a product title, for example) on a series of different products. Indeed, sometimes to build the strength of a corporate brand, a company will rename itself after a brand that it owns through a subsidiary. This is what Consolidated Foods did a quarter century ago (in 1985) when it successfully renamed itself Sarah Lee Corporation after one of its acquired brands.

In some cases, though, acquirers choose not to link their corporate identity with any of the brands they develop or acquire. Maintaining separate brand identities for their subsidiaries gives these acquirers more flexibility should they wish to sell the subsidiaries later. Autonomous brands that do not rely on their parent's identities can change hands many times in the lifetime of a consumer, and the consumer will notice only the brand, not its changing owners. This brings the valuable element of continuity to the best product brands.

Sometimes after a merger, there is a shift from a corporate identity to a brand identity. DaimlerChrysler did this after its merger. The firm's brands include Maybach, Mercedes-Benz, Chrysler, Jeep, Dodge, and smart.

In the United States, communications and dealership signage gave more emphasis to the corporate brand (represented by the Chrysler Pentastar) than to the product brands. Furthermore, most product brands had inconsistent identities across different applications (dealerships, cars, marketing materials, signage).

If brand value is independent of the owner's identity, why do acquirers have to work to preserve brand identity after a merger? Can't they just do nothing (so to speak)?

Acquirers need to bear in mind that when they buy a brand, they don't just buy a name and logo. These aspects (technically called a trademark and service mark) are just the tip of the iceberg. Acquirers of brands buy four things: the brand's definition (values it promises); its culture (how the brand's previous owner has honored the brand's promise); its infrastructure (support internally and externally via advertising, distribution, marketing, promotion, and sales networks); and, finally and most apparently, the visual identity as expressed in a name and logo. To the extent that any of these elements change, the brand's value will change. Also, sometimes an acquiring organization fails to recognize the value of a brand it is acquiring. As one blogger put it recently, "You can bet your bottom dollar, major brand rationalization will occur, and will occur swiftly. [The acquirer] has a reputation for bean counting and anything that is not profitable or returning an adequate return on investment is given the chop. Many of the boutique brands will go."[35]

How can an acquirer preserve brand identity during the postmerger integration process?

By putting the brand first and integration second. The management of a newly combined company should not say, "Let's combine our advertising efforts" (or other brand support), thinking that what works for one brand will work for another. This can bury a brand. Instead, managers should say, "Let's build this brand." In other words, managers should use integration as a means, not an end. In the process of building a brand, an acquirer should have special reverence for existing names and logos and what they mean to employees and others.

Integrating Tangible Resources

What about tangible resources? How can these be integrated?

From a balance sheet perspective, these will typically be combined. Therefore, in addition to financial assets (for example, cash, marketable securities, and accounts receivable), a consolidated balance sheet will include combined values for plants, equipment, inventories, and land.[36]

In addition to being combined on a balance sheet, are these tangible assets ever actually combined from an operational standpoint?

Plants, equipment, and inventories may be combined in whole or in part when two companies integrate their operations. Land and real estate, of course, cannot be combined physically, but the leasing or ownership terms for the use of the land may be consolidated.

Plants

How can plants be combined operationally (as opposed to merely on the balance sheet)?

First, let's define our key term. A *plant* is a production operation at a defined physical location. It is usually envisioned in a manufacturing context. A plant's major assets include real estate, structures (foundations, buildings, framework, and related improvements), equipment (for production, communication, control, and administration), distribution assets (such as piping, conveyers, and docks), wiring and instrumentation (for electrical supply, communications, and control of operations), and software. In a service context, a plant may be a physical location in which services are performed. Examples of service plants include a computer processing facility, a branch bank facility, and a phone operation.

In both the manufacturing and service sectors, plants can be consolidated in many different ways, ranging from plant closings to integration of plant operations through common, integrated systems.

What are the main costs associated with plant consolidation?

In consolidating plants, employers may incur costs associated with disposal of assets (including environmental aspects); relocation, termination, and/or recruitment of employees; investments in physical assets or software to support consolidation; and redesign of products and/or services to accommodate integration. In addition, acquirers may have to spend money on new marketing efforts to preserve goodwill if plant consolidation has involved layoffs. Finally, closing or relocating plant operations may cause the loss of a group of customers or increase transportation and distribution costs to a set of customers (see the final section in this chapter on fulfilling commitments to employees).

Equipment

How can equipment be combined operationally?

Physically combining equipment is uncommon unless the equipment is mobile or unattached, such as forklifts, trucks, office equipment, and furniture. Combining companies are often at distant locations. Even when operations are consolidated, it is often preferable (if money permits) to purchase and install new equipment, rather than to remove, transport, and install older equipment from a discontinued operation. Furthermore, in addition to equipment purchased for replacement, some equipment may be purchased for enhancement—for example, to facilitate the integration of systems and operations.

Note also that the shareholder of the acquired business may retain some equipment, either to keep or to sell separately. The owners of closely held companies may wish to retain personal property (including equipment) for their own use, and such property will not convey with the sale.

What are the main valuation issues associated with the combination of equipment in a purchase?

All the equipment that will continue to remain in use after the acquisition should be restated at fair market value in use and integrated into the balance sheet accordingly. "Fair market value in use" means that certain delivery, installation, and setup costs should be included in the valuation of the equipment

since an acquirer of the equipment would have to bear the costs if each individual unit were acquired separately. Appraisers may consider replacement or reproduction cost as if new (including installation and freight), less economic and physical obsolescence as an appropriate measure of value.

Most other equipment (especially any equipment being moved or relocated, typically that of the acquired entity) should be valued at fair market value in exchange or, alternatively, stated to reflect the expected value to be realized (possibly negative) upon sale or disposal. The buyer can then expense or capitalize the costs associated with moving and reinstalling the equipment at the new location. The equipment's fair market value in exchange, plus the cost of bringing it into use in a newly consolidated operation, should equal the fair market value in use of the equipment once it is fully integrated into the new operations.

The difference between the fair market value of the sum of the financial and tangible assets should be recorded as goodwill or allocated to identified intangible costs.[37]

What are the cost implications of combining equipment?

The value of some equipment held by the acquired entity and/or the acquirer may be written off in value because of costs associated with disposing of it or transferring it (the aforementioned cost of transportation, installation, and setup that is part of fair market value in use).

Inventories

What tips do you have on valuing and combining inventories on a consolidated balance sheet and in reality?

Inventories of the acquirer are stated, as always, at the lower of cost or market (wholesale) value. If certain units in inventory become obsolete, are likely to be sold at a discount, or will require more time to sell, some downward adjustment in the value of these items in inventory may be appropriate. If significant, the inventories of the acquired entity should be audited during the due diligence process and appraised at the current fair value in exchange (wholesale).[38]

Land/Real Estate

How can land and/or real estate from two different companies be valued and "combined" on a consolidated balance sheet?

The real estate of the acquired entity should be valued at fair market value. Each tract of real estate is typically valued separately but in connection with any surrounding tracts commonly owned by the same entity.

What are some valuation issues to consider when combining the land and/or real estate of two companies?

It is possible for the value of two adjoining properties to increase as a result of having common ownership. A change in the expected use of a specific piece of real estate may impair the value of that real estate, especially if the property is to be sold after being acquired and the future use of the property would require some modification or remedial efforts. Land associated with a profitable manufacturing operation may be worth more than equivalent value land, especially when it is in full use.

INTEGRATING PROCESSES

Earlier, when discussing the merging of human resources, you mentioned the merging of HR *processes* as well. What other processes should be considered after an M&A transaction?

First, management structures (reporting lines) are extremely important. They are the means for the sharing of authority and the channeling of communication. Other important processes to merge include processes for product or service design, production, and supply. Finally, internal controls are also a key process. This section will cover all these points.

Merging Management Structures

Merging companies means merging their management structures. What is the best way to do this?

First, try to obtain copies of the organization charts (if they exist) for both organizations. To be sure, the *responsible leader* in any group, division, or company (the one on the organization chart, who has the title and accountability) may not be the same as the *effective leader* (the one who tends to prevail in decisions) or the *psychological leader* (the one who commands the greatest respect).[39] The responsible leader, however, is as good a proxy as any for understanding the complex dynamics of an organization. Thus (to paraphrase Winston Churchill) organization charts are a terrible way to represent company structure—and the only way.

OK. So how can an acquirer build new reporting patterns for the new company?

Building a new reporting structure for combining companies requires two things: knowledge of the old companies' past patterns and a sense of the companies' potential patterns as a newly combined company.

To gain knowledge of past structures, managers should try to obtain the latest organization charts for both organizations and to check them out via interviews. (If there are no charts, interviews will have to do.) The information from these charts and interviews might seem like old news after the merger, but in fact they are the foundation for the future. Those boxes, lines, and dotted lines reveal not only past experience but future expectations with regard to accountability and relationships.

The next step is to move beyond the past and into the future to build a new structure. A few truisms are in order here. The structure should be based on the business needs of the companies, not on some theory of what makes people happy. "Right" structure is not only a matter of comfort for employees but of fit with the company's economic environment. No structure guarantees behavior; a structure merely makes it easier or harder to get work done. Experience, not theory, will always be the best arbiter here.

What are the basic types of organizational structures and how common are they?

Actual organization structures differ widely (just study the hundreds of representative charts available from the Conference Board in New York), but it is possible to identify five basic types of organizational structure:

- Functional
- Geographic
- Market segment
- Product/service
- Divisional[40]

Any of these structures may coexist with a so-called *cluster framework* that organizes people by projects.[41]

In a *functional* organization, people are assigned to groups according to functions or specialties such as accounting, distribution, engineering, manufacturing, marketing, purchasing, and sales. This is common for small, new companies. A good example would be Tidal Software in Palo Alto, California, which has an executive team organized by function, and a management team under that, which is also organized by function.

In a *geographic* organization, employees' work is organized by physical territory. For example, the top level of Arch Insurance Group (a company within Arch Capital Group) is organized by Midwest, West, Southeast, and Northeast, with an executive vice president for each region. Sometimes companies that are organized by function or product then superimpose a geographic dimension. Amgen, a biotechnology company, and ADP, a computer services company, are both examples of this type of organization.

In a *market segment* organization, the customer also determines structure, but it is not the location of the customer that matters; rather, it is the customer's profile. Thus a financial company might be structured according to institutional versus retail clients. For example Pay by Touch, a single-product software company, has the usual senior titles (CEO, CFO, etc.) and then three more: Executive Vice President, Franchise Services; Senior Vice President, Retail Sales; Senior Vice President, Financial Institution Sales.

In a *product/service* organization, functional specialists are grouped according to their responsibilities toward a given product or service. For example, K-Tron International, a Nasdaq-listed company in Pitman, New Jersey, is organized in two business lines based on products: feeding and pneumatic

conveying equipment and size reduction equipment. This organizational structure emerged as the logical result of a series of acquisitions broadening the company's product reach.[42]

In a *divisional* organization, families of products are grouped into independent divisions (or strategic business units). This organizational structure, which is highly decentralized, has always been dominant for very large, complex companies and is becoming more so. General Electric, for example, is currently organized into nine divisions, ranging from GE Commercial Finance to GE Transportation.

When two companies have very different reporting patterns, how can they be integrated?

If following the path of least resistance, the pattern with the most complexity should prevail. Thus a divisional structure will prevail over a product/service or functional structure, and a product/service structure will prevail over a functional structure. These structures are like Russian dolls. Each of them can stand alone, but they can also contain smaller structures. A divisional structure (the biggest doll) can easily contain a products/service structure within it (the next biggest doll), and that structure can easily contain territories and/or functions (the smallest dolls).

But engineering isn't everything. As observed throughout this book, other factors can come into play, such as size. Large acquirers can and usually will impose their structures on the smaller, less powerful units they acquire.

This is unfortunate. If an acquirer uses its own organizational structure as a template, ignoring that of the acquired company, employees of the acquired company will continue to have the same expectations of their fellow employees as they did before the merger. If these expectations are unfulfilled, this may provoke disappointment. If they are fulfilled, this may cause trouble. The positive alternative must be a new structure that is sensitive to the expectations arising from the old structures, while serving the needs of the newly combined organization.

Following are some important checkpoints to bear in mind:

- Appropriateness of reporting lines
- Adequacy of staffing and experience levels
- Clarity of delegation of authority and duties

Which organizations tend to be more profitable—those associated with centralized hierarchies or those associated with flatter, more decentralized organizations?

Both can be profitable, but these organizational types derive their income in different ways. As mentioned earlier, centralization is associated with cost cutting, whereas decentralization is associated with revenue building. Adding or subtracting management layers intensifies this contrast. If a middle manager has to seek approval before spending money, he will tend to invest less of it—but also to generate less of it. By the same token, if a manager has no restraints on spending money, she may tend to invest more of it and, if successful, generate more.

Which basic option is better for postmerger integration, a hierarchical centralized structure or a flat decentralized structure?

Hierarchy makes integration a lot easier, enabling managers to promulgate universal policies throughout the organization, deliver financial and technological support, and resolve conflicts between and among units.[43] Extreme decentralization, by contrast, can make integration more difficult, unless the organization has identified a position or unit with authority to create and disseminate policies and a network for sharing or redistributing resources.

On the other hand, centralization does not guarantee success. In the case of a *detrimental parent,* headquarter's policies may be wrong for the organization, or it may fail to deliver enough of the right kind of support to its units. Conversely, a *beneficial parent* knows how to overcome the challenges of decentralization and to link units without a centralized, hierarchical structure.[44]

Are there many detrimental parents among acquiring firms?

Apparently so. The corporate headquarters of many large, multibusiness companies (often operating as parent companies to various acquired units) actually do more harm than good by exerting influence that is inappropriate and/or expensive.[45]

Why don't all corporate parents add value to the units they integrate?

Potential problems include too many rigid controls, not enough communication and support, lack of understanding of the business, a focus on the wrong issues, hiring or promoting the wrong managers, and pressing for the wrong levels or measures of performance.

In short, postmerger management requires the same kinds of judgment calls as other kinds of management, but focusing on the unique challenges of integration with techniques and tools—our next subject.

What can managers actually do to enhance integration?

Following a merger, designated managers can work to ensure that company units share space, goals, standards, and/or services to some useful degree.[46]

Sharing Space

How can sharing space help M&A integration?

It is a well-known fact in manufacturing circles that the layout of a work site can prevent or encourage collaboration, and that collaboration is linked to higher productivity.

A study funded by the National Center for Manufacturing Sciences showed that in *process-complete* departments, layouts that permitted people to see others' work, had cycle times 4.4 times faster than those with layouts that did not.[47] The study defined process-complete departments as those responsible for most manufacturing steps, and defined cycle times as total throughput (order to delivery) time for the three products that accounted for the highest percentage of the department's output for the most recent six-month period.

Common sense suggests that the link between collaboration and productivity applies to work in any realm, including corporate headquarters. In any work environment, acquirers should avoid falling prey to the fifth-floor phenomenon—isolating all the acquired staff on their own floor—or the that-function mentality—isolating employees according to their function. While this may be sensible from an operational, business-as-usual standpoint, it can hinder the kind of spontaneous interaction that leads to innovation. Some mixing or conjoining of office locations is almost always desirable and achievable.

Another way to achieve integration is to have certain work spaces used by employees from different functions, product/service lines, and/or divisions. Shared computer rooms, laboratories, and libraries can foster increased communication and hence integration among units, even in very large companies.[48]

Sharing Goals

How can sharing goals help M&A integration?

Common goals can serve to integrate two or more units for a period of time. Setting exact timetables and procedures for new product development can impel the different units of the organization to work together in small groups or clusters to accomplish the development by the target date. Or, to cite another example, a five-year plan to improve shareholder value (if employee compensation is linked to stock price) can create unity of purpose in an entire organization for half a decade. The more units that share the goals, and the longer the time span necessary to accomplish the goals, the more integration is accomplished.

Sharing Standards

How can common standards help M&A integration?

Shared standards can create a sense of cohesion throughout the company; they are the very essence of integration. Types of standards useful in M&A integration include operating procedures, technological specifications, ethical values, internal control guidelines, or most important of all, employee performance yardsticks—setting comparable performance *standards* using comparable *measures* to obtain comparable *rewards* throughout a company.

For example, no matter how a company defines its subunits (be it by function, geographic territory, customer segment, product/service, and/or division) it will need to find a way to measure the financial performance of the identified unit. There is not one set method of doing this. In fact, there are several possible ways—including cost center, profit center, investment center, or producer of residual income.[49]

Sharing Services

How can sharing services help M&A integration?

Sharing services can help eliminate duplication in a decentralized structure. Instead of each unit having its own accounting staff, for example, there may be an accounting staff at headquarters. The same goes for legal, public relations, information processing—the list is virtually infinite.

The classic way to share services is to use common staff, typically located at headquarters. Another way to share services is to create *shared-services units* for nonoperating activities, and to allow other business units to buy services from the unit. Companies currently using shared-service units include BMW, Boeing, DHL, HBSC, Monsanto, Rhone-Poulenc, and Shell Oil.

The underlying principle driving shared internal services is that a business-oriented unit can employ common management practices focused entirely on delivering needed services at the lowest cost with the highest value to internal customers. This is more effective than having multiple points of responsibility and varied management practices. Also, it provides more accountability than the classic headquarters model.

The shared-services unit is based on the classic *functional* organizational structure, described previously. In this structure, companies have units or departments to provide an enterprise with discrete functions, such as information systems, internal control, or pay systems. Moreover, these functions are devoted to transactional areas such as data systems entry, payroll check processing, or benefit claims processing. Because of the discreteness of these functions, these are the same ones that are sometimes outsourced (an activity sometimes referred to as shared services). A true shared-services unit idea takes this concept further, creating a single unit that provides all of these services and more.

How is using shared services different from using headquarters staff?

When headquarters staff provides services, it is typically under monopoly conditions: all units must use the company's central services at a cost determined by headquarters and borne by the company as a whole. It's the only game in town. The shared-services model, by contrast, puts competition into the equation. Heads of company divisions and their key employees negotiate

with the shared-services unit for the services they will receive and the price they will pay. They may go outside for services if they are not satisfied. Unlike headquarters staff, the shared-services unit is not a cost center; it is a profit center. Corporate headquarters still has a role, but this is confined to the high-level areas of strategy and governance.

Integrating Processes for Product or Service Design, Production, and Supply

If two merging companies make and/or distribute the same product and/or service, how should they go about integrating these activities?

First of all, it's a good idea to step back and compare each company's quality control programs. There are several different ways of controlling quality, and if two companies have different systems, these will need to be integrated.

Could you give an example of merging companies that merged their quality control systems?

Honeywell, which merged with Allied-Signal in 1999, has five key initiatives, according to its August 2005 Web site: growth, productivity, cash, people, and various quality "enablers," including Six Sigma, a program pioneered by Motorola in the mid-1980s. Prior to the merger, Honeywell had a program called "Quality Value Assessment," but this was folded into Six Sigma after the merger.[50]

What are some systems for quality improvement that can be used in a postmerger setting to improve operations?

Consider a standard benchmark such as the *ISO 9001 Quality Systems-Model for Quality Assurance in Design, Development, Production, Installation, and Servicing.* The ISO, which stands for International Standards Organization, is a network of the national standards institutes of some 150 countries, with a central office in Geneva, Switzerland, that coordinates the system and publishes the finished standards. There are also other benchmarks used in particular industries in particular countries.[51]

What exactly are the ISO 9001 series standards, and how can they help companies integrate their plant operations?

The ISO 9001 standards are guidelines for ensuring quality of design, manufacturing, and supply systems. They are jointly determined by national standards bodies in countries around the world (146 as of late 2005), drawing on recommendations from technical advisory groups (nearly 3,000 of them). The standards are used by an estimated 100,000 organizations around the world. For companies that do only manufacturing and supply, there is a shorter version called ISO 9002, and for those that perform only supply, there is the even briefer ISO 9003. The top-level series, called ISO 9001:2000, provides guidance as follows:

- Management responsibility
- Resource management
- Product realization
- Measurement, analysis, and improvement[52]

This sounds like good guidance for companies in general. Why would a company need it following a merger?

A change in ownership usually means a change in managerial control, hence operations. Whenever there is a change in operations, companies may suffer certain setbacks.

First, the *quality of the plant's products or services* may suffer after a merger. This may be a temporary change based on redesign or integration of processes and standards, or it may be permanent if standards and incentives deteriorate or morale declines. There is usually some initial inefficiency when plant employees have to relearn or reorient their activities. The distractions resulting from a merger may reduce actual production time or increase production costs. Larger operations may have greater information asymmetries: critical information may fail to reach the right people at the right time. Having good standards for process mapping and information flow will help.

Second, there may be *logistical problems.* The consolidation of plant activities will affect the production and flow of products and services. For manufacturing firms and retailers alike, there may be disruption in inventory control, stock, transportation, and distribution. In this situation, having good standards for logistics can help.

For instance, Cingular and AT&T Wireless, at the time of their 2004 merger, were running some 2,800 retail stores, and tens of thousands of authorized agents and third-party resellers like Best Buy and Wal-Mart sell their handsets and calling plans. To decide which of these stores to close and which to expand, Cingular's consulting firm, Accenture, weighed multiple factors, including the number of subscribers each store has signed up, its cost for signing up customers, its location and distance from other company stores (and stores operated by rival carriers), and its size and lease provisions.[53] A similar process is ongoing with the three-way AT&T, Cingular, and BellSouth merger.

What is an example of a successful effort to integrate manufacturing plants?

Delphi (formerly Automotive Components Group Worldwide), which operates 167 plants around the world, is no stranger to restructuring.

The company was created in 1991 as an amalgamation of various units General Motors had acquired nearly a century earlier.

In 1996, the company integrated its 50 most troubled plant operations. In the 1996 restructuring, Delphi:

- Phased out old mass-production lines where one mistake could stop hundreds of operators
- Introduced work cells—small teams of workers with a voice in daily plant operations and production levels
- Worked toward a 24-hour production cycle
- Streamlined job classifications

In 1999, GM spun off Delphi, which became its own public company via an IPO.

In 2005, Delphi completed the sale of its battery product line to Johnson Controls Inc. The sale included facilities in France, Mexico, and Brazil. Delphi also closed its Lansing Cockpit Assembly plant in Lansing, Michigan. In October 2005, Delphi filed for protection from creditors under Chapter 11 of the U.S. bankruptcy code, with plans to emerge by mid-2007. Those plans appear to be on course. As of February 2007, Delphi was still operating successfully, announcing new management initiatives to maintain productivity.[54]

How can you consolidate plants?

First, as mentioned, management can *adopt a common set of systems and standards* for activities.

Second, management can *forge closer links* between plants. New links

may emerge from common information systems, inventory control, supply relationships, pipelines, or rail links.

Third, management can *pursue more vertical integration,* having different operations focus on different stages of production. Some facilities may specialize in producing specific components or intermediate goods while other operations become more oriented to producing finished goods, or finishing and packaging goods for local or regional markets.

Fourth, when and if there is excess capacity and/or redundancy in capacity, a company may *close certain operations* and move certain productions activities and assets from the closed operations to the other facilities.

Fifth, a company may *shift production allocations* across facilities to allow each operation to become more focused in its production of a subset of products or to serve a narrower geographic region or customer base.

What are the chief benefits and drawbacks of postmerger plant closings?

It depends on the company's situation. If there is excess capacity or significant redundancy, closing plants may make economic sense. However, acquirers should bear in mind the economic costs associated with plant closings, often taken as a significant one-time charge against earnings.

Also, having too few manufacturing sites may be risky and inefficient. Having manufacturing locations at multiple sites may reduce operational risks while increasing flexibility and efficiency. Following the tragic events of September 11, 2001, many corporations started building redundancy in their most critical operations.

Therefore, when demand is low, it may be more efficient to shut down a select number of small units entirely on a temporary basis than to experience a partial, long-term idling of larger, consolidated units.

Finally, there can be reputational costs associated with plant closings, costs that eventually impact a company's bottom line.

Integrating Internal Financial Controls—A Key Process

What exactly are internal financial controls and why are they important following a merger?

Internal financial controls are the processes a company uses to make sure that its financial statements are reliable. In a mom-and-pop microbusiness,

these controls can be as simple as keeping the checkbook balanced and requiring two signatures on every check (from the two owners). In a major public company, they may involve literally thousands of procedures.

The Securities and Exchange Commission defines "internal control over financial reporting" as follows:

> A process designed by, or under the supervision of, the registrant's principal executive and principal financial officers, or persons performing similar functions, and effected by the registrant's board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:
>
> (1) Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the registrant;
>
> (2) Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the registrant are being made only in accordance with authorizations of management and directors of the registrant; and
>
> (3) Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the registrant's assets that could have a material effect on the financial statements.[55]

The SEC issued this definition in the aftermath of the financial scandals that ushered in Sarbanes-Oxley 2002. Enlightened enterprises have always had formal internal control functions; Sarbanes-Oxley's Section 404 made this a requirement for all public companies.

Under Section 404 of Sarbanes-Oxley, all public companies must have internal controls and have their managements and auditors assess them.[56]

As for management's assessment, SEC rules implementing Section 404 state that "the assessment of a company's internal control over financial reporting must be based on procedures sufficient both to evaluate its design and to test its operating effectiveness."[57]

In particular, "an assessment of the effectiveness of internal control over financial reporting must be supported by evidential matter, including documentation, regarding both the design of internal controls and the testing processes."

Controls subject to such assessment (again quoting verbatim from the SEC final rule) include:

- Controls over initiating, recording, processing, and reconciling account balances
- Classes of transactions and disclosure and related assertions included in the financial statements
- Controls related to the initiation and processing of nonroutine and nonsystematic transactions
- Controls related to the selection and application of appropriate accounting policies
- Controls related to the prevention, identification, and detection of fraud

As for the auditors' assessment of controls and their assessment, the standard is the PCAOB's Auditing Standard No. 2—"An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements," issued in March 2004, clarified in May 2005, and revised in May 2006.[58]

The Committee of Sponsoring Organizations of the Treadway Commission, or COSO, has a broader definition. They say internal control has five interrelated components:

- Control environment
- Risk assessment
- Control activities
- Information and communication
- Monitoring

Clearly all these are important following a merger. For one thing, they can help the management of the acquiring company manage the acquired company.

How can an acquirer assess and ensure the quality of these five components in its newly merged entity?

In the last section of its report on *Internal Control-Integrated Framework,* COSO provides three things:

- Blank guidesheets (called *tools*) for assessing each component
- A reference manual for filling in the guidesheets
- Sample filled-in guidesheets

The guidesheets feature COSO recommendations for the five components on the left-hand side of each page, along with blank spaces on the right-hand side of each page. The filled-in guidesheets show how an assessor might fill in the guidesheets.[59]

This sounds important but time-consuming. What can the acquirer of a small organization do on Day 1 to hit the ground running with internal controls, namely with respect to cash?

Excellent question. Of all of these elements of internal control, certainly the one that will require the most urgent and immediate attention from the acquirer will be procedures for cash management.

The day the acquisition is completed, the acquirer should assume control over all cash receipts and disbursements by the acquired business. For each location, a new checking (or lockbox) account should be established and all receipts deposited into this account. Access to this account should be limited to individuals designated by the acquirer. In addition, a separate cash disbursements checking account should be established for payroll and accounts payable.

Having separate accounts for receipts and disbursements makes sense, but it sounds complicated. How exactly does it work?

Typically, the financial management of the acquired company requests a weekly transfer of funds to the disbursement account (the checking accounts for payroll and accounts payable) with appropriate justification, such as payroll or vendor payments (by name and invoice number). The manager designated by the acquirer should collect all receipts and transfer funds to the cash disbursement account as requested.

What other techniques can the acquirer use to establish financial control?

In addition to setting up separate accounts for receipts and disbursement, the acquirer can establish a budgeting process and a signatory level requirement.

The budgeting process will vary from company to company, but it usually involves identifying revenue sources and expenses for the upcoming 12 months, along with a forecast of balance sheet changes. Once the acquirer and

the acquired company have agreed on this budget, they can monitor the acquired company's progress each month against the forecast. If there are changes or trends indicating that the budget is inaccurate, the acquirer can ask the budget managers to revise it. If the revisions are not satisfactory, the managers can be replaced.

Signatory levels will also vary from company to company, as levels of materiality differ according to company size. An expenditure of $1,000 might require the signature of an officer in a $1 million company but not in a $1 billion company. Here is a sample signatory requirement for a midsize company with sales levels between these extremes. In this example, the acquired company is operating independently from the acquiring company, with its own senior management team.

Sample Signatory Levels

1. All checks over $5,000 must be signed by the senior financial officer and the chief operating officer of the acquired company.
2. All checks over $25,000 must be cosigned by a staff member of the acquiring company.
3. All sales contracts over $1 million or with potential liabilities over this level will require a signature by the CEO of the acquirer or a manager the CEO designates.
4. All compensation to senior management (defined by job function or by name) must be approved by the CEO of the acquiring company.

This system, we should emphasize, is ideal for small companies or for units of large companies. A large company with many units will need a more complex system for cash control, and should consult a public accounting firm with experience assessing Section 404 compliance under the PCAOB's Standard No. 2.

INTEGRATION OF KEY RESPONSIBILITIES

What key responsibilities should be considered after an M&A transaction?

Note: The press release announcing the acquisition should make it clear that the new company will honor commitments to constituencies, including employees and customers. See Appendix 9A for a sample acquisition announcement mentioning these stakeholders.

Commitments to Customers

What commitments to customers will a company typically inherit after a merger?

As mentioned earlier, every company comes to a merger with a unique set of promises it has made to various individuals and groups, including customers. Some of these promises are written, some unwritten. Some are contractual (enforceable by law), some covenantal in nature.[60] As companies merge, they must merge these promises, and the first step is defining what they are.

To fulfill commitments to wholesalers and distributors (who buy directly and in bulk), a first step for the integration team will be to look over all the legal agreements the company has inherited along with these customers. For each product or service, the company will need to know *how much* each company had promised to provide *what customers* at *what price* for *what period of time.* It will also want to know about any *exemptions* or *waivers* that may apply to those conditions.

To fulfill commitments to retail customers (who buy indirectly and in small quantities), the first order of business for the integration team will be to study any promises the company has published to the general public, such as slogans used in space ads. If they have had any value, these slogans are not just words—they are commitments.

More generally, managers might consider a list that appears in the "Stakeholders" section of the Caux Round Table's *Principles for Business.* This document, reprinted in full at the end of this book, is the consensus of leading business executives from the United States, Europe, and Japan, who meet regularly to discuss global business ethics. Here is the "Customers" section of the stakeholder list (with our postmerger *CHECKPOINTS* added in italics).

Customers

We believe in treating all customers with dignity, irrespective of whether they purchase our products and services directly from us or otherwise acquire them in the market. We therefore have a responsibility to:

- Provide our customers with the highest quality products and services consistent with their requirements

  CHECKPOINTS: What quality programs does each merging company have in place? Will these programs be merged? If so, who will do this, how, and by when?

- Treat our customers fairly in all aspects of our business transactions, including a high level of service and remedies for their dissatisfaction

  CHECKPOINTS: What standards of fairness does each company have with regard to customers? Will these standards be reconciled? If so, who will do this, how, and by when?

- Make every effort to ensure that the health and safety of our customers, as well as the quality of their environment, will be sustained or enhanced by our products and service

  CHECKPOINTS: What product, health, and safety standards does each of the merging companies have? Will these standards be reconciled? If so, who will do this, how, and by when?

- Ensure respect for human dignity in products offered, marketing, and advertising

  CHECKPOINTS: Is human dignity a distinct value in both of the merging companies? How can managers work to ensure that it will be?

and

- Respect the integrity of the culture of our customers

  CHECKPOINTS: What are the cultures of the customers in the newly combined company? How can managers show respect?

  OVERALL: How does the compensation of managers and employees reward behavior that accomplishes all the goals listed here?

Why is it so important to fulfill commitments to existing customers after a merger?

First of all, there is the ethical dimension. Promise-keeping is one of the oldest and most basic moral principles known to humankind. Also, there is the legal dimension: keeping promises is a good way to prevent lawsuits. Last but not least, there is also the economic dimension. Customers are a key driver of a company's economic value, and current customers are worth more than future ones—especially after a merger, when a buyer's market prevails.

Why do you say existing customers are more valuable than new ones?

It is usually easier and less expensive to maintain an existing relationship than to attract a new one. Business appraisers acknowledge this fact when

allocating purchase price to various financial, tangible, and intangible assets. When allocating price to intangibles, they allocate present and future customers differently. As stated in Chapter 5, GAAP allocates purchase price to an acquired customer list, but treats potential future customers as part of goodwill. Statement 142 gives this example: a direct mail company acquires a customer list and expects that it will be able to derive benefit from the information on the acquired customer list for at least one year but no more than three years.

- The customer list is amortized over management's best estimate of its useful life.
- By contrast, the expectation of future customer relationships becomes part of goodwill.

More generally (beyond postmerger price allocation), values assigned to present relationships are much higher than those assigned to future relationships. This is true whether the values are derived from an income approach or a replacement cost approach. Appraisers use an income approach to value customer relationships when they can identify income directly attributable to customers, and a replacement cost approach when they cannot. For replacement cost, they assume that the amount of money a business is willing to spend to attract a new customer equals the value of an existing customer. Similarly, in allocating marketing and selling expenses, the income and/or replacement cost attributable to present relationships is often higher than that attributable to future ones.

Take, for example, the classic rule of diminishing costs used in the periodicals publishing industry, which says that for every marketing dollar it takes to get a new subscriber, it takes only 50 cents to get that same subscriber to renew in Year 2, 25 cents in Year 3, 12.5 cents in Year 4, and so forth, assuming stability of publication quality and of customer interest. This simple algorithm would suggest that the value of an existing customer is at least double that of a future customer.

What percentage of customers usually leave after a merger, and what can a company do to stem this exodus?

It depends on how much competition there is for the customer's business. The old rule of thumb was a 5 to 10 percent loss, but that is very low for industries with many players.

Yankee Group research indicates that a sizable portion of PeopleSoft customers may stop using PeopleSoft following the merger—particularly those who use customer relationship management (CRM) products from PeopleSoft. Out of 162 PeopleSoft customers surveyed after announcement of the deal, 46 percent reported an intention to switch off their current applications, with another 30 percent remaining undecided.

The issue was not product functionality; survey respondents reported above-average levels of satisfaction with that. The issue was service-level agreements (SLAs).[61]

To keep customer drain to a minimum, companies need to strive for *positive continuity*—maintaining or improving service levels for all customers after the merger, irrespective of the amount of business these customers represent.[62]

What benefits can mergers bring to existing customers, and how can these be communicated?

Merger announcements often claim that the mergers will benefit customers by increasing product range and/or by reducing prices through economies of scale and technology.

Examples of product range abound: any merger that diversifies into new product areas by definition will deliver on that promise.

Price savings do not materialize as often as they are promised, but they do occur. For example, following its merger with Compaq in 2002, HP was reportedly able to lower its components costs and thus prices. As a concrete example, before the merger, its prices ran about 15 percent higher than its competitor Dell. Nine months later, they were in line, and five years later still have an edge.[63]

Legal Aspects of Customer Relations

What are customer lawsuits usually about?

According to the annual Tillinghast—Towers Perrin survey of D&O liability claims, the most common issues alleged were:

- Antitrust law violation
- Contract disputes
- Cost/quality of products or service
- Debt collection

- Deceptive trade practice
- Dishonesty/fraud
- Extension/refusal of credit
- Lender liability[64]

Why do regulators often try to block mergers?

The main issue is antitrust—the idea that a merger will lessen competition for a particular product or service in a particular market. This stands to reason. After all, basic economics—and common sense—will tell you that the presence of a competitor will give any business a stronger drive to provide consumers with the highest possible quality at the lowest possible price. If a business has a monopoly on a market, that incentive is weakened. Of course, a strong sense of right and wrong can provide that drive, but not all business decision makers have that. If they did, many of our business laws would not be necessary.

Do customers ever sue to block mergers?

This is rare, but it does happen, usually as a private class action lawsuit that shadows a government lawsuit. Government lawyers do most of the litigation work, and then plaintiff attorneys shadow the effort. This occurred in the case of *In re First Databank Antitrust Litigation* (January 2, 2002). The FTC had opposed a merger as anticompetitive and, as part of the settlement, got First DataBank to agree to refund $16 million to consumers. Later, private class action counsel negotiated a settlement that added $8 million to the fund, for a total of $24 million. Attorneys for the class action suit wanted 30 percent of the $24 million as a fee. But the FTC pointed out that would deliver attorneys 90 percent of the value added by their efforts, with customers receiving only 10 percent. The court lowered the amounts payable to private counsel to 30 percent of the $8 million value added.

Commitments to Shareholders

What commitments does a company typically have to fulfill for its shareholders after a merger?

All shareholders possess stock certificates showing that they have ownership in a company. But what does ownership really mean? Without protections, ownership is fragile indeed—especially when shareholders are not managers.

Despite the increasing use of the term *shareowner* by some shareholder groups, the sad reality is that shareholders don't always possess what they own, much less control it.[65] Depending on the *liquidity* of a given share of stock—that is, the ease with which it can be bought or sold—an owner may or may not be able to derive value from it. In an extreme case, a stock certificate may be worth no more than the paper it is printed on.

This is where corporate promises come in. To give value to the stock certificates it trades for cash, a corporation promises to adhere to certain standards. In privately held companies, these standards are typically expressed in shareholders' agreements. In publicly held companies, standards have their life and force in federal and state securities laws and in stock exchange listing rules.[66] Companies that sell shares to the public must disclose certain information according to certain standards in offering documents prior to listing, and in financial statements after listing. They also have to grant holders of common stock certain voting rights, often exercised by proxy—hence the term *proxy voting*. And beyond these mandatory and legally enforceable promises are some that corporations may make and keep voluntarily as part of their bylaws or corporate policies.

How exactly can postmerger integration teams make sure that the new company meets these various commitments to shareholders?

In a merger that involves a privately held company, legal counsel (internal or external) should look over all the agreements the company has signed with its owners, asking what rights each company has promised to what owners, under what terms, and for what period of time.

In a merger involving a publicly held company, the advisor will need to know where the company stands with respect to the securities laws for the jurisdiction (for example, in the United States, both state and federal securities laws).

For firms that have a general counsel or other inside attorney, the resources of an organization like Association of Corporate Counsel (ACC) can be helpful. When outside counsel is engaged, a resource such as Martindale-Hubbell can guide the selection of a firm with experience in securities law.[67]

Attorneys specializing in securities law keep abreast of these issues and often send out letters to clients (and potential clients) summarizing major trends. Securities regulators, such as the SEC (sec.gov) in the United States regularly post new and pending rules.[68]

In addition to compliance with securities law, what are some general ethical considerations?

With respect to the ethics of shareholder relations, postmerger integration managers can benefit from consulting a document such as Caux Round Table *Principles for Business,* mentioned earlier as an excellent checklist for essential corporate commitments.

Here is the "Shareholders" section of the stakeholder list (with our postmerger *CHECKPOINTS* added in italics).

Owners/Investors

We believe in honoring the trust our investors place in us. We therefore have a responsibility to:

- Apply professional and diligent management in order to secure a fair and competitive return on our owners' investment

  CHECKPOINTS: Do the managers of the new company think like owners? Are they owners?

  How do they define return on owners' investment (ROI)? How will they benchmark it against the competition?

- Disclose relevant information to owners/investors, subject only to legal requirements and competitive constraints

  CHECKPOINTS: In disclosing their postmerger plans, have the managements of both companies met the disclosure requirements of federal and state regulators? Have they stayed within the "safe harbor for forward-looking statements"?[69]

- Conserve, protect, and increase the owners/investors' assets

  CHECKPOINTS: Has the financing of the deal had a negative impact on share value? If one or both companies experienced a decline in value after the announcement of the merger, what plans has management made and communicated to restore that value? How realistic are these plans? Who will monitor their achievement?

- Respect owners/investors' requests, suggestions, complaints, and formal resolutions

  CHECKPOINTS: Have the two merging companies encouraged communications from their shareholders about the merger? What kinds of communications have shareholders made? What kinds of responses did they get?

Another important manifesto for shareholder rights is the landmark *Principles of Corporate Governance* published by the Organization of

Economic Cooperation and Development in 1999, and updated in June 2004. All member nations of the OECD agreed to this document. Adhering to codes such as Caux or the OECD guidelines can ensure retention of shareholders after a merger.

Why is it so important to retain existing stockholders after a merger? Why not just let them take the Wall Street walk by selling, and court new shareholders to replace them?

Beyond the obvious ethical and legal advantages of keeping explicit and implicit promises to existing shareholders, there are economic ones—at least three of them:

- First, it is less expensive to retain old shareholders than to court new ones.
- Second, companies that honor their promises to shareholders tend to attract the most desirable kind of shareholders—long-term rather than short-term.
- Third, stable ownership can reduce share price volatility and thus contribute to a higher shareholder value.

On your first point, why is it less expensive to retain existing shareholders than to court them?

In any competitive market, as seen in the previous chapter with respect to customers and vendors, it is usually easier and less expensive to maintain an existing relationship than to attract a new one.

Certainly the market for equity shares is competitive. A company's stock is only many investment vehicles available at any time—including investments in peers. That is one reason why investor relations or IR professionals devote a large part of their energies after a merger (and in fact in any strategic season) to the shareholders their company already has, rather than merely attempting to court new ones.[70]

On your second point, could you say more about the long-term versus trader investors?

Yes. The spectrum of shareholders has two ends.

At one end, there are long-term shareholders, who invest for a relatively long period of time, and who base their buy-sell decision on fundamentals of

performance, both financial and nonfinancial. At this end of the spectrum we find individuals and some institutions, notably pension funds for public-sector and private-sector employees.

At the other end of the spectrum, there are short-term holders who base their trades on technical minutiae, such as differences between analyst projections of earnings and published earnings reports. This kind of trading is most common among money managers, mutual funds, and banks.

Although neither state nor federal law makes a distinction between these two types of shareholders, many court opinions support the notion that companies should not be operated for the benefit of short-term shareholders, but rather for the benefit of long-term shareholders and other long-term constituencies. Leading corporate executives and investors support this notion.

Typical long-term owners—for example, the pension funds that belong to the activist Council of Institutional Investors—cannot easily sell a large position. Instead, such holders prefer to engage in activism through such vehicles as shareholder resolutions to change policies. Although activism can be beneficial over time, it can be embarrassing to the company and its management in the short term.

And on your third point, why are current holders more likely to stabilize share prices than potential future shareholders, and why does this matter?

Shareholders whose ownership predates a merger are by definition owners who have some level of confidence in the merger. Confident shareholders are less likely than tomorrow's buyer to drive stock price down by selling out in hard times. This means less volatility in stock price, an important consideration. Some investors consider high volatility, or high beta, to be a negative factor when calculating a company's value to them. This is one of the basic principles of the shareholder value approach to company valuation.

What is the shareholder value approach to company value?

The *shareholder value approach* to company valuation says that the total economic value of a company, or its corporate value, equals the value of its

debt plus the value of its equity or shareholder value.[71] This sounds as easy as a balance sheet (just subtract debt from equity), but it is not. In this approach, the value of debt and equity are not computed separately. Rather, they are seen in dynamic interrelationship.

Corporate value in this approach is defined as the present value of cash flows from operations during a forecast period, plus the present value of business attributable to a period beyond the forecast period (or residual value), plus marketable securities. In calculating present value, companies have to figure out the cost of a company's capital—on both the debt and the equity side. This is where beta comes in, by the way: stock volatility is considered part of a company's cost of equity capital.

Should postmerger financial reports include non-GAAP financial information? Why or why not?

Postmerger reports should include a range of information that shareholders will find useful. Some of it will conform to GAAP, but some will not. (Consider the shareholder value calculation just discussed.)

Non-GAAP numbers are desirable to shareholders because accounting numbers can be constrained by accounting conventions that may lose economic sense over time. A favorite culprit is the book value (historical price) of an asset—obviously a number that has little value years later as the true value of the asset grows or declines. Fortunately, there is a constant evolution of accounting standards to keep pace with economic value. For example, GAAP standards make many allowances now for fair value in reporting. In fact, the accounting profession has long recognized the importance of nonaccounting measures, and has always encouraged accountants to note them.[72] Whenever non-GAAP measures enable abuses—for example, the off-balance-sheet entities that enabled Enron's fraud—they eventually come under GAAP. And to cover all bases, securities law requires a disclaimer for non-GAAP disclosures, so investors can take them or leave them, as they wish.

Most major companies today take an eclectic approach to valuation and reporting. Many include discounted cash flow statements in their annual reports alongside required accounting-based financial statements. For example, major business publications such as the *BusinessWeek 50* use a mix of measures to judge financial performance. The lesson is simple: give shareholders a variety of performance measures to consider.

Building Shareholder Value

From a general, strategic point of view, how can managers increase shareholder value after a merger?

A number of general strategies appear to build the value of a company's shares, no matter how that value is measured. Here are three to consider:

- *Aim for continued, profitable growth.* When it comes to shareholder value, profitable growth is superior to cost-cutting, and unprofitable growth is superior to downsizing.[73] Companies that grow profitably have a disproportionately higher stock appreciation than do companies that only cut costs: a dollar earned through growth is worth more to shareholders than the same dollar earned through cost-cutting. (Of course, in some cases, cost-cutting and downsizing may be the best option.)
- *Alternate external and internal growth.* In pursuing growth, a company can buy or build. Obviously, by the time a company has reached the integration stage, it has already chosen to buy rather than build in at least one case. But after every major acquisition, a company starts back on square one with the same question, Should we continue to buy rather than build, or should we spend time building instead? Most companies alternate the two strategies, going from periods of acquisition to periods of internal growth, just as farmers rotate crops. These companies take time to integrate major acquisitions before embarking on new ones. (Again, there is not a single correct choice. Some companies may be suited to growth that is entirely internal, others to a steady flow of acquisitions.)
- *Develop and disclose good corporate governance practices.* Corporate boards that practice good governance are likely to have the independence and expertise necessary to oversee financial performance after a merger. Good governance practices include, but are not limited to, independence of the board and its key committees (such as the audit committee), development and disclosure of processes for senior executive evaluation and compensation, and lack of undue restrictions on shareholder voting. Although individual companies lacking some or all of these practices may be successful for long periods of time, these practices tend to be associated with positive share price performance, and many business catastrophes can be traced in part to the absence of one or more of them.[74]

Companies have followed these governance practices on a voluntary basis for years, in part thanks to urging from shareholders. Until recently, however, these practices were not required. The bankruptcies of Enron and WorldCom changed that. In response to these financial disasters, Congress passed the Sarbanes-Oxley Act of 2002. This new law focused mainly on strengthening the audit committee, internal controls, and whistle-blowing. But Sarbanes-Oxley also triggered new stock listing rules pertaining to governance. In late 2003, after consulting with shareholder groups and others for their best-practice recommendations, the New York Stock Exchange, Nasdaq Stock Market, and AMEX Stock Market all announced new governance standards. These governance standards have caused more board and shareholder involvement in areas previously considered management turf.[75]

Are there any model governance guidelines a merging company could consider adopting?

The most comprehensive and stringent governance standards today are the ones required of New York Stock Exchange companies, namely *Section 303A: Corporate Governance Rules,* most recently amended in November 2004. With a few exceptions, these rules could be beneficial to most companies.[76] In addition, companies can study national or international surveys of director and shareholder views or study national and global proxy voting trends.[77] Peer company examples can also be helpful. Most public companies today disclose their governance guidelines on their Web sites.

What postmerger financial indicators are most important to shareholders?

Shareholders will look at sales growth and earnings growth, as well as several key ratios based on numbers from the balance sheet, the income statement, and/or stock prices.

In debt-financed acquisitions, shareholders may focus on ratios involving debt, namely:

- Current ratio (current assets/current liabilities)
- Debt ratio (total liabilities/total assets)
- Debt-equity ratio (total liabilities/total equity)
- Net working capital (current assets minus current liabilities)

If the merger was financed through equity capital, then shareholders may focus on ratios involving equity:

- Earnings per share (net income – preferred dividends/common shares outstanding)[78]
- Price/earnings (market price per common share/earnings per share)
- Equity ratio (total stockholders' equity/total assets)
- Return on common stockholders' equity (net income – preferred dividends/average common stockholders' equity)

If a company issues more shares to pay for a merger, this may dilute the value of shares. How can a company mitigate concerns about this?

First, be straightforward about the dilution. Shareholders will notice it, so you might as well point it out and explain it. If future earnings prospects are good, say so, then explain how they will be achieved.

Are there any rules against dilution?

No, but there are rules that require disclosure and/or approval of potentially dilutive transactions. For example, in the mutual fund area, the SEC requires the board of any mutual fund that merges with a trust fund or account not registered with the SEC to make sure that the interests of the fund's shareholders will not be diluted as a result of the merger. As part of this determination, the fund's board has to approve procedures for the valuation of the securities (or other assets) that the unregistered entity will convey to the fund. The records of the merger must include a report by an independent evaluator on the fair market value of any assets not quoted on a market.[79]

Could you give an example of a successful postmerger communication about dilution?

Here are excerpts from a postmerger press release emphasizing share value on a diluted basis.

> **Income from Continuing Operations Up Nine Percent; Sales Up 23 Percent; Company Confirms Its Fiscal Year 2006 Outlook**
> ORRVILLE, Ohio, Aug. 22/PRNewswire-FirstCall/—The J.M. Smucker Company (NYSE: *SJM-News*) today announced results for the first quarter ended July 31, 2005, of its 2006 fiscal year. . . .
>
> Income from continuing operations was $29.9 million, an increase of 9 percent over $27.5 million in last year's first quarter. Sales growth was mostly

offset by increased marketing costs in support of the brands, costs associated with establishing the Company's new distribution network, an increase in net interest expense, and compensation expense related to the Company's new restricted stock program. Earnings per diluted share from continuing operations for the first quarter of 2006 were $0.51, compared to $0.50 last year, *impacted by the additional shares issued as part of the Multifoods transaction.*

Income from continuing operations for the first quarter of 2006 included pretax merger and integration costs of $2.9 million, or $0.03 *per diluted* share, and restructuring charges of $1.6 million, or $0.02 *per diluted share.* Income from continuing operations for the first quarter of 2005 included pretax merger and integration costs of $2.8 million, or $0.03 *per diluted share,* and restructuring charges of $3.0 million, or $0.04 *per diluted share.* Excluding these costs in both years, the Company's income from continuing operations was up 6 percent. *Due to the additional shares issued as part of the Multifoods transaction, earnings per diluted share* were $0.56 and $0.57, in the first quarters of 2006 and 2005, respectively.

One cause of dilution is the use of equity to finance a deal. Could you comment on equity versus debt?

Sure. There are four common ways to finance a merger, as mentioned earlier in this book. In order of frequency, companies use cash, stock, a combination of cash and stock, and a combination of notes and cash and/or stock. Each of these payment strategies will have a different impact on the value of a company's equity.[80]

Equity impact of an all-cash deal. This can vary, depending on whether or not the acquirer used its own cash or borrowed it. Overall, when compared to share-financed deals, cash-financed deals have a more positive impact on share prices over a long (five-year) term. Acquirers should avoid taking on too much debt, though. As explained in Chapter 4, a debt-financed transaction that causes the acquirer to have a debt-equity ratio of 0.75 or more is considered to be a heavily leveraged transaction (HLT). Such transactions often have a negative impact on share values.

Equity impact of an all-stock deal. This impact also varies depending on the source (in this case, the source of the stock). In exchanging its stock for the seller's stock, the acquirer can either issue new shares or convince existing shareholders to exchange their shares with the seller's shareholders.

- The first scenario (using new shares) may cause dilution.
- The second scenario (using existing shares) can signal that the acquirer knows its stock is priced high.

Both of these possibilities can explain why share values do not do as well overall following stock deals as following cash deals.

Equity impact after a cash-and-stock deal. If the acquirer combines cash and stock in the payment, the impact on postmerger compensation may be positive or negative, depending on the sources of these instruments, as previously explained.

Equity impact of a contingency deal. Sometimes acquirers offer notes to the seller promising additional payments or earnouts based on meeting certain financial goals. Obviously from the shareholders' perspective, this mode of financing, although rare, is ideal. If the goals are not met, the company (and its shareholders) pay nothing. If the goals are met, then the company (and the value of its equity) is bound to improve. This is especially true if the performance goals relate to share price or to ratios that relate to share price.

In summary, an acquisition may have a negative or a positive effect on the acquirer's share prices, and this effect depends in part on how the deal was financed. It is up to postdeal managers to do what they can to ensure the most positive outcome for shareholders, and to admit, explain, and work to correct any negative result to existing shareholders, rather than hoping for a new generation of owners to come along.

Many companies today put frequently asked questions (FAQ) sections on their Web sites following a merger to address concerns of various constituencies. The following example, from JPMorgan Chase, includes questions shareholders might ask (see Box 9-4).

LEGAL ASPECTS OF SHAREHOLDER RELATIONS

How often do shareholders sue companies, what are their main issues, and how much do they sue for?

In 2005, 52 percent of all directors and officers' liability insurance claims were filed against officers and directors of public companies by shareholders.[81]

BOX 9-4

Frequently Asked Questions from Shareholders–
An Example from JPMorgan Chase (September 2005)*

Merger FAQ for stockholders

What happens to my JPMorgan Chase stock?

What happens to my Bank One stock?

What should I do with my Bank One stock certificates?

Is the exchange of Bank One stock certificates mandatory?

What if I cannot locate all of my Bank One certificates or if I have any questions about lost, misplaced, or stolen shares?

Will I receive a physical certificate from the exchange of my Bank One common stock certificates?

How long will it take the exchange agent, Mellon Investor Services, to exchange my Bank One certificates?

How should I send my Bank One stock to the exchange agent, Mellon Investor Services?

Does JPMorgan Chase pay a dividend on its common stock?

How will I get paid for dividends going forward?

Does JPMorgan Chase have a dividend reinvestment plan?

What are the tax consequences of the merger?

What is the tax basis of my new JPMorgan Chase stock?

What is JPMorgan Chase's ticker symbol?

Who can I contact if I have additional questions?

*This FAQ was posted on the JPMorgan Chase Web site following the September 2005 merger of JPMorgan Chase and Bank One. For another example from Limited Brands in late 2006, see www.limitedbrands.com/faq/investor.jsp#faqlink7JpMorg.

Could you give an example of a major shareholder lawsuit over a merger?

In August 2005, Time Warner reached a $2.4 billion settlement with a shareholder group (or class) that had filed a class action lawsuit against the company for poor financial performance after its merger with AOL.[82] Under the settlement, Time Warner agreed to pay $2.4 billion into a settlement fund for the members of a class action suit that alleged fraud at America Online. The reserve covers only the primary securities class action. Additional litigation included shareholder derivative actions and securities actions brought by individual shareholders.

Time Warner established an additional reserve of $600 million for those unresolved complaints. The shareholder class named in the suit as plaintiffs was the subset of owners who had purchased shares in AOL or Time Warner between January 27, 1999, and August 27, 2002. At the time of the lawsuit, the company's shares were still trading at 75 percent lower than premerger levels.[83]

How can shareholders sue over strategic decisions such as mergers or sell-offs? Doesn't the business judgment rule protect directors and officers against these kinds of lawsuits?

Yes, the business judgment rule—a judicial doctrine used in state courts—offers some legal protection. The rule says that directors cannot be sued for making any particular decision (even one with bad results) as long as they made the decision on an informed basis, in good faith, and in the honest belief that the action taken is in the best interest of the company. The burden is on litigants to prove that directors failed to meet these standards. However, the legal meaning of these standards has evolved over time in response to changing aspirational standards—as noted by Chancellor William Allen in the August 2005 decision concerning excessive compensation to a departing CEO at the Walt Disney Company.[84]

So how can companies avoid getting sued because of mergers and other strategic decisions?

In making decisions, companies should not only follow the spirit of the business judgment rule, but keep a paper trail to prove it. Also, before, during, and after any major corporate decision, companies should seek the views of

shareholders (particularly major, long-term shareholders) to ensure their support.

You mentioned earlier that a corporate board of directors owes its primary fiduciary duty to shareholders "in most cases." When can other stakeholders take primacy?

In U.S. law, there are two well-defined circumstances in which directors can place a priority on nonstockholder interests. The first is a merger or other special transaction, and the second is insolvency.

The first circumstance arose from backlash to the hostile takeovers of the 1980s. A majority of states have passed laws that allow directors to look beyond short-term shareholder returns in making decisions on corporate transactions, including mergers. These laws go under a variety of names—*stakeholder laws, other constituency laws, director's duties laws, nonmonetary considerations laws,* and *nonstockholder considerations laws*—but they all mean the same thing: directors need not automatically and always put shareholder interests first, but may consider the effects of a transaction on other groups, including customers, suppliers, bondholders, lenders, employees, and communities. So, for example, directors may refuse to accept a hostile takeover bid that pays a premium to shareholders at the price of massive layoffs.

Insolvency can bring nonshareholder interests to the fore, thanks to the absolute priority principle under Chapter 11 of the U.S. Bankruptcy Code. This principle says creditors must be paid before shareholders. Traditionally, this absolute has put bondholders, lenders, and other creditors ahead of shareholders in a bankruptcy. Some experts believe that this affirmative duty to creditors can begin well before a formal declaration of insolvency.

COMMITMENTS TO EMPLOYEES

What commitments does a company typically have to fulfill for its employees after a merger?

Once again—as with customers, suppliers, stockholders, bondholders, and lenders—managers should review all outstanding contractual commitments with employees. Ideally, this will be a second review, benefiting from good due diligence (see Appendix A).

For a general overview, the Caux Round Table's *Principles for Business* again proves useful. Here is the "Employees" section of the stakeholder list, with our postmerger *CHECKPOINTS.*

Employees

We believe in the dignity of every employee and in taking employee interests seriously. We therefore have a responsibility to:

- Provide jobs and compensation that improve workers' living conditions

  CHECKPOINTS: Are there plans to eliminate locations and/or jobs as a result of this merger? Are these plans iron-clad, or can the company consider alternatives such as divisional sales? If layoffs are unavoidable, has the company given adequate notice and compensation? For those who stay, will work and pay improve? Can workers who are to be laid off be used as part of the team that closes operations?

- Provide working conditions that respect each employee's health and dignity

  CHECKPOINTS: How do the two merging companies compare with respect to working conditions? Does either company have a history of violations of Occupational Safety and Health Act (OSHA) violations? If one company's policies are clearly superior to the other's, will its policies take precedence?

- Be honest in communications with employees and open in sharing information, limited only by legal and competitive concerns

  CHECKPOINTS: What is the communications style of the leading postmerger management team? What about the rest of the company? What can be done to improve the postmerger communications environment?

- Engage in good faith negotiations when conflict arises

  CHECKPOINTS: What potential conflicts concern management of the newly merged concern? Who should address these, when, and how? What procedures will the new company have for resolving grievances?

- Practice and promote equal opportunity of hiring and advancement to people of differing ages, genders, races, religions, and other personal attributes considered to be potential sources of bias

  CHECKPOINTS: Does the newly merged company have a clear, consistent plan for equal opportunity? What is the level of diver-

sity/proversity in each of the two merging companies?[85] *Is there a plan to improve these?*

- Promote in the business itself the employment of differently abled people in places of work where they can be genuinely useful

  CHECKPOINTS: With respect to the differently abled, do the hiring, training, and promotion practices and policies of the newly merged company engage and reward the best in people, making reasonable accommodations for their differences?

- Protect employees from avoidable injury and illness in the workplace

  CHECKPOINTS: What safety and health policies does each of the merging companies have? How will these be combined?

- Encourage and assist employees in developing relevant and transferable skills and knowledge

  CHECKPOINTS: What training and retraining will the combination require? To what extent will the new company consider these as alternatives to employee replacements?

- Be sensitive to the serious unemployment problems frequently associated with business decisions, and work with governments, employee groups, other agencies, and each other in addressing these dislocations

  CHECKPOINTS: Is management of the newly merged company engaged in a dialogue with various stakeholders about the long-term employment outlook? What hope can this dialogue offer? What outplacement programs does the new company offer?

Of all the Caux lists, this one is the longest, presenting positive values for nine distinct values: job creation, working conditions, communications, negotiations, equal opportunity, accommodation of differences, safety/wellness, training/retraining, and outplacement. If the merging companies have made commitments in these areas, the new company must honor them. If the new company has not made commitments in these areas, it should consider doing so for reasons discussed throughout the rest of this chapter.

Why is it important to make and keep commitments to employees?

Once again, as we have seen in considering other stakeholders, the answer involves ethics, law, and economics. Breaking a promise is not only wrong

(and sometimes illegal), but it is likely to have negative economic consequences. For example, key employees may leave because they lose trust in the new organization.

If employees leave, can't the new company just hire new people to replace them, or outsource their work?

Yes, but each of these alternatives can be costly. Existing employees have already been recruited and trained. Replacing them with equally qualified employees is not economically neutral, because it usually means that a company must pay for recruitment and training a *second time* for the same positions.

In addition, there are the negative multiplier effects of employee departures, whether voluntary or involuntary. For example, remaining employees may feel guilt with respect to the employees who lose their jobs—either personal guilt because they (as managers) axed jobs or survivor guilt because their own jobs were spared.

Some acquirers turn to outsourcing, but it is not a magic bullet. It takes a lot of management time communicating with a vendor about expectations. Also, vendors have their own overhead to cover, and the hourly rate of their employees or contractors reflect that charge.

What is the financial impact of downsizing?

Generally speaking, it is a formula as follows: On the positive side, there are savings from a smaller payroll. On the negative side, there are costs of early retirement packages, termination benefits (usually taken as a one-time charge), disability claims, and so forth.[86] Also, impact on morale is usually negative. Finally, companies with fewer employees generally get less done.

How do pension funds respond to downsizing after mergers? Do they ever vote against mergers because they might cause downsizing?

Pension funds are not supposed to vote for the interests of current employees; they are supposed to vote for the interests of retirees. Explaining this point requires a little historical background. Under ERISA, which covers private (nongovernment) companies, fund fiduciaries have an affirmative

duty to vote in the interests of beneficiaries. For many years, most funds ignored this duty and voted instead with management.

In 1988, however, David Walker, assistant secretary of the U.S. Department of Labor, wrote a letter to the Avon Company pension fund that articulated this duty. The letter was widely influential. Many fiduciaries interpreted it to mean that they should in most cases vote for a high-premium bidder, even if it was a known liquidator that would lay off union members.

In subsequent communications, the Department of Labor has clarified this "Avon letter duty," letting pension funds consider long-term returns to beneficiaries. Fund fiduciaries can vote against a tender offer with a high premium, said the DOL, if they have reason to believe that resisting the takeover would bring larger gains to beneficiaries over time.

For pension funds, the proxy voting decision in a hostile deal is not always simple—not always the story of the rich bad guy versus the poor good guy, not always a choice between new life with a raider offering high returns and a small workforce versus continued life with a target offering low returns and a large workforce. Companies resisting takeovers can do so through defensive restructurings that are in essence preemptive liquidations, and not every hostile acquirer downsizes.[87] Over time, though, funds have developed confidence in their ability to distinguish unnecessary layoffs from necessary ones—as witnessed by the recent CalPERS initiatives.

In recent years, many large companies have undergone massive layoffs. Are mergers to blame?

Mergers account for about 25 percent of job cuts from year to year, according to the executive recruiting firm Challenger, Gray & Christmas. Merger activity accounted for the elimination of almost 77,000 jobs in the first quarter of 2005, or 27 percent of the cuts that were announced. In recent times, however, merger-related job cuts have declined, suggesting greater positive postmerger synergies.[88]

When employees sue companies, what do they sue for?

Most lawsuits are for wrongful termination. Other issues, in order of frequency, are discrimination, breach of employment contract (not termination), harassment or humiliation, employee benefits, defamation, and workplace safety.[89]

What other legal and regulatory issues should managers look out for after a merger?

Pensions continue to be an important area in the United States, where companies have special duties to employees present and past as administrators of their employee pension plans under ERISA. Now, after more than a quarter century, this law is receiving renewed attention from all three branches of the U.S. government.

- The Supreme Court offered an expansive interpretation of fiduciary duties in the merger setting *Varity Corp. v. Howe.* The court said Varity breached its ERISA duties when it convinced the participants and beneficiaries of a pension plan to transfer their employment and plan coverage to a new, money-losing subsidiary.
- In 2002, as part of Sarbanes-Oxley, the U.S. Congress made it illegal to have pension fund blackouts that would prevent employees from selling employers' shares unless officers were also frozen out.
- The FASB, a standard-setter for the SEC, has expanded pension disclosure requirements under Financial Accounting through Statement 158.[90]

Time off—both paid and unpaid—is another issue. The Family Medical Leave Act of 1993 mandates 12 weeks off without pay for certain family situations, such as the birth or adoption of a child or care for a parent.

How does the existence of collective bargaining agreements affect postmerger management?

Obviously, collective bargaining agreements are a major source of obligations for new management when it comes to working conditions—including hours, safety, and staffing. Also, some agreements stipulate that companies must consult with employees in a change of control. In such cases, employee leverage prior to deal closing may help preserve or improve employee working conditions. All agreements negotiated by labor organizations in the United States receive strong enforcement from the National Labor Relations Board (NLRB).

In May 2005, when US Airways and America West announced plans to merge, labor issues posed a challenge to the potential merger partners. Although the pilots and flight attendants from the two companies belong to the same unions, the mechanics belong to two different unions: the International Brotherhood of Teamsters at America West, and the International Association of Machinists and Aerospace Workers at US Airways, raising questions of seniority and assignments.[91]

Can a group of nonunion employees negotiate with management over working conditions?

No, not under current labor laws. Under the National Labor Relations Act, only *labor organizations*—unions independent of management—may do so. This may change, however, if the U.S. Congress passes the Teamwork for Employees and Management (TEAM) Act. This proposed law would allow nonunion groups to form and negotiate over working conditions.

What role can job training and development play in the postmerger phase?

Training programs are the fastest way to reassure employees of both the acquired and the acquiring company that their jobs are secure. These training programs should have two aspects.

First, the management of the newly combined companies can start by educating all employees in the values, vision, and mission of the newly combined companies. These elements should reflect the histories of both companies, even if their framework is derived largely from the acquirer.

What are some relocation issues newly combined companies should consider?

Five questions will arise in the relocation of a company's headquarters, plant, or branch. In order of importance, these are: *Why* is it relocating? *Where* is it going? *Who* will be asked to relocate? *How* will the acquirer handle relocation? *What* support will be provided? Also, facts and figures about the new locations should be disseminated. Comparative information can lessen the shock and trauma of relocation—and may even make it appealing. At the very least, it will enable employees to make good decisions.

In any event, the acquirer should establish a detailed relocation policy that includes adequate reimbursement of expense and job security following the move. Several companies provide such information. One established company, Economic Research Institute of Redmond, Washington (www.economicresearchinstitute.com), provides cost-of-living comparisons between any 7,200 Canadian and U.S. cities. These are used to assist employees considering a relocation offer or temporary assignment.

What would be a good example of a generous relocation policy?

GM's relocation policy offers a good example. Under its current three-year contract with the United Auto Workers, GM not only guarantees the jobs of senior union members, but provides each worker with a relocation package worth $60,000.

What is outplacement and why is it important for companies that are cutting jobs?

According to the ACOFI, the *outplacement* industry is composed of "firms and professionals who help organizations to *plan, implement,* and *follow-up* individual terminations and group layoffs" (emphasis ours). Outplacement services, whether provided by outside consultants or by inside human resources managers, can make the best of a bad situation. Proper planning can keep job losses to a strategic minimum, proper implementation can preserve corporate and personal dignity, and proper follow-up can foster goodwill with departing employees. With good outplacement, layoffs can preserve the trust that is essential to corporate life.

POSTMERGER COMPENSATION: A COMPLEX ISSUE

What guidance do you have on postmerger pay to employees?

This is a complex topic related to all the topics discussed—resources, processes, and responsibilities. Pay rewards human resources by spending financial resources; pay requires a process; and pay fulfills responsibilities. Thus it is worthy of separate attention.

When integrating pay plans (or designing new ones), what are the various pay elements and pay arrangements that postmerger planners should consider?

There are basically four pay elements:

1. *Base pay,* otherwise known as *salary,* is a fixed amount of cash. It is typically determined annually and paid on a weekly or (in small companies) monthly basis.

   For most employees, this is the dominant portion of pay (though to large company senior executives it is of minor importance).
2. *Bonus pay* is a lump-sum award in cash and/or stock paid to an employee for past performance. Bonus pay is typically determined and paid on an annual basis. Some companies call their bonuses *incentive pay,* but compensation purists reserve that term for pay that is awarded according to a predetermined plan, not after the fact.
3. *Incentive pay* is compensation awarded to employees because they (or their team, division, or company) have met a predetermined performance target. This pay, which may be in cash and/or stock (either outright grants or options), is truly variable; it may not be paid at all. It may be awarded annually and/or long-term, with the term defined by the company. Incentive pay is often awarded as *deferred compensation.* Funds are usually put into an escrow account that appreciates according to a standard interest rate (such as Treasury bills).
4. *Benefits* include plans for pensions, health care, employment security, and, at the board level, liability insurance. Benefits may also include extras or *perquisites* such as use of a company car.[92]

In addition, there is a potentially infinite universe of *special pay arrangements* that can come up during or after a merger.

1. Through *no-compete agreements,* companies can take the first of many steps in keeping key executives—not only retaining their talent, but also preventing them from joining (or becoming) competitors of the new company.
2. Through *signing bonuses* (called *golden handshakes*), companies can increase the motivation of executives they wish to hire.

3. Through *severance agreements,* companies can promise to compensate employees in the event of job loss.
4. Through *change-of-control plans* (offered in addition to plain-vanilla severance agreements), a company agrees to pay employees in the event of job loss following a merger or acquisition. At the senior level, these M&A-related severance packages are called *golden parachutes.* At lower levels, they are called *tin parachutes.*
5. Finally, through *retention agreements* (also called *golden handcuffs*) companies promise rewards if an employee stays a stated length of time.

The sum total of all basic pay elements and all special compensation arrangements is generally referred to as *total compensation.* Most consultants today offer services in total compensation planning.

When two companies merge, to what extent should they merge their compensation plans?

It depends on whether or not the new companies will be integrated or managed separately. As explained earlier in this book, not all acquisitions lead to integration. If an acquirer has only a financial (as opposed to strategic) reason for buying a company, it may choose to keep its pay plans separate. And even if an acquirer has a strategic reason to buy a company and does plan to integrate resources and systems, the company's leaders may still decide to keep some aspects of pay separate (especially if they are venturing outside their company's core industry).

Given all of these factors, the burden of compensation design is generally shared between the acquirer parent company and its units. In a typical situation:

- The parent company will determine a policy for how much of senior management pay will be in stock (for example, five times salary) and how managers will receive it (by award or purchase, and, if the latter, whether the purchase will be mandatory or voluntary). The division will encourage and enforce compliance with the parent's target ownership plan (often called a TOP).
- The parent company will determine the desired competitiveness of base pay (below market, at market, above market), while the unit will identify the labor market in which it will be competing (local, regional, national).

- The parent company will decide on a policy for bonuses, while the unit will decide who will receive them.
- The parent company will set targets for incentive pay. Achievement of the targets can be based on various metrics (including accounting ratios, stock price, qualitative factors, and/or discretionary factors) and valuation methodologies (economic value added, cash flow return on investment, or other model), while the unit will select whether to award the incentive pay based on unit, team, or individual performance. The parent is also responsible for ensuring that pay plans do not incentivize short-term performance at the expense of ethical behavior.
- The parent company will decide on a benefits policy, while the unit will administer the policy, making occasional exceptions as necessary by contract or law.

Note, however, that even when parents have the power to set uniform policies and targets, they may use their power to vary pay plans from unit to unit, or may delegate their power outright.

Why would a newly combined company want to have different pay plans for its units?

- Because the units may have very different pay environments.
- Base pay may differ from industry to industry for similar jobs. Also, a company in a mature industry will have a greater percentage of pay in base pay as opposed to variable pay from bonuses or incentives.
- There may be regional differences in pay. The U.S. Office of Personnel Management has recognized this and has developed detailed tables of pay by region.[93]
- Bonus pay may be hard to align following a merger between one firm with huge bonuses and another one with none. Any acquirer of a Wall Street investment bank or brokerage firm knows that trying to moderate year-end bonuses in these cultures can be difficult if not impossible. (Even Warren Buffett, widely revered and successful chairman of Berkshire Hathaway, failed to do this as outside chairman of Salomon Brothers in the early 1990s.)
- Incentive pay targets for early-stage high-growth companies should be linked to sales growth, market share, and product development—not short-term profit performance—whereas the opposite would

apply for a mature company. Or to use an industry example, consider the differences between a mutual fund, which lives and dies on stock prices, and the mutual insurance industry, which depends more heavily on long-term relations with policy holders. Incentive plans in such companies are likely to be different and should remain so in a merger.

- Finally, incentive plans may reflect differences in managerial philosophy, valuing the formal versus informal, and quantitative versus qualitative.
- Benefits are another area where postmerger disparity may be necessary. Suppose that in the negotiation phase, the acquirer agreed to let the selling company's senior management keep certain perquisites, knowing full well that it would not extend these same perks to its own senior team. If that was the deal, the acquirer has no choice but to live with these strings attached, and to explain them as a *grandfather clause* to the envious. Furthermore, there may also be regulatory restrictions on merging certain benefits, such as retirement plans.

All these differences can add up, resulting in sharp contrasts between companies and, once merged, units. For example, a mature, centralized, business with heavy capital investments, stable profit margins, little technological change, and few competitors should strive for the following:

- Senior management depth
- Predominantly fixed compensation
- Moderate incentives
- Moderate equity participation
- Discretionary evaluations

At the other end of the spectrum, a changing, decentralized business with low capital investments, pressured profit margins, significant technological change, and many competitors should strive for the following:

- Little senior management depth
- Predominantly variable compensation
- Heavy incentives
- Heavy equity participation
- Objective evaluations

Are you saying there is no role for pay-plan integration—that each unit should have its own pay plan?

No, to the contrary. To be fair to all employees, pay plans should be as uniform as possible, within the limits of what makes sense for each business unit. Few mergers will involve companies as diverse as the two described previously. (Indeed, mergers between such opposites face immense barriers to success, partly because of the incompatibility of their pay cultures!) The important thing is to recognize and value differences, not ignore them. At the same time, pay planners should work holistically. A pay plan—whether for an entire company or a single unit—must be a true plan, not a patchwork quilt.

Aren't there some general principles of compensation that apply in any type of company? If so, what are they?

Yes, there are universal principles for good pay planning. The first is that if it works, it is good. Compensation theory is continually testing itself against the reality of experience. That blend of theory and proven practice appears continually in articles and books written by compensation experts.

Take, for example, the principle of equity ownership. The basic idea of linking management and ownership is good, but there are challenges, such as the volatility of stock prices and the risk that managers will get windfalls and leave.[94] In recent years, a number of innovations have emerged to solve this problem; for example, linking pay to share price through an indexed option plan, and putting restrictions on the exercise of some options following a term of service.[95] Moreover, compensation experts have put a greater emphasis on stock-based pay in the more glamorous high-tech, high-growth area and have not recommended equity pay as heavily in lower-tech, mature industries. Here is a list of principles already widely accepted in corporate and compensation circles:

Do

- Encourage real share ownership at all levels
- Link pay to performance
- Reward executives for both shareholder value and quality of products/services[96]
- Make sure that pay is competitive in local markets

- Communicate appreciation of an employee through promotion and recognition as well as through pay

Don't

- Award excessive, repriceable stock options to senior management
- Keep increasing pay no matter what
- Use a variety of benchmarks, not just accounting measures (which can be manipulated) or stock price (which can be influenced by external events)
- Rely too heavily on benchmarks such as quartiles, which by their very nature keep rising as long as everyone tries to stay at the top
- Agree to compensation contracts that can pay very large amounts under some scenarios[97]

What generally happens to senior management pay levels after a merger and why?

Pay levels per employee tend to go up following a merger. This is not surprising since mergers make companies bigger, and bigger companies tend to pay their top managers more than smaller companies do. Size is not the only factor, though. Companies that have expanded by takeover have systematically higher top management pay growth than same-size peers that are expanding by internal growth.

There are two reasons for postmerger pay inflation. First, postmerger equality is easier to achieve through pay raises than pay cuts. If senior executives from Company A and Company B are doing similar work, but Company A executives are getting paid more, it is more likely that B executives will be raised to A levels than the other way around.

Second, there are the special M&A compensation arrangements mentioned earlier, such as golden handshakes, golden parachutes, and golden handcuffs. Total costs for these elements, under various scenarios, can run in the tens and even hundreds of millions.

Speaking of golden parachutes, aren't they discouraged by law?

Yes and no. Ironically, the law that was passed to discourage parachutes may have actually *encouraged* them.

The 1984 Deficit Reduction Act set fines against companies who pay them and executives who receive them. Triggered by public outrage over the $5 million golden parachute William Agee got after the Bendix-Allied Signal merger in 1983, the law added two new sections to the tax code, which exist to this day. Section 280G of the IRC defines an *excess parachute payment* as one that equals or exceeds three times the executive's average W-2 compensation over the previous five years. Section 4999 of the IRC imposes in such cases a 20 percent excise tax on the amount exceeding average annual compensation and denies the company a tax deduction for that amount.

But the government maximum quickly became an industry norm. Many companies began to raise their levels of parachutes to 2.99 times average annual compensation—just in time for the merger boom of the mid-1980s (and in plenty of time for the boom of the mid-1990s).

Parachutes proliferated. At the time of the golden parachute laws, only about one-third of major companies had parachutes. Today, the figure is over two-thirds. And nearly half of all companies *offer to pay taxes* on amounts in excess of the 2.99 norm!

What about stock purchase rights or options that get triggered in a change of control? Do they count?

Yes. If a stock option will be granted or vested because of a change in control, this may constitute a parachute payment under Revenue Procedure 2003-68, which provides guidance on the valuation of stock options for this purpose. This could include any shareholder rights (poison pill) antitakeover arrangements that function as golden parachutes.[98]

If an acquirer gives golden handshakes to acquired company managers, what prevents the managers from walking away with the gold the very next day?

An acquirer can prevent a golden handshake from becoming a golden escape hatch by adding either a *back-end* provision or a *take-back* provision to the manager's contract. In a back-end provision, a company defers part of the promised sums, making them payable late in the contract period. In the take-back provision, an acquirer states in the manager's employment agreement

that he will have to repay all or part of the bonus in the event of departure prior to contract expiration. This second strategy can be layered, with heavier penalties for earlier departure. For example, a four-year contract might set the following penalties for repayment of a $4 million signing bonus:

Year 1: $4 million repayment
Year 2: $3 million repayment
Year 3: $2 million repayment
Year 4: $1 million repayment

These retention provisions are often referred to as *golden handcuffs*. Another type of golden handcuff is the no-compete agreement, discussed previously.

PLANNING PAY INTEGRATION: A STRATEGIC OVERVIEW

Assuming that two companies want to combine their pay systems, how should they do this?

A newly combined company must reconcile the individual and the collective, the past and the future. As individuals, employees will naturally want a pay package comparable to or better than what they had in the past. But pay planners must also look ahead, designing a pay system that makes sense for the long-term.

One very simple way is to chart the basic elements of compensation (base pay, bonus pay, incentive pay, and benefits) against the past approaches of each of the merging companies and the future needs of the combined enterprise in the view of senior management. By weighing these, planners can come up with a bridging strategy that takes both into account (see Box 9-5).

When designing new compensation plans (or adjusting old ones), what general principles should compensation planners keep in mind?

First, reach out. Consult some of the many guides available on this topic. Ask for expert advice. Most leading compensation firms offer services in

BOX 9-5

Sample Sketchpad for Compensation Planning

Compensation Elements	Past Approach of Company A	Past Approach of Company B	Future Needs of Company AB	Bridging Strategy
Base pay	Below market	At market	At market	Raise A's salaries; keep B's on course.
Bonus pay	None	Generous	Minimal	Finish out year keeping the status quo. Then start modest awards for all based on B's system, but reduced.
Incentive pay	None	None	Generous	Design pay-for-performance system. Employees: Additional 20 percent on base if goals for unit profits met. Senior management: Additional 30 percent on base if goals for company ROA met.
Benefits	Average benefit plans (cafeteria); generous, flexible benefit plans; no perks	Below average in health and retirement; lavish perks	Average health and re-tirement; mod-est perks	Improve B's health and retirement plans. Cut B's perks. Upgrade health coverage.
Special	1-year severance	6 months' severance	1-year severance	Extend B's severance.

Note: This is a sample, not a paradigm. Planners should use their own terminology and make their wn choices.

total compensation planning, and many have expertise in the postmerger arena.

Of course, there are many things a company can do on its own. The important thing is to strive for viability—financial, emotional, and technical.

How can a planner ensure the financial viability of a new play plan?

Planners need to consider the financial condition of the newly combined company. Although this condition will be based in part on the previous condition of the two merging companies, the new entity will have its own financial dynamics.

Aside from the merger price tag and related charges (which can be substantial, as explained in Chapter 5), the new company's condition will naturally be affected by the way the deal is financed.

There are four common ways to finance a merger. In order of frequency, these are cash, stock, a combination of cash and stock, and a combination of notes and cash and/or stock. Each of these payment strategies can have an impact on the financial condition of the new company—and therefore on the new company's compensation system.

1. *Pay after an all-cash deal.* If the acquirer uses its own cash to finance the deal, depending on the amount of cash used, the impact on compensation planning may be slight, especially if the cash used came from a full treasury. In such a case, planners have a clean slate for their creations. If the acquirer borrows cash to finance the transaction, the deal may be a heavily leveraged transaction, or HLT. *Highly leveraged transaction* means an extension of credit to or investment in a business by an insured depository institution where the financing transaction involves a buyout, acquisition, or recapitalization of an existing business and one of the following criteria is met:
   - The transaction results in a liabilities-to-assets leverage ratio higher than 75 percent.
   - The transaction at least doubles the subject company's liabilities and results in a liabilities-to-assets leverage ratio higher than 50 percent.
   - The transaction is designated an HLT by a syndication agent or a federal bank regulator.[99]

   Pay packages following HLTs should not be cash-heavy, since the company will need cash to pay debt. Incentive pay should be paid in stock or stock options and based on improvements in cash flow.
2. *Pay after an all-stock deal.* If the acquirer finances the deal through an exchange of stock using newly issued shares, the transaction may cause dilution. In such a scenario, pay planners should be conservative about granting more stock or stock options

to managers, unless the company can buy back its own stock (which is difficult following a pooling of interests). Companies facing potential dilution by using stock-based pay might consider *phantom* stock grants (payments based on stock performance).

3. *Pay after cash-and-stock deal.* If the acquirer combines cash and stock in the payment, the impact on postmerger compensation may be nil, unless the cash is borrowed (in which case, the HLT caveats may apply) or the stock is generous (in which case, beware of dilution).
4. *Pay after a contingency deal.* If the acquirer offered notes to the seller, promising additional payments or earnouts based on contingencies (such as 20 percent sales growth), postmerger compensation should be structured to give managers a chance to make good on those targets. Managers who were owners of the merged company (and therefore noteholders after the merger), will be most concerned about being given the authority, autonomy, and resources they need to meet performance targets. Obviously, the performance targets in pay-for-performance plans should be in sync with the targets set in the earnout notes.

Finally, how can planners make sure that a new compensation plan will be, as you say, emotionally viable?

Mergers bring up many negative emotions: loss, anxiety, jealousy. Planners need to make sure their pay plans signify the opposite: gain, security, fairness. One of the best ways to do this is to strive for *positive comparability.* Employees of the newly merged firm may not get the same compensation they did before, but it should be similar or better.

Consider employees of Company AB (shown previously in Box 9-5). The employees who worked for old Company A will rue the decline in their benefits, and employees in old Company B will dread the phase-out of their bonuses, even though both groups stand to benefit from other, positive adjustments in the total pay package. For example, in this scenario, A employees have a lot to gain: raises, bonuses, and additional incentive pay. Company B employees gain in the areas of incentive pay and benefits.

It is up to management to help employees focus on the positives, not the negatives. In this example (and in the case of any postmerger pay plan worth its salt), the message is this: "Your pay package is not the same as it was in

the past, but it is comparable, and in some ways it is better." (In other words, don't just practice your compensation philosophy, preach it!)

In addition to comparability, another byword in the emotional realm is *patience.* It is widely believed that employees resist change, hence the burgeoning field of change management. Certainly new compensation plans meet with resistance. According to one pay consultant, it takes three years for a new plan to take hold. The first year is for trial and error, the second for progress, the third for noticeable impact.

Of course, change doesn't end with a new plan. As time goes on, managers will want to continually adjust their pay practices to meet changing realities. A word of advice, though: Compensation is a very expensive way to tell employees they are valued. Pay can do only so much to attract, retain, and motivate people. Meaningful work, a sense of worth, and a chance to advance must also come into play. If these are absent, no amount of raises, bonuses, incentives, benefits, and special deals can take their place. The best and brightest will take their talents elsewhere.

How can planners make sure a new pay plan is technically viable?

Compensation rules change frequently. Every day, some new rule or some new interpretation of a rule appears to change the technical nuances of a pay plan. Therefore, compensation planners should rely on specialized experts inside and, often, outside their companies to find out the latest appropriate changes in accounting and legal treatment of base, bonus, incentive, and benefits pay.

Benefits pay is particularly complex, so much so that many employers use outside vendors to keep records for their benefit programs. But outsourcing does not free an employer of its obligations, whether longstanding or newly acquired. Buyers and sellers alike often fail to realize how many different kinds of benefits there are, and what obligations each benefit entails.

MERGING BENEFITS PLANS

What are the main kinds of employee benefits plans?

There are three primary employee benefits: *pension* plans, *health* plans, and *employment/advisory security* plans. The rest of the benefits can be considered perquisites limited only by the human imagination.

What are the different types of pension plans?

There are two types of pension plans: *qualified* (meaning that they meet certain federal standards and qualify for tax-favorable treatment) and *nonqualified.* Furthermore, there are two types of qualified pension plans: a *defined benefits plan,* and a *defined contributions plan.*

A *defined benefits plan* is a pension plan that determines the total value of benefits by a formula and requires the employer to meet certain actuarially determined standards in making contributions to the plan. Contributions must be enough to pay obligations when they fall due.

A *defined contributions plan* is a pension plan with shorter-term requirements. Minimum contributions are required year by year for each year in which the plan is in existence. These plans can take the form of profit-sharing plans with or without salary deferral (the well-known 401(k) plan) and usually have variable contribution levels.

Both of these qualified, defined plans are subject to a $200,000 compensation cap under recent tax law.[100] More broadly, they are subject to rules set forth under the IRC, administered by the Department of Treasury, and ERISA, administered by the Department of Labor.

If a buyer and seller both have defined contribution plans, how can these be merged?

This is a complex area best understood on a plan-by-plan basis. Let's take the example of the most common defined contribution plan, the 401(k). It depends on whether the acquirer bought the stock of the acquired company or its assets. In an asset acquisition, plans must remain separate, and the acquired company plan must be managed by the seller. In a stock acquisition, three approaches are possible: maintaining separate plans, terminating the acquired plan, or merging the two plans.

- To maintain separate plans, the acquirer simply has to make sure that each group files its own forms (Form 5500) and satisfies federal requirements for the nature and extent of coverage. One benefit of maintaining separate plans is that there is no break in coverage, as both plans continue to exist. If plan years are the same, the acquirer can take a full calendar year to come into compliance. (If plan years are different, the acquirer should check on its timetable; it may be shorter.)
- Terminating the seller's plan requires a one-year waiting period. The IRS's *successor plan rule* says that an acquired company's plan will be disqualified if more than 2 percent of its employees

participate in another defined contribution plan (except for an employee stock option plan) within one year of the acquisition. And even if an employer respects the 2 percent limit, it must pay sanctions to prevent those employees from being taxed.

- Merging the two plans can save administrative expense, but can be complicated. Assets from the old plan move to the new one. While this is done, employees are locked out of their plans for a period of time—typically two weeks to four months. During this time the old record keeper runs a final tally on the account, the shares are sold, and the money is moved to the new record keeper. Employees may have to select new investments when they can again access the plan. Sometimes, the money is automatically invested in the nearest matching fund in the new plan. During the lockout period, employees typically aren't allowed to take a loan or withdrawal or pick new investments. However, their contributions and loan obligations and repayments continue. The pension fund blackout provisions of Sarbanes-Oxley added restrictions.[101]

What health plans do most major public companies today offer?

Most offer one of two types. The *indemnity plan* is a fee-for-service plan. The *managed care plan,* which has become more prevalent in recent years, falls into three categories, ranging from most restrictive to least restrictive. All three types of managed care plans are offered by major health-care insurers such as Aetna, CIGNA, Health Net, Prudential Insurance Company of America, and Anthem/WellPoint, as well as some 50 other organizations of varying size and quality. Also, some corporations act as self-insurers for their plans.

On the most restrictive end of the managed care spectrum you will find *health maintenance organizations* (HMOs). These plans rely on a tight network of health-care providers (physicians and hospitals) and require participants to use a primary care physician as a gatekeeper. HMOs can keep their costs down by obtaining contracted rates from participating providers for specific services during a set time frame. These plans have the strongest cost controls and quality oversight and therefore tend to be on the low end of the cost spectrum. Insurers providing HMOs have come under legal attack from physicians and others in recent years.[102]

On the least restrictive end of the spectrum you will find *preferred provider organizations* (PPOs). These plans rely on a loose network of providers that have agreed to provide medical services at a discount to PPO

plan participants. These plans do not require the use of a physician-gatekeeper; participants can go directly to specialists for reimbursement under the plans. Because of their flexibility, these plans tend to be on the high end of the cost spectrum.

Between these two extremes are *point of service plans* (POSs), a relatively new hybrid product. POSs feature the physician-gatekeeper and tight provider network of the HMO, thus offering relatively low costs. On the other hand, they enable participants to opt for providers outside the network at lower rates of reimbursement, as long as the care is accessed through the gatekeeper.

In addition to managed care plans, many companies offer additional health benefits. These include not only dental, vision, long-term disability, dependent care, accidental death or disability (business travel, accident), and of course traditional life insurance, but also sick leave and various wellness benefits—often linked at no cost or low cost with local health-care providers. These can be single health-care events such as Flu Shot Day or Spring Health Fair, or they can be ongoing wellness programs such as employee assistance programs (EAPs), which provide ongoing treatment for substance abuse or mental health problems.

What usually happens when a company with one type of health-care provider network buys a company with another type? What should happen?

Many acquirers phase out their affiliations with the networks of acquired firms and put the firm's employees on their own network. For example, if the acquirer has an HMO and the acquired company has a PPO, the acquirer will cancel the PPO and put everyone on the HMO.

But this may not always be the best course of action. Companies often make their selections based on the conditions prevailing in their geographic region. In one area, an HMO may be the best choice, while in another area, a PPO will be the best choice.

Therefore, the best strategy is to reexamine the needs of the new company and maintain (or switch to) one or more network types according to need. Even if a company uses multiple networks, it can still use a single insurance carrier. This will require extra work on the part of the company and the insurer, but it is worth the effort. By using one carrier for all networks, the company can enjoy economies of scale and spread risk. It can also accomplish efficient price structuring.

Do different networks use different pricing methods? If so, how can an acquirer integrate them?

Pricing can and often should vary according to the type of health-care network used.

Services may be offered at a discounted fee for service, at a predetermined fee for service, or at a capitated fee.

A *discounted fee for service* is common in plans that use PPOs. In this approach, the network organization and the employer agree on a discount from each provider's regular fee for each visit to a hospital, doctor, or other provider by a covered employee, and premiums are set accordingly. The advantages of this approach are that employees enjoy freedom of choice, and doctors have no disincentives for treating any patient. The disadvantage is that prices are hard to predict. This approach is best for a company or unit with low claims experience.

A *predetermined fee for service* is more common in HMOs or POSs. In this approach, the network sets a price for each service performed, and charges accordingly. Price changes occur slowly over time. The advantage here is cost control. The disadvantage is lack of employee flexibility.

Capitated fees, also used in HMOs and POSs, stipulate that a certain amount of money will go to the provider regardless of how much services are used. Like the predetermined-fee approach, this one offers the trade-off of higher control and lower flexibility. It has the added disadvantage of physician disincentives at levels above the preset cap.

Aside from the type of network, what about the level of service provided by the network? Can the same company have different levels in locations or units?

Generally speaking, it is best to have the same level of coverage for all employees at all locations. The only exception will be for a company unit that maintains its own identity and its own policies, including compensation policies.

Suppose an acquirer with one level of health-care coverage acquires a company with a different level? How can these be combined?

There are two dimensions to this question. One dimension involves employee satisfaction; the other involves business strategy. Employees of the newly

combined company should be reasonably satisfied with their level of health-care coverage. On the other hand, this level should be suitable to the newly combined company's business purposes.

Obviously, to ensure employee satisfaction, acquirers should strive to make health-care coverage better (or at least the same) following a merger and avoid making it worse.

Fortunately, mergers often trigger an upgrade to the acquiring company's superior coverage from the acquired company's inferior coverage. For example, if a $5 billion public company acquires a $5 million private company, chances are that the acquirer's level of health-care coverage will be higher than that of the acquired company and that the employees of the acquired company will be automatically added into the acquirer's plan.

Sometimes, though, a merger will lead to the downgrading of health-care coverage for acquired company employees. This should always be for sound business reasons, which should be communicated prior to the merger. Communications should stress any positive trade-offs received by the acquired firm's employees.

What business reasons should be taken into consideration when integrating health-care coverage levels?

First of all, health-care coverage should be considered part of an overall strategic compensation plan, as previously discussed. That plan should take into account prevailing compensation trends in companies comparable to the parent. In addition to such benchmarking, however, the company should look to its own strategic needs.

A strategic review of health-care coverage will involve a series of steps, as follows:

1. *Determine health-care plan objectives.* Before making any decision about integrating health plans, an acquirer should give each of its effected units an unsparing financial and strategic checkup. In considering the level of health-care coverage provided to employees, companies should consider the state of their industries. A company in a profitable, high-growth industry with intense competition for human resources will need to make a heavy investment in top-of-the line products. By contrast, a firm in a moribund industry with survival issues may opt for a sturdy but low-cost safety net.

2. *Research health-care plan options.* What products are being offered by comparable companies? Although competitive information may be difficult to obtain on a local basis, national trends are tracked by compensation consulting groups—both independent firms and those affiliated with public accounting firms. It's also worth finding out what employees want in a health-care plan.
3. *Draft the company's health-care wish list.* After learning what products are being offered in various industries and markets and how company employees perceive these products, an acquirer will be well on the way to designing an ideal package that fits its overall compensation approach.
4. *Balance value and cost.* When reevaluating existing health-care plan contracts or entering new ones, look to quality as well as cost. For an objective assessment of quality, you can consult groups such as the National Committee for Quality Assurance (ncqa.org), which evaluates managed care networks (especially HMOs) and grants them yearly accreditation accordingly. Some major companies insist on an NCQA seal of approval for their health plans—something not every plan can obtain.
5. *Administer and monitor your postmerger program with care.* Excellence in postmerger benefits management requires constant vigilance through both administration and oversight.

Administration means putting in place and running a system for controlling quality and cost of benefits, and for managing productivity related to wellness. How frequently are employees submitting claims? How long are they waiting to be reimbursed? Are they taking advantage of the lowest rates offered by your plan, or are they opting to use providers outside the plan at higher rates? Are they satisfied with the care being provided? When employees are off work for health or disability reasons, how long do they stay off the job and at whose expense?

Oversight means ensuring the efficiency of this process. Who is in charge of making sure your administrators are doing their work? Whether it is the human resources director, a board committee, or an outside auditor, a responsible party must be assigned to keep watch over the administration of health-care benefits, not only just after the merger but in the months and years to follow.

Employment and Advisory Security Plans

What different types of employment and advisory security plans are there?

The most common are relocation, retraining, and severance pay. (Sometimes these benefits are lumped together with health and referred to as *welfare* plans.) Most senior managers and outside directors also receive directors and officers' liability insurance—today considered more a necessity than a perquisite or even a benefit.

Obviously, pension plans in U.S. companies are subject to a good deal of federal law. What about other benefits?

Like pension plans (but to a lesser degree) health and welfare plans are also subject to the tax code and ERISA.

Aside from these laws, what others apply?

There is no real body of compensation law, but there is considerable employment law, and the pay planner must master its fundamentals. Adhering to both state and federal law, companies must pay minimum wage or better, make proper withholdings, pay proper taxes, honor contracts, avoid discriminatory practices, and so forth. Many of the laws establishing these principles are well-known and have no special relevance to the postmerger scene.

A more arcane area, yet one with clear relevance to mergers, is disclosure. Postmerger planners should be familiar with SEC pay disclosure rules, and the disclosure and trading regulations under Section 16 of the Securities Exchange Act of 1934. Pay disclosure rules were updated in 2006.[103]

Can the Internal Revenue Service or others sue a company for paying excessive compensation to executives?

Yes. It is common for the IRS to monitor corporate deductions for wages paid to employee-shareholders, especially in closely held corporations. The IRS can claim compensation is not reasonable, and force the company to recharacterize the amounts as nondeductible dividends.

There are no specific dollar amounts that courts can use as guidelines to determine the actual value of services. Determinations are made on a case-by-case basis.

What do the IRS and courts look at when determining whether compensation is reasonable?

Courts ask the following questions to determine whether compensation paid to shareholders is reasonable:

- Would an unrelated outside investor consider the compensation reasonable?
- Is the amount of compensation consistent with the amount of dividends paid?
- Is it consistent with the profit performance of the corporation?
- Was the level of compensation based on corporate profit (rather than being set in advance)?
- Is the pay consistent with pay awarded in the corporation's industry?

The more "yes" answers to these questions, the more likely it is that the pay package will withstand IRS scrutiny.

What about golden parachute payments?

The IRS defines a parachute payment as compensation that is contingent on the change of ownership or control of a corporation and paid to certain officers, shareholders, or highly compensated individuals. The part of the payment that exceeds three times the recipient's base amount is not deductible as compensation by the corporation. In addition, the recipient is assessed a 20 percent tax on the excess amount. The base amount is average annualized compensation payable for the five years prior to the change in ownership or control.

DIVESTITURES

We've spoken about letting employees go after a merger. What about letting entire company units go by selling them? How often does this happen?

It depends on how long a timeline for divestiture you are considering. Few companies divest units immediately following an acquisition (unless they are compelled by antitrust regulators to do so), but many companies divest them eventually. This process is very hard to trace over a significant period of time since companies and their units are always undergoing restructuring and renaming.

In any given year, nearly half of acquisitions occur because the sellers are divesting a company unit. Given the fact that most major companies grow both externally and internally, it would be reasonable to assume that about half of these divestitures stemmed from acquisitions—as opposed to internal growth. According to this logic, we would conclude that over time, about one-fourth of all acquisitions are eventually divested. Yet in major companies, the level appears to be lower. In a 20-year follow-up study for the 10 largest mergers of 1985, an author of this book (Lajoux) found that only a minority of the deals had ended in a divestiture even after two decades—and most of the divestitures were partial.

What kinds of divestiture are there?

There are three basic types of divestiture: sell-offs, spin-offs, and split-ups. Some of these may involve a continuing involvement—a strategy referred to as a *satellite launch.*

What is a sell-off?

A *sell-off,* by far the most common type of divestiture (and usually referred to as a *divestiture*), is the sale of one or more company units to another company—for example, when Goodrich Corporation sold its JcAIR Test Systems business to Aeroflex Incorporated in 2005.

What is a spin-off?

A *spin-off* is a series of transactions through which a company divests or "spins off" one or more units—typically a small portion of its business with some common theme—by turning them into an independent company and selling the company's shares to the investing public. Recent U.S. examples include Sara Lee Corporation's spin-off of its apparel business (as Sara Lee Branded Apparel Americas/Asia) in 2005 and the spin-offs of Abbott Laboratories' hospital products division (as Hospira) and General Electric's insurance businesses (as Genworth) in 2004.

Sometimes spin-offs precede mergers. For example, in Switzerland, Sandoz and Ciba spun off their chemicals business units—one as a taxable initial public offering, one as a tax-free demerger—before merging their pharmaceutical cores into Novartis. The slimmed-down Ciba, renaming itself as Ciba Specialty Chemicals, then grew through acquisition. For example, it bought the Korean company Daihan Swiss, completing the acquisition in November 2004.

Spun-off units may be sold in separate spin-offs or may be combined into a single spin-off. This process usually begins with a pro rata distribution of stock to shareholders in the form of a special dividend, followed by (or combined with) an initial public offering of the unit's shares.[104] A common type of spin-off is the IPO carve-out in which the company goes straight to the IPO without the distributions to stockholders. If the parent retains interest in an IPO carve-out, this may be termed a *divestiture IPO.*

What is a split-up?

A *split-up* is the breakup of a company into two or more separate companies. It is different from a sell-off or a spin-off because it involves the entire company, not just a unit or two. The most famous split-ups have involved AT&T. In 1984, AT&T broke up under order from the Department of Justice Antitrust Division, dividing into a telecommunications company (today's AT&T) and regional Bell companies (a.k.a. *Baby Bells*) to handle local calls. Then in 1996, having grown through acquisition, AT&T divided itself again—this time voluntarily—citing business complexities that outweighed the benefits of integration.[105] One of the surviving units, interestingly, followed this split-up with the spin-off of a unit, Lucent Technologies in 1996, while another unit, AT&T Wireless, after spinning off in 2001, merged into Cingular in 2005.

What usually motivates postmerger divestitures?

Reasons for divestitures vary. A unit may be sold off, spun off, or split up because it is performing poorly and the seller wants to stem its tide of losses. Conversely, it may be sold as a crown jewel because it can fetch a good price. Finally, and least appealingly, it may be tagged for sale to appease regulators—for example, the Antitrust Division of the Department of Justice or the European Union—which may set this as a condition for regulatory approval of a merger. For example, Procter & Gamble had to sell its Crest SpinBrush toothbrush business in order to win European Union antitrust approval to buy Gillette in 2005.

How can an acquirer decide what to divest and when?

Companies often purchase other firms with the intent of selling off some units eventually, holding this divestiture option open until the businesses in question develop further or until the industry consolidates to the point that it becomes a seller's market. Assigning a quantitative value to each divestiture

option can help acquirers make the decision of keeping versus selling. It can also help set an appropriate price for the purchased company. The option to divest has quantifiable value, and can be calculated easily (see Box 9-6).

BOX 9-6

Valuing the Divestiture Option

The option to divest has quantifiable value, according to Kenneth W. Smith, of Mitchell Madison in Toronto, Canada, and Alexander Triantis, professor, School of Business, University of Wisconsin–Madison.

Consider the case of PJP* a large conglomerate contemplating the acquisition of another firm with substantial real estate holdings. If the acquisition goes through, PJP plans to develop a particular piece of centrally located real estate for a distribution facility in two years. Based on its projected use, PJP has valued this piece at $20 million. Market conditions will of course cause the value of this real estate to fluctuate over the next two years. However, if the firm's business outlook turns sour and the distribution facility is projected to be unprofitable, the firm would be able to sell off this land quickly for at least $15 million.

To account for the value of this divestiture option in its valuation of the acquisition, PJP's management uses a simple two-year binomial model. Management assumes that the value of the real estate to the firm (without taking into account the divestiture option) will either appreciate by 50 percent or depreciate by 40 percent each year. In the worst-case scenario, the land would be worth only $7.2 million to the company after two years. In effect, the divestiture option established a $15 million floor for the value of the real estate after two years, thus mitigating the risk of the acquisition.

Even though the value to PJP of the real estate as a site for its distribution facility may be only $12 million at the end of the first year, it is still not optimal for the firm to sell it at that time for $15 million if it can sell it for that price at the end of the second year. The firm would prefer to retain the option to develop the land at the end of the second year should business conditions improve (at which point the value of the land as a distribution site would rise to $18 million).

The incremental value of waiting to divest amounts to $710,000 at the end of the first year. Overall, the divestiture option increases the current value of the land from $20 million to $21.77 million. In practice, of course, the resale price of an asset is not guaranteed, and more sophisticated option-pricing techniques would be required. The logic behind the valuation and exercise of a divestiture option, however, is still instructive.

*PJP is a fictional composite based on real cases.
This text appears in Alexandra Lajoux, *The Art of M&A Integration: A Guide to Merging Resources, Processes, and Responsibilities* (New York: McGraw-Hill, 2006), and is here adapted with permission from Kenneth W. Smith and Alexander J. Triantis, "Untapped Options for Creating Value in Acquisitions," *Mergers & Acquisitions,* November/December 1994, p. 22.

If a company's senior management knows that the company may divest a unit, should it disclose this to employees or wait until it makes a final decision?

In this area, silence is golden. True, employees deserve full, current, and constant information about all material matters before, during, and after the merger—but speculative information is not considered to be material. It would not be covered, for example, by the WARN Act, which requires six-month notification of employees for certain kinds of layoffs (see Box 9-7). Hypothetical information about the possible divestiture of a unit falls into the "don't ask, don't tell" category.

BOX 9-7

The WARN Act: Basic Provisions/Requirements

WARN protects workers, their families, and communities by requiring employers to provide notification 60 calendar days in advance of plant closings and mass layoffs. Advance notice gives workers and their families some transition time to adjust to the prospective loss of employment, to seek and obtain other jobs, and, if necessary, to enter skill training or retraining that will allow these workers to compete successfully in the job market. WARN also provides for notice to state dislocated worker units so that they can promptly offer dislocated worker assistance.

A covered plant closing occurs when a facility or operating unit is shut down for more than six months, or when 50 or more employees lose their jobs during any 30-day period at a single site of employment. A covered mass layoff occurs when a layoff of six months or longer affects either 500 or more workers or at least 33 percent of the employer's workforce when the layoff affects between 50 and 499 workers. The number of affected workers is the total number laid off during a 30-day (or in some cases 90-day) period.

WARN does not apply to closure of temporary facilities, or the completion of an activity when the workers were hired only for the duration of that activity. WARN also provides for less than 60 days' notice when the layoffs resulted from closure of a faltering company, unforeseeable business circumstances, or a natural disaster.

Employee Rights

Workers or their representatives, and units of local government may bring individual or class action suits. U.S. district courts enforce WARN requirements. The court may allow reasonable attorneys' fees as part of any final judgment.

Continued

Compliance Assistance Available

For general information about WARN, a fact sheet and employer's guide are available from the Employment and Training Administration's Web site.

Specific requirements of WARN may be found in the act itself, Public Law 100-379 (29 USC 2101 et seq.). The Department published final regulations on April 20, 1989, in the *Federal Register,* pages 16042 to 16070 (Vol. 54, No. 75). The regulations appear at 20 CFR Part 639. A copy of the act and regulations may be obtained from the U.S. Department of Labor, Employment and Training Administration (ETA), Office of Adult Services, Division of Adults and Dislocated Workers, Room C-5325, 200 Constitution Avenue NW, Washington, D.C. 20210.

For additional assistance, contact the ETA help line at 1-877-US-2JOBS.

Penalties/Sanctions

An employer who violates the WARN provisions is liable to each employee for an amount equal to back pay and benefits for the period of the violation, up to 60 days. This may be reduced by the period of any notice that was given, and any voluntary payments that the employer made to the employee.

An employer who fails to provide the required notice to the unit of local government is subject to a civil penalty not to exceed $500 for each day of violation. The employer may avoid this penalty by satisfying the liability to each employee within three weeks after the closing or layoff.

Relation to State, Local, and Other Federal Laws

WARN does not preempt any other federal, state, or local law, or any employer/employee agreement that requires other notification or benefit. Rather, the rights provided by WARN supplement those provided by other federal, state, or local laws.

Source: U.S. Department of Labor, *The Employment Law Guide.* For the full text of the WARN Act, see Public Law 100-379 (29 USC 2101 et seq. Text can be found at Cornell University's Legal Information Institute, www4.law.cornell.edu/uscode/html/uscode29/usc_sec_29_00002101——000-.html.

If managers must address this issue (to address information leaks, for example), here are some principles to keep in mind if divestiture plans are in the making:

- *Honesty.* When asked, never deny (a "No comment" is sufficient).
- *Discretion.* Don't volunteer nonessential information.

- *Utility.* Keep your communications useful. For example, if a divestiture decision hinges on a unit's productivity or profitability, these factors should be flagged for employees' urgent attention.

If senior management knows that it will divest a unit, when should it tell employees, and how much should it tell them?

The principles of honesty, discretion, and utility apply here as well, but *not* the rule of silence. Once a plan is certain, silence is *not* golden. Immediate, complete, and frequent disclosure is the rule here.

Should all companies with diverse units consider divestitures?

Not necessarily. In many cases, when a unit separates from a nonintegrating parent, both enjoy improved performance. But a company with diverse products or services can achieve strong share performance if it can convince investors it has a unified strategy. General Electric is a good example of this type of company.

Wall Street does not pay premiums for GE spin-offs because GE is adding value to its units. The lackluster response to GE's spin-off of Genworth Financial illustrated this point.

Can an acquirer simply divest at will? What kinds of restrictions might come into play here?

As the new owner of an acquired company, the acquirer has a great deal of flexibility in how it integrates or separates from the resources it has acquired. Certain restrictions can and often do apply, however. The most common restrictions stem from contracts signed prior to the merger by either the seller or the buyer.

In terms of human resources, the selling company may have signed a labor agreement limiting or penalizing layoffs, and this agreement may extend to a future change of control. In terms of physical assets, the seller may have pledged not to sell assets used as collateral. Other restrictions stem from

federal or state law protecting the interests of various stakeholder groups. Ideally, all of these restrictions will have been faced and resolved during the due diligence process prior to closing.

CONCLUDING COMMENTS

Whether an acquirer keeps all the assets of a company or divests some of them, some responsibilities do remain ethically and legally, and these must be carefully weighed. Research shows that social responsibility benefits all stakeholders, including shareholders, over time.[106]

APPENDIX 9A

Sample Postmerger Press Release Highlighting Strategic Motivation

News Release

Company A Buys Customers and Networks of Company B

Acquisition of Customers and Networks Expand Service Area, Solidify Acquirer's Market Strength

City, Date. —Company A, a provider of local, long-distance, and Internet services for small and midsize businesses, today announced that it has signed an agreement to purchase Company B for $213 million in cash plus the assumption of approximately $4 million in capital lease obligations.

Under the terms of the agreement, A will purchase B, including its assets and customers, from the Owner. The parties expect to complete the transaction in the third quarter of 2007 upon obtaining necessary governmental and other approvals.

Acquisition Solidifies Market Strength

With the acquisition of Company B's network assets and customer base, Company A will become the most cash profitable and one of the largest competitive local exchange carriers (CLECs) in the West. Combined, the companies will have more than $300 million in annual revenue and more than $100 million in pro forma 2007 EBITDA, before any merger synergies. *Approximately 60 percent of the two companies' revenues derive from geographic markets and networks that overlap, creating the opportunity*

for significant network efficiencies and synergies. The acquisition will increase the number of Company A's metropolitan service areas from 18 to 23 and expand the number of states in which it serves from five to eight.

Most important, the combined companies will enjoy important strategic advantages resulting from Company B's eight-market, 2,200-route-mile (160,000 fiber miles) metropolitan area network, with direct fiber access into over 580 major commercial buildings. Many other competitive local exchange carriers are scrambling to find network alternatives in response to recent FCC rules that increase the cost of leasing network. Company A, by acquiring B's metropolitan area network, becomes one of the first to insulate itself from this unpredictable landscape of telecom regulation.

"These robust metropolitan fiber networks will substantially *increase our operating strength and provide a meaningful and sustainable competitive cost advantage over other local carriers,*" said John Doe, chief executive officer of Company A.

In addition to the metropolitan area networks, Company A will also own and operate B's unique long haul network—one of the largest of its kind in its region. The value of this network is evidenced by a blue-chip list of other carriers that lease connectivity from Company B to access their customers.

"We are eager to enhance this network and strengthen our relationships with those that rely on the connectivity we provide," added Doe.

Benefits to Customers

"I'm delighted for our customers," continued Doe. "*We will be offering a stronger regional and local telecommunications network alternative, and we will be better equipped to offer unique and powerful high-bandwidth data products, which are increasingly important to the business customers we serve.*"

Upon completing the integration, Company A *will expand the product sets and services currently offered by Company B to include those offered by A, including those that are tailored to the smaller business customer.* Doing so will increase the addressable markets in the important new service areas that come with the acquisition. "We look forward to introducing Company

B customers to Company A's brand of service, where we staff customer service locally in each major market we serve," said Doe.

"This is an excellent opportunity for Company B employees and customers," said Bob Smith, executive vice president and chief operating officer of the Company B. "Company A is a carrier we respect, with a proven track record of success."

Note: This press release is modeled on an actual press release of a merger that occurred in 2006. For additional samples of press releases, see Alexandra Lajoux, *The Art of M&A Integration: A Guide to Merging Resources, Processes, and Responsibilities,* second edition (New York: McGraw-Hill, 2006), Appendix E, "Sample Press Releases," app. 479–490.

APPENDIX 9B

Sample "Assets" Checklist of Resources, Processes, and Responsibilities[1]

Every corporation is composed of valuable resources, processes, and responsibilities. Following the acquisition of a company, it is important to make sure that management does not neglect any of these "assets" (using the term broadly). Every company will have its own list of assets, but this checklist may be helpful.

PHYSICAL ASSETS

- Equipment*[2] (including computer hardware and software)
  - Office equipment
  - Plant equipment
- Inventory*
  - Finished
  - Work-in-process
- Land*
- Materials
- Mines
  - Production, reserves, locations, development
  - Maps
- Real estate
  - Branch buildings*
  - Factory buildings*
  - Construction in progress
- Real estate—other*

FINANCIAL ASSETS

From Balance Sheet

- Financial Assets*
  - Cash
  - Investment securities
  - Accounts receivable
  - Prepaid income taxes
  - Other prepaid expenses
  - Deferred charges
  - Other financial assets
    - Goodwill
    - Long-term receivables
    - Investments in affiliates
    - Goodwill from previous acquisitions
    - *For banks*, debt owed to bank via outstanding loans

For other common balance sheet assets, such as Property, Plant, and Equipment, see "Physical Assets."

- Financial Liabilities and Equity*
  - Financial Liabilities
    - Accounts payable
    - Debt
    - *For banks,* cash deposits held by bank and owed by bank to customers
  - Financial Equity*
    - Common stock outstanding
    - Preferred stock outstanding
    - Retained earnings

From Income Statement

- Gross revenues
  - Growth trend
- Net revenues
  - Growth trend

INTELLECTUAL ASSETS

- Contracts (if favorable—otherwise, a liability)
  - Employment agreements
  - Franchise agreements
  - No compete agreements

- Culture
  - Reporting relationships (real versus formal)
  - Policies and procedures
  - Any other cultural factor not covered elsewhere in this taxonomy
- Marketing intangibles
  - Company name recognition
  - Brand name recognition
  - Service mark (right to use company signage)
  - Trademark (right to use company name)
- Production intangibles
  - Copyrights
  - Favorable supplier contracts
  - Patents
  - Product design
  - Product quality
  - Production costs
  - Production speed
  - Production standards
  - Software
  - Trade secrets

HUMAN ASSETS (PEOPLE)

- Knowledge, experience, competencies, and leadership and/or teamwork ability of each of the following individuals:
  - Directors (including chairman if separate)
  - CEO/COO/president
  - Other senior managers
  - Sales force
  - Other employees

See also "HR function" under "Organizational Assets."

ORGANIZATIONAL ASSETS (ACTIVITIES)

- Quality of the "infrastructure" described here
  - Contracts and commitments
    - Relating to all human capital and also to external relations

If a contract is unfavorable and/or broken, it can turn from an asset into a liability.

Primary Functions

- Management systems
  - Processes for design, production, and supply
  - Channels for distribution
- Inbound logistics (for manufacturing; see also "Purchasing" under "Support Functions")
  - Receiving
  - Storing
  - Material handling
  - Warehousing
  - Inventory control
- Outbound logistics
  - Distribution
- Manufacturing function
- Quality control policies applied to production R&D function
  - Laboratory notebooks
  - Invention disclosure forms
- Sales function
  - Established territories

Support Functions

- Accounting function
  - Bookkeeping
  - Treasury
  - Internal auditing
- Communications/marketing function(s)
  - Marketing
  - Public relations
- Corporate administrative function
  - Headquarters administration
- Facilities function
  - Facilities management
- Finance function
  - Financing (issuing equity, borrowing debt)
  - Management of funds (opening/closing deposits; lock box)

- HR function
  - Rewarding and giving incentives for performance
    - Base pay
    - Bonus pay
    - Pensions
    - Benefits
    - Special pay arrangements
    - Recognition programs (awards and honors)
  - Retention (retaining key qualities: relevant knowledge, experience, competencies)
  - Recruitment (seeking relevant knowledge, experience, competencies)
  - Termination/retirement (see also Compensation)
  - Performance management
  - Career development
  - Succession planning
  - Training
- IT function
  - Hardware, software, and systems for internal communications
    - E-mail
    - Telephones (LAN, WAN, routers, switches)
- Legal function
  - Compliance programs, including internal code of conduct (see also "Regulatory relations" in "External Relations")
  - Purchasing function—Policies pertaining to vendor relations
  - Internal Financial Controls (see COSO)
- Control environment*
  - Appropriateness of the entity's organizational structure and its ability to provide the necessary information to manage its activities
  - Adequacy of definition of key managers' responsibilities and their understanding of these responsibilities
  - Adequacy of knowledge and experience of key managers in light of their responsibilities
  - Appropriateness of reporting relationships
  - Extent to which modifications to the structure are made in light of changed conditions
  - Sufficiency of numbers of employees, particularly in management and supervisory capacity

Risk assessment
Control activities
Information/communication re finances
Monitoring

Mission, Vision, and Strategy

Mission statement
Vision statement
Strategic plan document

EXTERNAL RELATIONSHIP ASSETS

If any of these has a corresponding function, see that function under Organizational Assets.

- Customer relations
  - Reputation of brands
  - Reputation of service
  - Major customers (required under SAS131)
  - Major geographic areas (SAS131)
- Shareholder relations
  - Reputation for increasing market share/paying dividends
  - Stability of holdings by shareholders
- Bondholder relations
  - Reputation for repaying debt instruments
  - Bond rating
- Lender relations
  - Rate of interest charged by lenders
  - Credit rating
- Supplier relations
  - Favorable contracts (see also "Production intangibles")
- Community relations
  - Community programs
- Public relations
  - Reputation of company name re public issues—see also "Company name recognition" under "Intellectual Assets"
  - Regulatory Relations Lobbying (if any)—see also "Legal function" under "Support Functions"
- History of fulfilling contracts and commitments

NOTES

1 This list can be used as column D of a spreadsheet with these columns:

Column A—**Phase 1: Strategy**
Subphases:
- Planning
- Search
- Valuation
- Selection

Column B—**Phase 2: Transaction**
Subphases (these start during the Strategy phase and extend through the Transaction phase)
- Due Diligence
- Financing
- Negotiation
- Tax Structuring
- Closing

Column C—**Phase 3: Integration**
Subphases (these start during the Transaction phase and extend through the Integration phase)
- Integration Planning
- Integration Communication
- Integration Implementation

Column D—**Assets to Track during All Phases**
For more on this subject, see Chapter 1 and Appendix A.

2 Items with an asterisk appear on the balance sheet. Items without an asterisk do not appear on the balance sheet or any other traditional financial statement. However, they are usually discussed in the Management Discussion and Analysis section of the 10-K report, along with balance sheet items, especially if they are at risk.

APPENDIX 9C

Integration Planning Worksheet

The following two pages provide a simple template for applying project management principles to acquisition integration.

Key Business Process:						
Primary Integration Activities*	Priority	Tasks/Subtasks	Task Owner	Prerequisites	Required Tactical Data	Relevant Strategic Questions
	• Day 1	1.				
	• 100 days	2.				
	• 6 months	3.				
	• Year 1	4.				
	• Eventually	5.				
		6				
		7				
		8				
		9.				
		10.				
	• Day 1	1.				
	• 100 days	2.				
	• 6 months	3.				
	• Year 1	4.				

(Continued)

Key Business Process:						
Primary Integration Activities*	Priority	Tasks/Subtasks	Task Owner	Prerequisites	Required Tactical Data	Relevant Strategic Questions
	• Eventually	5.				
		6.				
		7.				
		8.				
		9.				
		10.				
	• Day 1 • 100 days • 6 months • Year 1 • Eventually	1.				
		2.				
		3.				
		4.				
		5.				
		6.				
		7.				
		8.				
		9.				
		10.				

APPENDIX 9D

Integration Timeline from a Midsized Acquirer

Sample Mission, Team, and Timeline for Acquisition

Team Mission

To facilitate a smooth assimilation of employees of newly acquired organizations into Company XY and to affect a smooth transition of their functional transactions into XY business plans, objectives, and strategies.

Source: Midsized company in Florida. Names fictional. Used with permission 2005.

Acquisition Integration Team

• Cross-Functional Team Members

- Mary Davis ≫ Payroll/Benefits Integration and Organizational Charts
- Sharon Peters and PR firm ≫ Marketing Communications
- Alma Rivers

  ≫Computer Requirements/Voice data interface/eConnectivity
- Jeff Coates

  ≫ISO 9000/Customer Service/Contracts/Facility/Environmental
- Sam Wilson/Tony Robins

  ≫Transaction Integration and Sales Expectations
- Bob Smith

  ≫Financial Institution Changes
- Felix Hernandez

  ≫Web Site Integration and Transaction Modeling
- Susan Ivory

  ≫Integration Progress Tracking/Single Point Contact for Acquirees

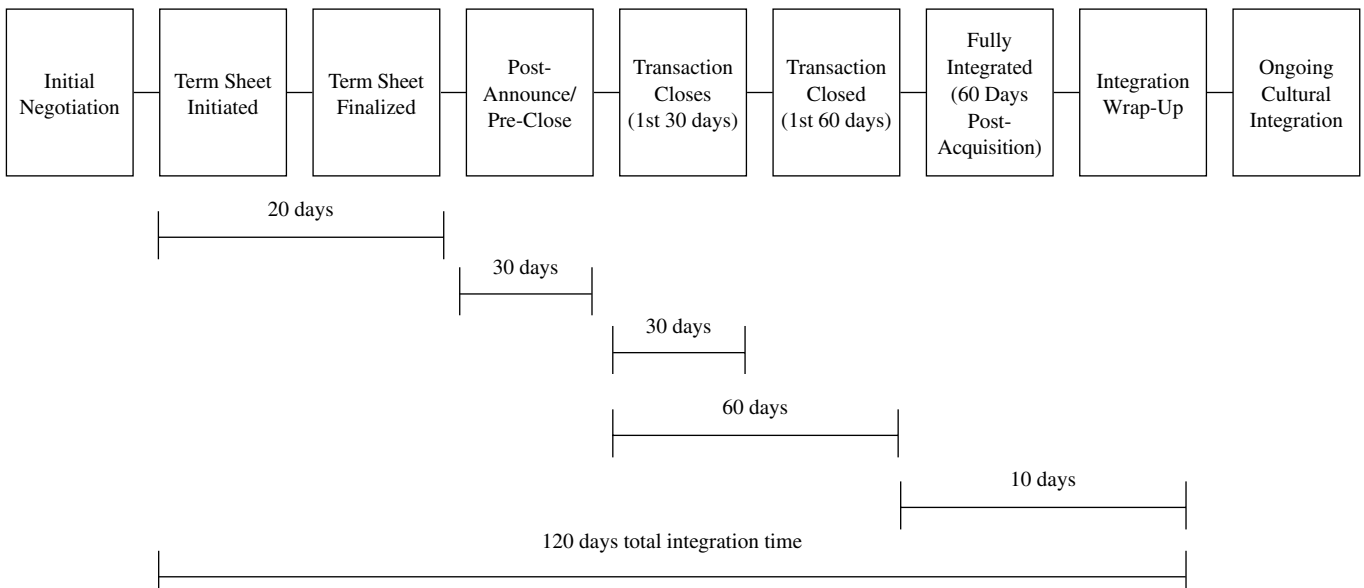
Acquisition Integration Team

- Roadblocks*
  - Confusing, duplicate communication with acquirees
    - Solvable through good internal processes
  - Firedrills at time of acquisition for employee integration
    - Solvable through closer communication with deal makers
  - Connectivity issues - email and internet accessibility
    - Solvable through synchronizing Rivers/Wilson/Ivory on timing
  - Cultural Integration
    - Solvable through more resources in HR and continued good communication from Sales Management
  - Development of overall company database
    - Need overall systems to facilitate faster access to customer community
  - Communication of requiremeents/sales goals for each facility to implementation team
    - Responsiveness to needs

*Notes from team meeting held to plan integration.

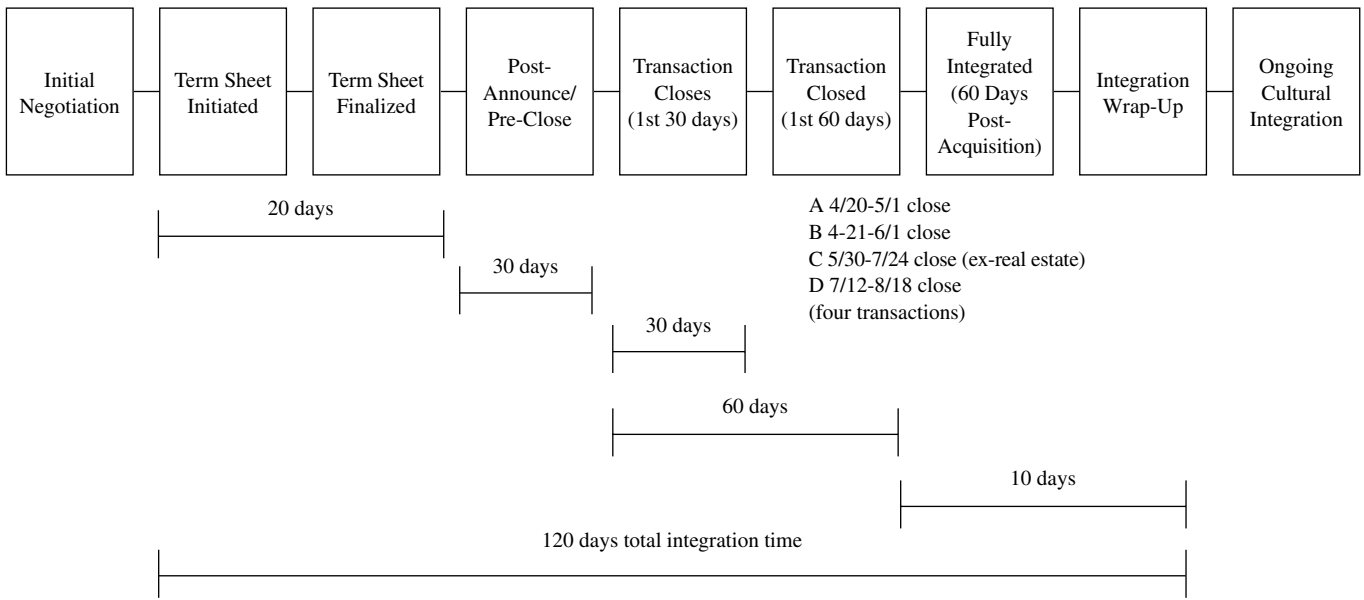
Acquisition Integration Process Timing

Closing Timeline

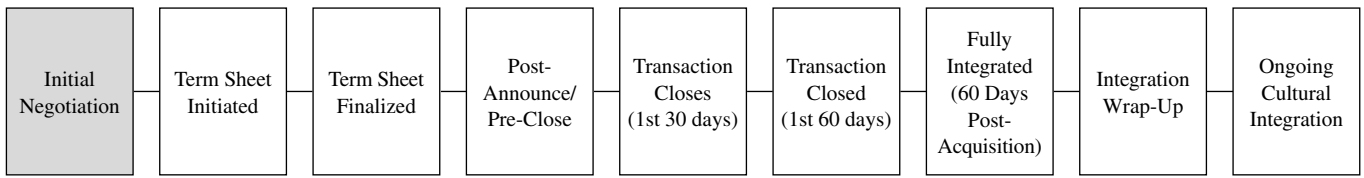


Acquisition Integration Process Timeline

Closing Timeline



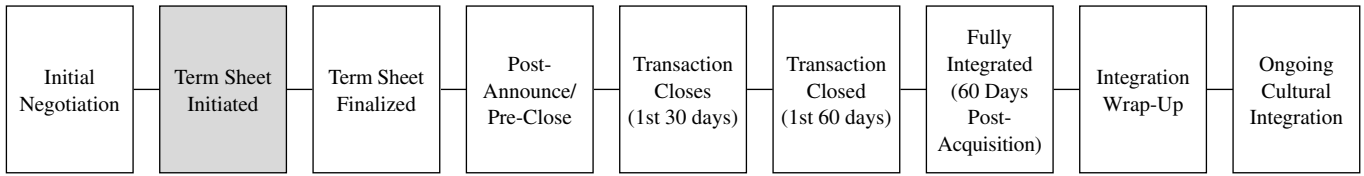
Acquisition Closing Timeline



Correlated Integration Activities

During Initial Negotiation Process:	Comments:
•Notification from James to Ivory and Davis (on alert)	-A - Complete -B - Complete -C - Complete -D - Complete

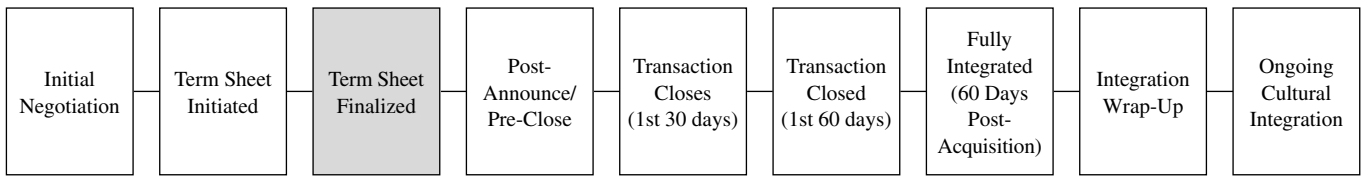
Acquisition Closing Timeline



Correlated Integration Activities

During Term Sheet Initiation:	Comments:
• James Notifies Ivory and Davis	-Complete through D
• HR Information Collected (Current Employee and Payroll Info) (Davis)	-Open: D
• Notify Acquirees of Initial On Site Orientation (Davis)	-Open: C and D
• Marketing Communications prepares press release and customer letters (Peters)	-Open: C and D
• IT addresses internet connectivity and orders circuits required (Rivers)	-See Attached Plan
• Ivory updates new acquisition contact sheet and distributes to Acquisition Team and Integration Team	-Open: Add C and D
• Sales prepares profile on new facility to Integration and Acq. Teams	-Open: A, B, C, D

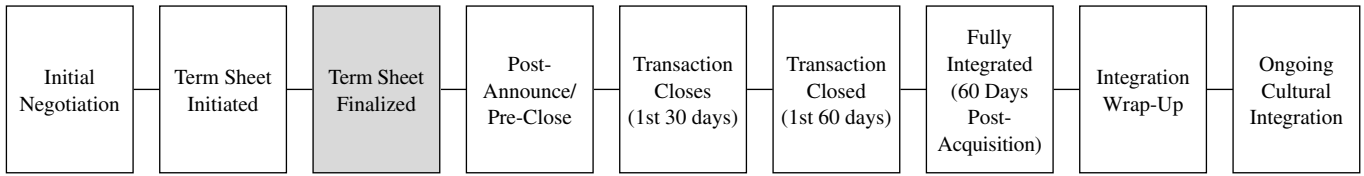
Acquisition Closing Timeline



Correlated Integration Activities

Once Term Sheet is finalized:	Comments:
• Announcement date determined by James and communicated to Ivory/Davis	-Open: C, D
• Conference Call scheduled with Newly-Acquired employees (Davis)	-Open: C,D
• Internal announcement from Management to current employees regarding acquisition and significance (Davis)	-Open: C,D
• Finalize dates for initial on site employee orientation (Davis)	-Open: C,D
• Marketing Communications send letter to current and newly expanded customer database (Peters and PR firm)	-Open: B,C,D
• Marketing Communications releases announcement to public (Peters and PR firm)	-Open: B,C,D

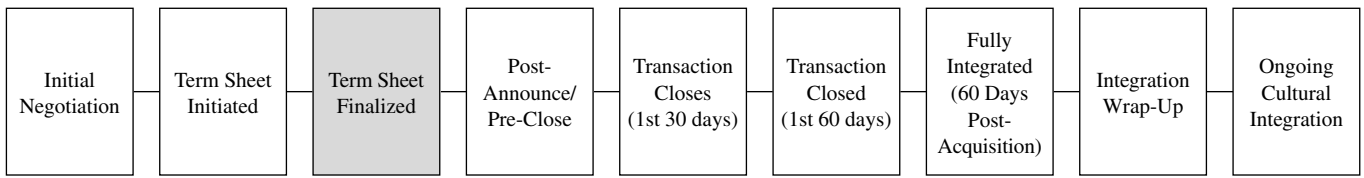
Acquisition Closing Timeline



Correlated Integration Activities

Once Term Sheet is finalized:	Comments:
• Sales provides Requirements for Connectivity to IT (City/State/Zip/Contact Name/Phone #) - (Wilson)	-Open: ALL
• Finance orients acquirees on financial institution process, timing • And logo use for transactions (James/Smith)	Open: B,C,D.
• Integration Handbook to new acquirees (Ivory/Davis)	Open: ALL
• Ivory established as primary integration contact	Open: D
• Sales provides IT with new employee name, job title, e-mail access, laptop or desktop PC through new hire form completion. IT places order appropriately (Wilson)	Open: ALL

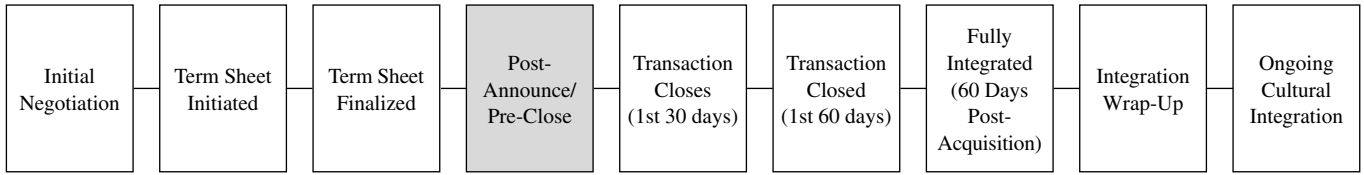
Acquisition Closing Timeline



Correlated Integration Activities

Once Term Sheet is finalized:	Comments:
• IT sets up training dates for new employees for computer/ e-mail orientation (Rivers)	Open: ALL
• Ivory updates facility chart and distributes to acquisition and integration Teams	Open: C,D

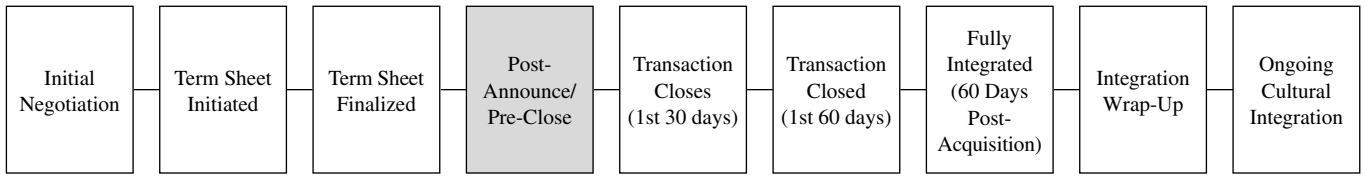
Acquisition Closing Timeline



Correlated Integration Activities

During Post Announcement/Pre-Close Phase:	Comments:
• Conduct initial on site employee meeting (Davis, Ivory)	Open: C,D
• Present XY business strategy, significance of new acquiree to strategy, key contacts, organizational charts and XY locations (distribute facilities list to all employees) (Wilson, Davis, Ivory)	Open: D Open: ALL
• Distribute/Discuss Assimilation Handbook internally (Davis, Ivory)	Open: ALL
• Conduct Acquiree Principal "Expectation Meeting" in Florida (Sales/Forecasts/Integration Process/Org Chart/Marketing Communications- logo/identity manual) - (Wilson/Ivory)	Open: C,D
• Letterhead/Business cards ordered (Partridge)	Open: B,C,D

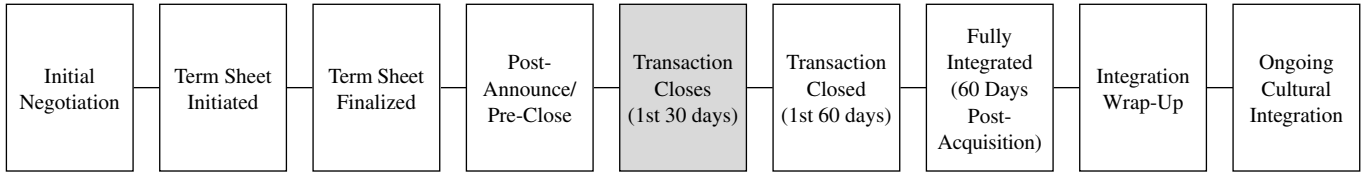
Acquisition Closing Timeline



Correlated Integration Activities

During Post Announcement/Pre-Close Phase:	Comments:
• Determine Customer Service Call Routing with Principals and determine plan (Coates)	Open: ALL
• Physical Facility plan (including signage) initiated including ISO 9000 regulations and environmental concerns (Coates)	Open: ALL
• Determine Contracts Administration plan (Coates)	Open: ALL
• Hernandez evaluates transactions and makes recommendations to Robins	Open: D
• Marketing Assessments for demographics initiated (Hernandez)	Open: ALL
• Travis Robins develops plan for transaction integration	Open: C,D

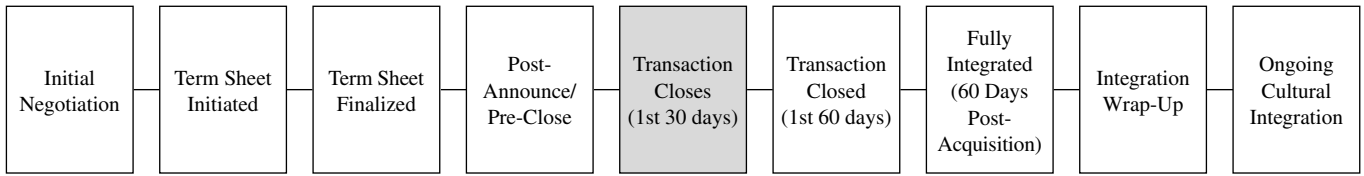
Acquisition Closing Timeline



Correlated Integration Activities

Once Transaction is CLOSED (1st 30 days):	Comments:
• Establish bank accounts for acquiree (Smith)	Open: C,D
• Transaction Integration Implemented (Sales, Robins)	Open: C,D
• Letterhead issued (Partridge)	Open: C,D
• Business cards issued (Peters)	Open: C,D
• Logo Changes instituted (all paperwork) - (Peters/Smith)	Open: ALL

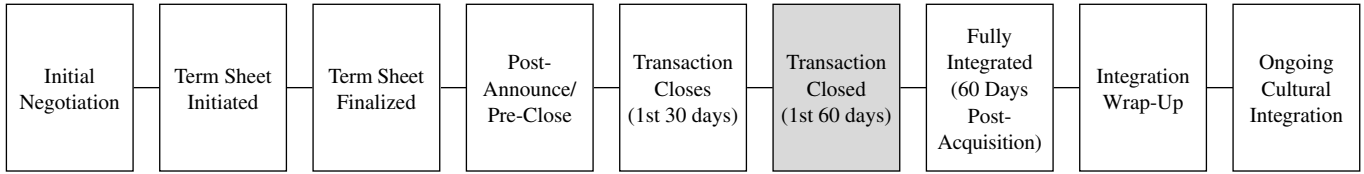
Acquisition Closing Timeline



Correlated Integration Activities

Once Transaction is CLOSED (1st 30 days):	Comments:
• Phone Answering Training initiated for all acquirees (Coates)	Open: ALL
• New Contract Administration Plan becomes effective (Coates)	Open: ALL
• Physical Structure changes begin and ISO 9000 process becomes effective (Coates)	Open: ALL
• Computers Installed and e-mail training conducted for on site employees (Rivers)	Open: ALL
• Voice Mail additions established/ training for newly acquired employees (Coates)	Open: ALL

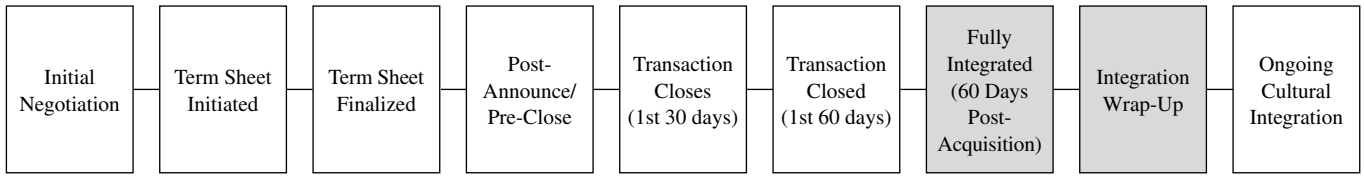
Acquisition Closing Timeline



Correlated Integration Activities

Once Transaction is CLOSED (1st 60 days):	Comments:
• Registration and Insurance Evaluation/Compliance (James)	Open: C,D
• Building • Vehicles	
• P&S Notification (James)	Open: ?
• Web Site Integration Addressed (Hernandez)	Open: ?
• Acquiree employee training on (Wilson/Ivory)	Open: ALL
• XY Products • XY Business Plan	

Acquisition Closing Timeline



Correlated Integration Activities

Once Fully Integrated:	Comments:
• Close Out Meeting scheduled to Review Process with Acquiree Principal in Florida (Wilson/Ivory)	Open: ALL
• Distribute Feedback Surveys on Integration or other Concerns to New Acquirees (Wilson/Ivory)	Open: ALL
• Collect, collate and distribute results and open issues to Sales, Executive Management and Acquiree Principal (Wilson/Ivory)	Open: ALL

APPENDIX 9E

Pairwise Comparison

During integration, it is important to prioritize actions. One way to do this is to consider proposed actions in a series of pairs, picking the most important one, pair by pair, and in that way creating a ranking. The following primer on pairwise comparison (using a stepladder as an example) can be useful.

Introduction

Pairwise comparison is a kind of divide-and-conquer problem-solving method. It allows one to determine the relative order (ranking) of a group of items. This is often used as part of a process of assigning weights to criteria in design concept development.

Consider the evaluation of a stepladder. In that problem, the following criteria were deemed pertinent:

- Functionality
- Durability
- Quality
- Affordability
- Fabricability
- Usability
- Maintainability
- Safety
- Marketability

In order to weigh these criteria, we could simply tackle the problem all at once and, for example, discuss what weights should be assigned to each criterion. This can be very difficult; it can become an insurmountable task in more complex problems where there may be dozens of criteria. An alternative is to divide the problem of assigning weights into two parts:

1. Determine *qualitatively* which criteria are more important (i.e., establish a ranking of the criteria).
2. Assign each criterion a quantitative weight so that the qualitative ranking is satisfied.

Pairwise comparison can be used for Step 1. Here's how it would work.

Step 1: Identify the Criteria to be Ranked

This is already done. Typically, the criteria can be derived from the functional requirements and product characteristics (PCs) determined during the development of a product design specification (PDS). Assuming you keep the PDS very handy while you evaluate concepts, you can just use the main PCs as the criteria, as we've done here.

Step 2: Arrange the Criteria in a $N \times N$ Matrix

For the ladder design problem, the matrix would look like Figure 9-E.1. Obviously, we need only one triangle of the matrix. That is, since the rows and columns contain exactly the same things in the same order, one triangle of the matrix will contain exactly the same cells as the other triangle.

Furthermore, the diagonal itself does not matter—it simply doesn't make sense to consider how important one criterion is with respect to itself! So now we have Figure 9-E.2.

FIGURE 9-E.1

Setting up the Pairwise Comparison Matrix

		A	B	C	D	E	F	G	H	I
Functionality	A									
Durability	B									
Quality	C									
Affordability	D									
Fabricability	E									
Usability	F									
Maintainability	G									
Safety	H									
Marketability	I									

FIGURE 9-E.2

Identifying the Useful Part of the Matrix

		A	B	C	D	E	F	G	H	I
Functionality	A	–								
Durability	B	–	–							
Quality	C	–	–	–						
Affordability	D	–	–	–	–					
Fabricability	E	–	–	–	–	–				
Usability	F	–	–	–	–	–	–			
Maintainability	G	–	–	–	–	–	–	–		
Safety	H	–	–	–	–	–	–	–	–	
Marketability	I	–	–	–	–	–	–	–	–	–

Step 3: Compare Pairs of Items

For each row, consider the item in the row with respect to each item in the rest of the row. In the example, we begin with functionality versus durability. Which is more important?

In the corresponding cell of the matrix, we put the letter that we consider most important in each pairwise comparison. If we really, really think the two criteria are equally important, we put both letters in the cell. There are, of course, other ways to fill the cells. The point is that whatever way is chosen, it must represent which of the items is more important.

Note that the comparison is *pairwise*—we completely ignore all other criteria.

Say we determine that functionality is more important than durability. We would put an *A* in cell (2,4) of the matrix. We continue doing this until all of

the first row is complete. We then proceed to the second row and repeat until the upper triangle of the matrix is filled. We could end up with Figure 9-E.3.

Note the double letters. We have used this convention to indicate that there is no difference in importance between the items being compared.

Step 4: Create the Ranking of Items

Now we simply create an ordered list of the items, ranked by the number of cells containing their flag letter. This leads to:

1. Safety (7)
2. Usability (6)
3. Affordability (6)
4. Quality (5)

FIGURE 9-E.3

Filling the Useful Part of the Matrix

		A	B	C	D	E	F	G	H	I
Functionality	A	–	A	C	D	A	F	A	AH	I
Durability	B	–	–	C	D	B	B	B	H	BI
Quality	C	–	–	–	D	C	F	C	H	C
Affordability	D	–	–	–	–	D	F	D	D	I
Fabricability	E	–	–	–	–	–	F	E	H	E
Usability	F	–	–	–	–	–	–	F	FH	I
Maintainability	G	–	–	–	–	–	–	–	H	I
Safety	H	–	–	–	–	–	–	–	–	H
Marketability	I	–	–	–	–	–	–	–	–	–

5. Marketability (5)
6. Functionality (4)
7. Durability (4)
8. Fabricability (2)
9. Maintainability (0)

Conclusion

We now have a ranked list of the relative importance of the various criteria. Given this, we can now begin considering the actual weights we wish to attach. This is the extent of the pairwise comparison technique, but we can take this particular problem one step further and consider how we could assign the actual weights.

Consider the constraints on the problem of assigning weights.

1. The total of all the weights must be 100 percent.
2. The weights must obey the qualitative ranking given above.

We can either begin to wrestle with the problem in a strictly ad hoc manner, or we can try to structure our solution. It's inevitable that some iteration will be required, so there's no point in looking for a method that will give us actual weights in one pass.

However, we can try to set up an initial set of values that does satisfy the constraints, and then tweak the values until they are satisfactory to all stakeholders.

One very easy way to get that initial set of values is to assume a linear proportion between all the weights and solve the following equation:

$$100 = 7x + 6x + 6x + 5x + 5x + 4x + 4x + 2x + 0x$$

Therefore, $x = 2.56$ (approx.), where the coefficients are the number of occurrences of each criterion in the matrix. This leads to:

- Safety: $7x = 18$
- Usability and affordability: $6x = 15$
- Quality and marketability: $5x = 13$
- Functionality and durability: $4x = 10$
- Fabricability: $2x = 5$
- Maintainability: $0x = 1$

Note: The "1" for maintainability arose by gathering all the round-off from the other calculations.

There are obviously problems with this. For example, the lowest-ranked item in a pairwise comparison will, strictly speaking *always* end up with zero importance. This means that we cannot assume that zero importance implies we can omit it altogether. If, for example, we omit handling because it ranked zero, and redo the pairwise comparison, we will then find that readability and portability will now rank zero. This would quickly lead to a set of *no* criteria at all.

Still, there is now a baseline from which meaningful discussion can ensue. It is noted that we can get the actual weights shown in the concept evaluation matrix by taking a few points away from each criterion and giving them to the handling criterion. This may be enough.

Whatever is done, however, it is *essential that all stakeholders in the project agree to the actual weights.*

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NOTES

1. For example, when it bought DPI in 2006, Galapagos emphasized one item when it announced, "We are extremely pleased that we will be able to add the excellent *drug discovery activities* of DPI to our BioFocus division" (emphasis added). The press release continued with broader language. "We believe that DPI's capabilities will substantially strengthen our technology, product offering and customer base." Source: Press release of June 13, 2006. www.glpg.com/press/2006/13.htm.
2. The merger "will benefit customers through new services and expanded service capabilities. It will strengthen Cingular through unified ownership and a single brand," and offer "greater financial, technical, research and development, network and marketing resources," states AT&T Chairman and CEO Edward E. Whitacre Jr. in the March 5, 2006, press release, posted at http://att.sbc.com.
3. See Alexandra Reed Lajoux, *The Art of M&A Integration: A Guide to Resources, Processes, and Responsibilities,* Second Edition (New York: McGraw-Hill, 2006).
4. As explained in Chapter 1, *acquisition* describes any transfer of ownership, whereas *merger* describes a transfer of ownership when one entity legally

disappears into the other, or when both entities disappear into a third entity created for the purpose of merger. These terms describe the nature of the transaction that brings two companies together, not the nature of their subsequent "afterlife" together. In the more common, nontechnical sense, the term *merger* is used generally to describe that afterlife. In this sense, *merger* refers to any acquisition consummated with a plan for integration of significant resources, operations, and/or technology. So, for example, Kmart's union with Sears was structured as an acquisition, as Kmart bought Sears, but the companies referred to it as a merger. The Web site for the new parent company, Searsholding.com, says: "The *merger* of Kmart and Sears as Sears Holdings Corporation closed on March 24, 2005, following affirmative shareholder votes of both companies." (emphasis added)

5. Willard T. Carlton, Robert S. Harris, and John F. Stewart, *An Empircal Study of Merger Motives,* completed under an interagency agreement with the Federal Trade Commission, this is one of the earliest studies ever done on why companies merge.
6. The authors gratefully acknowledge J. Fred Weston, Cordner Professor of Money and Financial Markets, University of California–Los Angeles, as the source of this list.
7. This is where the so-called *q ratio* comes in. The q ratio is the market value of shares divided by the replacement costs of the assets represented by the shares. Of all motives, this may be the most fundamental. (Noted management author Peter Drucker, in his classic essay "The Five Rules of Successful Acquisitions," *Wall Street Journal,* October 15, 1981, boiled M&A motives down to this one: a flight out of money into assets.)
8. For example, to avoid the penalty of depreciation on lower historical costs during a period of inflation, a company might make an acquisition in order to achieve a stepped-up basis for depreciable assets.
9. Jack Sweeney, "A Firm for All Reasons," *Consulting Magazine,* September 2004.
10. "Clusters and Nuggets: Mastering Postmerger IT Integration," The Boston Consulting Group, July 1, 2004 (white paper).
11. Robert F. Bruner, "Does M&A Pay," *Applied Mergers & Acquisitions* (New York: McGraw-Hill, 2004), pp. 30–66. See also *Deals From Hell: M&A Lessons That Rise Above the Ashes* (John Wiley & Sons, 2005).
12. Federal Trade Commission 2003 and Bureau of Economic Analysis. www.ftc.gov/be/rt/businessreviewpaper.pdf; National Bureau of Economic Research (NBER) Working Paper No. 9532; Accenture (for 2005 Accenture Study).
13. This press release language is quoted from an actual press release that appears in Appendix 9A.

14. The average size of merger premiums has been declining in recent years, according to Securities Data Corporation, Newark, New Jersey. This could indicate that acquirers are improving their ability to price transactions.

15. This imperative reveals the importance of obtaining objective fairness opinions. The National Association of Securities Dealers, parent of the Nasdaq Stock Market, has proposed Rule 2290, which would require member firms on the exchange to disclose whether they will receive a fee contingent on completion of the transaction. Comments were due February 27, 2007, and were being analyzed at press time.

16. Over the past decade and a half (1990–2005), as corporate cash reserves have grown while equity values have stayed flat, more companies have been paying in cash, according to Securities Data Corporation, Newark, New Jersey.

17. In a joint press release dated May 11, 2005, the companies announced the new name as a harbinger of the future. "Our new name will reflect that our merger has created a new company," said Wood. "We will not be Crompton. We will not be Great Lakes. We will be the Chemtura team, focused on the future."

18. Employees can get attached to company identity. In the article "Making Connections," in the May 19, 1996, issue of the *Washington Post,* we learn that "hardened linesmen cried when they had to punch out the bell logo from their identity cards" following the 1984 breakup of AT&T's Bell System. The company had featured a bell in its logo for nearly a century—ever since its founding in 1889.

19. Ianthe Jeanne Dugan, "Why Hedge Funds Hunt for Animals, Search the Stars: As Firms Proliferate, Finding the Right Name Is Tough; 'Clade' Beats 'Catalyte.' " *Wall Street Journal,* July 25, 2005, p. A1.

20. For a list of the top 100 global brand names in 2006, see http://bwnt.businessweek.com/brand/2006.

21. See B. Kenneth West, "Does the Corporation Have a Soul?" *Directors Monthly,* February 2003. For a discussion of company soul in the context of M&A, see Alexandra Lajoux, *The Art of M&A Integration,* op. cit., p. 192.

22. This discussion is based in part on the writings of John H. Bodley, *Cultural Anthropology: Tribes, States, and the Global System,* 1994. Professor Bodley is the chair of the Department of Anthropology at Washington State University.

23. Freek Vermeulen, "How Acquisitions Can Revitalize Companies," *MIT Sloan Management Review,* Summer 2005.

24. See Robert Bruner, *Deals from Hell* (New York: John Wiley, 2004).

25. "Time Warner employees considered their AOL counterparts to be too pushy and aggressive, while AOLers considered Time Warner staffers to be coddled, passive, and lazy." Morningstar report cited by Peter Haapaniemi, "Coping With M&A Culture Clash," *Business Empowered* (Bearing Point), 2005, Issue 2. For more on the Time Warner transaction, see Chapter 11 of this book.

26. "Former executives refer to the culture of 'learned powerlessness' that pervaded the toy giant's operations. In contrast, employees at TLC exhibited a sense of urgency, camaraderie, and entrepreneurial zeal. The conflict between these styles peaked over the company's Internet strategy. TLC employees were eager to launch online operations, while Mattel executives dragged their heels, fearing that Web sales would alienate retailers." *Leverage Points,* October 19, 2000.

27. Source: J. Robert Carleton, *Achieving Post-Merger Success: A Stakeholder's Guide to Cultural Due Diligence, Assessment, and Integration* (Pfeiffer, 2004). Carleton's firm, Vector Group Inc., conducted the focus groups and interviews as consultants to HP. The source of the 78 percent turnover figure is Michelle Kessler, "Brain Drain Signals Trouble at Technology Companies," *USA Today,* November 1, 2004.

28. See Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, March 3, 2003, www.sec.gov/rules/final/33-8177.htm.

29. Subjects typically covered by corporate policy statements include: conflicts of interest; corporate opportunities; confidentiality; fair dealing with customers, suppliers, competitors, and employees (including, for example, policies forbidding sexual harassment); protection and proper use of the company's assets; compliance with laws, rules, and regulations (including insider trading laws); encouraging the reporting of illegal or unethical behavior ("whistle blower protection"). The New York Stock Exchange requires inclusion of these policies in the ethics codes of its listed companies. For examples of common corporate policies, see www.ppspublishers.com, the Web site of Personnel Policy Service, Inc., Louisville, Kentucky. Also, for a service enabling policy notification to employees, see www.eknow.compliance/overview.html, a service line of E-Know, Arlington, Virginia. Alexandra Lajoux, an author of this book, serves on the E-Know advisory board.

30. Appendix 9B is adapted from one that appears in Alexandra Reed Lajoux, *The Art of M&A Integration* (op. cit., note 3), pp. 457–463.

31. For specific guidance on integration of sales teams, senior management teams, and boards of directors, see Alexandra Reed Lajoux, *The Art of M&A Integration* (op. cit., note 3), pp. 119–127.

32. The Mercer Survey is cited in *Personnel Today* (August 11, 2005)

33. The term *tracking* is not an accounting term. Rather, it is a plain English word chosen by the authors to describe the purpose of accounting.

34. See Alexandra Reed Lajoux, *The Art of M&A Integration,* op. cit., note 3.

35. Blogged on torbwine.com.

36. Plant and equipment may also be referred to as property, plant, and equipment (PP&E), and is sometimes also called furniture, fixtures, and equipment (FF&E) in a retail or office-type business.

37. The allocation of value to identified intangible assets should be based upon the application of valuation methods appropriate for each asset. For more on this subject, see Chapter 5.

38. For large inventories—even with heterogeneous units—it is possible to use sampling techniques to value the inventories with reasonable precision by comparing the market value of a set of units sampled to the current book value for those same units. For example, an acquired salvage operation reports $2,560.35 million on its balance sheet as the cost basis of its inventory of used parts. A sample of 5,000 out of 100,000 items (representing $245,199.10 of inventory at original cost) reveals that the current cost (at wholesale auction) of these items would be $250,619.50. This yields a value-to-book ratio of 1.022106. Thus the overall inventory can be valued based on this cost-to-book ratio at $2,616,751.50.

39. These terms come from the classic leadership textbook by Dr. Eric Berne, *Structure and Dynamics of Organizations and Groups* (New York: J.B. Lippincott Co., 1963), pp. 105–107. Berne is the author of the popular psychology book *Games People Play* (Penguin, 1968).

40. For a good explanation of these organizational types, see Danna Greenburg, "Designing Effective Organizations," in *The Portable MBA in Management,* ed. Allan R. Cohen (New York: John Wiley & Sons, 2002), pp. 243–275.

41. The government of Ontario uses a cluster organization rather than traditional ministries. See cio.gov.on.ca.

42. Description current as of February 26, 2007.

43. One hierarchically organized company that moves with speed is WellPoint, which recently acquired Anthem. This became an issue in their integration in 2005. "WellPoint traditionally moved with greater *speed* and greater direction *right from the top.* Anthem, on the other hand, made more of its decisions by consensus; it was a more collaborative, more discussion-oriented company" (emphasis added). Connie Van Fleet, "Culture Shock: How Two Cultures Become One in a Merger," *Across the Board,* May–June 2005. Van Fleet is vice president of integration planning and implementation at WellPoint Inc.

44. These terms were first introduced in a National Science Foundation study by Professor Alok Chakrabarti of the New Jersey Institute of Technology in "Organizational Factors in Post-Acquisition Performance," *IEEE Transactions in Engineering Management,* 37, No. 4 (November 1990), pp. 259ff.

45. A 2005 study of spin-offs suggests that parent companies of diversified subsidiaries add less value than parents of value. More recently, a study of spin-offs suggests the same. "This . . . studies 91 parent-subsidiary pairs operating in the service sector, analyzing performance in the decade following the subsidiary's listing and finds that, on sales growth, the subsidiaries tend to show stronger advances than their parents. . . . [S]ubsidiaries that operate in the same sector as their parent tend to underperform the parent while those that enter a different industry tend to outperform their parent." See Elizabeth Rose and Kiyohiko Ito, "Widening the Family Circle: Spinoffs in the Japanese Service Sector," *Long Range Planning,* February 2005.

46. This section is based in part on "Designing Effective Organizations," a chapter by Phyllis and Leonard Schlesinger in *The Portable MBA in Management,* ed. Allan R. Cohen, cited in note 40.

47. Ann Majchrzak and Qianwei Wang, "Breaking the Functional Mind-Set in Process Organizations," *Harvard Business Review,* September–October 1996, pp. 93ff. This study looked at productivity in 86 manufacturing departments—31 of them process-complete and 55 of them functional. Process-complete organizations were found to have faster cycle times if they had at least one of the following: participative decision-making and work styles, overlapping responsibilities, team-based rewards, or work spaces that let workers see or learn about each other's work (such as open work areas or shared conference rooms). See also Satyandra K. Gupta, Ujval Alva, Deepak Process Planning for Small Batch Manufacturing—white paper posted as of August 2005 on University of Maryland, Department of Mechanical Engineering and Institute for Systems Research (glue.umd.edu/~skgupta/PPforSmallBatchMfg.htm).

48. See "Elements in Merging Laboratory Operations," *Journal of Clinical Ligand Assay,* Vol. 24, No. 4, December 1, 2001, pp. 239–244. Sandia Corp., which is managed by Lockheed Martin, reported $50 million in savings after it merged its laboratories. The Sandia example was cited recently during meetings about merging Los Alamos Laboratories. See "Lab workers press DOE for Answers," lamonitor.com, posted August 8, 2005.

49. For a discussion of these different types of accounting for business units, see Lawrence A. Gordon, *Managerial Accounting: Concepts and Empirical Evidence* (New York: McGraw-Hill, 2004), pp. 179–186.

50. For the history, see Glenn Haske, "Merger Marries Quality Efforts," *Industry Week,* August 21, 2000.

51. For example, in the United States, standards have been published by the Federal Aviation Administration's (FAA Production Certification), the Federal Drug Administration (FDA Good Manufacturing Processes), Department of Commerce (Malcolm Baldrige Award), among others.

52. See iso.org.

53. See Ken Belson and Matt Richtel, "Cingular, Becoming No. 1 Also Poses Risks" September 27, 2004 (posted at Wirelessadvisor.com).

54. "Delphi Builds Global Expertise in Biofuel Compatibility," press release, February 15, 2007, http://delphi.wieck.com.

55. Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, SEC, www.sec.gov/rules/final/33-8238.htm#iia.

56. Sarbanes-Oxley requires that annual reports contain an "internal control report" stating "the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting" and must "contain an assessment, as of the end of the most recent

fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting." The law made the SEC responsible for setting this standard. Second, it requires that company auditors must "attest to, and report on, the assessment made by the management of the issuer." The law made the PCAOB responsible for setting this standard. Both the SEC and the PCAOB have prescribed the methods for assessment in great detail.

57. *Final Rule: Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports Securities and Exchange Commission.* Release Nos. 33-8238; 34-47986; IC-26068; File Nos. S7-40-02; S7-06-03. Source: SEC, www.sec.gov/rules/final/33-8238.htm#iia. This rule was effective August 14, 2003 for fiscal years starting on or after June 15, 2004, with exception of small companies, which had until July 15, 2007, to comply.

58. The original standard was Auditing Standard No. 2: An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements. The PCAOB has proposed Auditing Standard No. 5: An Audit of Internal Control over Financial Reporting That Is Integrated with an Audit of Financial Statements, pending as of February 26, 2007. If approved AS5 will replace AS2.

59. For a sample featuring one of the components—the control environment—see Alexandra Reed Lajoux, *The Art of M&A Integration* (op. cit, note 3), Appendix 7C, pp. 253–256.

60. For more on a company's covenantal commitments, see Robert K. Mueller, *Enforcing the Unenforceable: Anchoring Points for Corporate Directors* (New York: Quorum Books, 1997). See also Stephen Young, *Moral Capitalism: Reconciling Privcate Interest with the Public Good* (San Francisco: Barrett-Koehler, 2003).

61. Lisa Vaas, "Study: Many PeopleSoft Users Inclined to Ditch Software Post-Merger," E-Week.com, March 4, 2005.

62. In April 2005, the author interviewed an account representative who had been working for AT&T and who survived the transition into Cingular. A change in territory, combined with problems of technical integration, doubled his workload. "I get 100 e-mails a day," he lamented. And even though gas prices were rising, he continued to make on-site calls. Cingular wisely provided this dedicated worker with an assistant.

63. John G. Spooner, "HP Aims to Match Dell on Price," CNET News.com, February 13, 2003. For the sequel, see Connie Guglielmo, "Hewlett-Packard Trounces Dell to Extend PC Lead, Boost Profit," February 20, 2007, www.bloomberg.com/apps/news.

64. Tillinghast—Towers Perrin Directors and Officers Liability 2005 Survey (published in 2006), www.towersperrin.com/tp/getwebcachedoc?webc=TILL/USA/2006/200601/DO_2005_Exec_Sum.pdf.

65. See for example *Board-Shareowner Communications: Report of the CII-NACD Joint Task Force* (Washington, D.C., 2004).

66. In the United States, federal securities laws are embodied in the Securities Act of 1933 and the Securities Exchange Act of 1934. State laws are modeled (more or less) on the Model Business Corporation Act compiled and periodically updated by the American Bar Association–American Law Institute. The three main U.S. stock exchanges are the New York Stock Exchange, the Nasdaq, and the AMEX.

67. The Web site for ACC, which used to be called American Corporate Counsel Association, is acca.com. The Web site for Martindale Hubbell is www.martindale.com.

68. It is beyond the scope of this chapter to review securities law pertaining to mergers. For an overview of securities laws pertaining to mergers, see Alexandra R. Lajoux and Charles M. Elson, *The Art of M&A Due Diligence: Navigating Critical Steps and Uncovering Crucial Data* (New York: McGraw-Hill, 2000), and Alexandra R. Lajoux and H. Peter Nesvold, *The Art of M&A Structuring: Techniques for Mitigating Financial, Tax, and Legal Risk* (New York: McGraw-Hill, 2004).

69. The safe harbor for forward-looking statements is found in regulation Fair Disclosure (FD), on Selective Disclosure and Insider Trading. See www.sec.gov/rules/final/33-7881.htm.

70. This is not to deny the importance of courting new shareholders. For guidance, see Benjamin Mark Cole, *The New Investor Relations: Expert Perspectives on the State of the Art* (New York: Bloomberg, 2003). Also, anything published by the National Investor Relations Institute (NIRI), at niri.org.

71. This answer is a summary of the undisputed bible on the subject, Alfred Rappaport's *Creating Shareholder Value* (New York: The Free Press, 1986/1997), pp. 50–58.

72. Consider, for example, the Business Reporting Research Project of the Financial Accounting Standards Board at www.fasb.org/brrp/.

73. See Adrian Slywotsky, *How to Grow When Markets Don't* (New York: Warner Books, 2003).

74. Classic studies linking governance and performance include Lili Gordon and John Pound, *Governance Matters: An Empirical Study of the Relationship Between Corporate Governance and Corporate Performance,* June 1991; Wilshire Associates, *Rewards from Corporate Governance,* January 1992; Paul MacAvoy and Ira Millstein, *The Active Board of Directors and Improved Performance of the Large Publicly Traded Corporation,* December 1997; and Sang Woo Nam, Il Chong Nam, "Linkage Between the Quality of Corporate Governance and Firm Performance, Asian Development Bank Institute, February 2005," www.adbi.org.

75. For a recent survey, see David W. Anderson, Stewart J. Melanson, and Jiri Maly, "An Emerging Governance Model," paper, August 14, 2005. The Toronto-based authors are affiliated, respectively, with HRI Corporation; Rotman School of Management, University of Toronto; and McKinsey & Company.

76. The NYSE guidelines state that audit committees must have charters detailing duties, and set forth a minimum list of duties that may not be delegated to any other committee. One of the duties is oversight of legal compliance. Many directors and their counsel believe that it would be better to have a separate independent committee to oversee legal compliance, as financial risk oversight is already a very broad task for the audit committee.

77. See David W. Anderson, Stewart J. Melanson, and Jiri Maly, "An Emerging Governance Model," op. cit., note 75. See also the 2006 Public Company Governance Survey (Washington, D.C., 2006).

78. Companies that have issued instruments (bonds and/or preferred stock) that are convertible into common stock make more complex calculations.

79. This was part of an SEC rule relaxing restrictions on mergers between affiliated funds. See Investment Company Mergers, Securities and Exchange Commission, Final Rule, 17 CFR Part 270, Release No. IC-25666; File No. S7-21-01, RIN 3235-AH81, July 26, 2002.

80. The value of equity can be measured in various ways. In this discussion, we are assuming a simple valuation—stock price appreciation or decline over a defined postmerger period.

81. Tillinghast, op. cit., note 64. In February 2007, the Insurance Institute released a comprehensive update on trends. See "Liability System," February 2007, at 222.iii.org/media/hottopics/insurance/liability.

82. "Time Warner Sets Settlement Of Suit Over AOL Merger: Media Conglomerate Sets Share Buyback, Swings to $321 Million Loss for Quarter," Wall Street Journal Online, August 3, 2005. In 2006, additional settlements occurred. However, as of February 2007, the shares have recovered. See Paul R. La Monica, "Wall Street Ready for a Time Warner Shuffle," February 16, 2007, cnnmoney.com.

83. See Note 82, Ibid.

84. See *In re Walt Disney Derivative Litigation* Case No. 411, 2005 (Del. June 8, 2006).

85. *Proversity* is a term coined by R. Roosevelt Thomas, author of *Building on the Promise of Diversity: How We Can Move to the Next Level in Our Workplaces, Our Communities, and Our Society* (New York: Amacom, 2005).

86. "Downsizing—rightsizing—reorganization—whatever we call it, there is an impact on disability. . . . We need to develop stronger links among programs that improve productivity while integrating medical and disability, and implement programs that focus on disease management, stress prevention, and

stress management," said Mark Marsters, Cigna, Feb. 2, 2004, press release from Cigna Group Insurance, March 29, 2004. Previous Cigna research (a 1996 study of 292 companies with 100 or more employees) showed that after a downsizing, employees—whether they go or stay—file more disability claims for longer periods of time. For a case on employee rights to information about plan applicability after a merger, see *Horn v. Cendant Operations,* 10th Cir., No. 101-5205 (July 3, 2003).

87. "We find that layoffs and sell-offs are less important in justifying the target premium in foreign takeovers than in domestic takeovers. In contrast, U.S. targets in foreign takeovers subsequently make more post-takeover investments than in domestic takeovers." See Jun-Koo Kang, Jin-Mo Kim, Wei-Lin Liu, and Sanghi Yi, "Post-Takeover Restructuring and the Sources of Gains in Foreign Takeovers: Evidence from U.S. Targets, *The Journal of Business,* vol. 79 (2006), pp. 2503–2537.

88. Between January and October 2006, a total of 62,725 merger-related job cuts were announced, down 45 percent from the 114,036 job cuts resulting from mergers during the same period in 2005. " 'The fact that merger-related job cuts are down in this environment suggests that companies are expanding through acquisitions and are much more likely to retain workers,' said John A. Challenger, chief executive officer of Challenger, Gray & Christmas." Source: "U.S. Mergers Set blistering Pace This Year," UPI, November 15, 2006, upi.com.

89. Tillinghast, op. cit., note 65.

90. See Chapter 4, note 46.

91. Micheline Maynard, "US Airways and America West Plan to Merge," *New York Times,* May 20, 2005.

92. The words *acquisition* and *perquisite* both share the same route *quœrere* "to seek to obtain." Acquisition comes from *ad-* "extra" + *quœrere,* refers to something extra that is obtained. *Perquisite* comes from per—"through"—*quaerere.* It originally referred to goods obtained by means other than inheritance.

93. See "2007 General Schedule (GS) Locality Pay Tables" at the Web site for the Office of Personnel Management: www.opm.gov/oca/07tables/indexGS.asp.

94. Target ownership plans are positively associated with improvements in firm performance. See John Core and David Larcker, "Performance Consequences of Requiring Target Stock Ownership Levels," March 21, 2000. A white paper from the Research Center, Accounting Department, University of Pennsylvania, Wharton School of Business.

95. This forward-looking idea was first advanced by Ira M. Millstein, Senior Partner, Weil, Gotshal & Manges, New York, and by Paul W. McAvoy of Yale School of Management, New Haven, in a letter mailed to the members of the National Association of Corporate Directors, April 11, 1996.

96. For example, links to quality can be offered through a variety of means, including customer satisfaction survey results, rate of returned merchandise, defect rate, and other quantitative measures. It may seem difficult to use more than one measure, but this is a fundamental principle of the "balanced scorecard" approach that is sweeping management consulting circles.

97. The case of Disney, cited in note 84, shows how important it is to understand the results of executive contracts. The case involved payments made to former CEO Michael Ovitz.

98. Statement No. 123 (revised 2004). *Share-Based Payment* (Issue date 12/04).

99. Federal Deposit Insurance Corporation Rules and Regulations, Part 235—Capital Maintenance, Subpart A—Minimum Capital Requirements, Section 328.2—Definitions.

100. The Economic Growth and Tax Relief and Reconciliation Act of 2001 (EGTRRA) raised the ceiling on previous lower limits. The limit is now $200,000. There is also a $1 million cap on the deductibility of compensation under IRC Section 162(m). This cap may be waived for plans that include performance incentives approved by an independent committee of the company's board of directors.

101. *Insider Trades During Pension Fund Blackout Periods.* Securities and Exchange Commission, 17 CFR Parts 240, 245, and 249, Release No. 34-47225; IC-25909; File No. S7-44-02, RIN 3235-AI71. Effective date: January 26, 2003. These rules clarify the application and prevent evasion of Section 306(a) of the Sarbanes-Oxley Act of 2002. Section 306(a) prohibits any director or executive officer of an issuer of any equity security from, directly or indirectly, purchasing, selling, or otherwise acquiring or transferring any equity security of the issuer during a pension plan blackout period that temporarily prevents plan participants or beneficiaries from engaging in equity securities transactions through their plan accounts, if the director or executive officer acquired the equity security in connection with service or employment as a director or executive officer. In addition, the rules specify the content and timing of the notice that issuers must provide to their directors and executive officers and to the Commission about a blackout period. The rules are designed to eliminate inequities that may result when pension plan participants and beneficiaries are temporarily prevented from engaging in equity securities transactions through their plan accounts. The 401(k) part of this answer is based in part on information provided by the Web site 401khelpcenter.com.

102. *Pegram v. Hedrich,* 530 U.S. 211 (200) recognized that the nation's health care system now operated under a "congressional policy of allowing HMO organizations." The court rejected claims that an HMO structure providing an inherent financial incentive to limit patient care breached the plan's fiduciary

duty to its beneficiaries. The court said that the law would not permit attacks on the structure of HMOs, "untethered to claims of concrete harm." Nonetheless, health care providers have sued insurers over problems. Currently, major insurers are named in litigation called *In re Managed Care Litigation* MDL No. 1334, and are in the process of making payments to settle this litigation.

103. Source; www.sec.gov/rules/final/2006/33-8765ft.pdf.

104. Some spin-offs do not involve widespread public ownership of the unit stock. As noted in past client letters of Fried, Frank, Harris, Shriver & Jacobson, a spin-off may be combined with or follow an acquisition or merger by a third party or may involve continued ownership by the original parent company. Generally speaking, though, the term *spin-off* implies independence for the previously owned units.

105. "The complexity of trying to manage these different businesses began to overwhelm the advantages of our integration," AT&T CEO Robert Allen told the *Wall Street Journal* the day after it announced its decision to break up. (John J. Keller, "Defying Merger Trend, AT&T Plans to Split into Three Companies," September 21, 1996, p. A1.) In the past 20 years, the AT&T name has survived despite numerous changes. In 2005, when Cingular bought AT&T's wireless operations, the Cingular name predominated. In 2006, however, the remaining remnant of AT&T merged with BellSouth and Cingular, and revived the AT&T name.

106. See *Values Matter: Emerging Business Policies and Practices for Building Trust and Good Will,* Business Civic Leadership Center, U.S. Chamber of Commerce, January 2007, www.uschamber.com.

CHAPTER 10

Special Issues for M&A in Public Companies

INTRODUCTION

To this point, we have discussed transactions involving all kinds of companies, whatever their ownership status (private, closely held, or public). This chapter should serve as a guide through the unique legal and business considerations that affect acquisitions of *public* companies.

Public companies offer distinct challenges for M&A. By definition, the equity in such companies is held by the public—large numbers of owners, including powerful institutional owners holding large blocks of stock. Also, by definition, these companies are heavily regulated, as state and federal or national regulators see themselves as the protectors of the public interest.

This chapter begins with general and legal principles relevant to M&A of public companies. It then covers the two main ways to gain control of a public company—the *tender offer* and the *proxy solicitation.* (A tender offer is a general, publicized bid by an individual or group to buy shares of a publicly owned company at a price significantly above the current market price. A proxy solicitation is an effort to effect a change of control by getting shareholders to vote their shares via proxy at a shareholders meeting.) A section on how to disclose changes of control follows. In conclusion, readers will find a brief discussion of takeover defenses and state laws that enable them. (For international implications, see the last chapter in this book.)

The bulk of this chapter will focus on friendly transactions involving the voluntary, negotiated sale of public companies in whole or in part. Most

of the rules and regulations cited here, however, apply as well to *hostile acquisitions* of public companies. By hostile acquisition we mean one pursued directly with shareholders via a tender offer or proxy solicitation rather than negotiated with the target's board of directors. This is important to note, since virtually every company selling equity securities to the public (some 10,000 companies in the United States[1]) is vulnerable in this regard. So if you are a director, officer, employee, or advisor involved with a public company, this chapter is must reading.

GENERAL CONSIDERATIONS

What exactly is a "public" company and why would a company's "public" status affect an acquisition?

Generally speaking, a public company is one that sells securities (stocks and/or bonds) to the general public. Because of their impact on society, publicly held companies are subject to a relatively high number of federal and state securities laws, compared to privately held companies.

What exactly is a security?

The Securities Act of 1933 defines security broadly as follows:

> The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.[2]

When a company sells securities to the general public, it becomes subject to securities laws. These laws also affect transactions involving public companies, including M&A transactions.

What are the main differences between buying a public company and buying a private company?

First, let's note similarities. In both kinds of transaction, the board of directors of both the buying and selling companies must fulfill their fiduciary duties of loyalty, care, and good faith under state law. Furthermore, basic principles of all the phases discussed earlier in this book—planning, valuation, financing, structuring, and due diligence, and closing—apply to both kinds of transactions.

As far as differences go, transactions involving public companies tend to be more complex. The structure, timing, financing, and negotiation of the purchase of a public company are all greatly affected by federal and state securities laws. To understand and negotiate a public company acquisition, the first step is to gain a working understanding of the basic federal securities laws that govern the transaction. These include not only the rules on acquiring a controlling interest in a company (through a partial acquisition or a tender offer for all shares) but also rules on disclosure of negotiations,[3] insider trading,[4] and certain filings upon the acquisition of a 5 percent or more holding of common equity in the target. Because of these laws, any acquisition of a public company is conducted in a fishbowl, as most aspects of the transaction quickly become public knowledge.

For example, there is usually a public announcement of an agreement in principle as to price and structure with a successful bidder. Also, the financing of tender offers is subject to certain unique rules that make this kind of financing somewhat more difficult than the normal financing. Moreover, the necessary statutory and practical delays in closing the transaction provide ample opportunity for a new bidder to arrive on the scene. In fact, the board of directors of the selling company may be required under state securities law to provide information to a competing bidder. This can mean the board may no longer be required (or even allowed) to recommend the agreed-upon transaction to stockholders once a better, credible offer is on the table. In any event, the stockholders will be free either to vote against the proposed merger with the buyer or to tender their shares into a more desirable tender offer. Thus, in a public company transaction, an agreement by the board on behalf of the company has only limited value when another bidder appears on the scene with a bid that seems more favorable.

Also, as a result of the publicity surrounding its offer, the buyer becomes a stalking horse to attract other bidders. This can put the first bidder at a disadvantage, as it will have incurred substantial transaction expenses such

as legal and accounting fees and it may have laid out significant sums as commitment fees to lenders to arrange for financing. The first buyer may have also passed up other investment opportunities while pursuing the acquisition of the target.

Ironically, the individuals making the decision in a public company acquisition are often people who will not be there for the long haul to ensure that the company succeeds or to benefit from its success. In a tender offer, for example, the shareholders who enable the transaction are shareholders who sell their shares to the acquirer. By definition, they will not be there to own the resulting company. Thus, they may be indifferent to post-merger performance and its repercussions on remaining shareholders and on employees, communities, and other parties. Thanks to state laws protecting "other constituencies" (discussed at the end of this chapter), these additional interests may be considered by boards as they respond to offers.

Could you give an overview of federal and state laws that apply when buying a U.S. public company?

The United States has a federalist system of government with both federal and state components.

At the federal level, securities laws are encompassed in two main laws: the previously mentioned Securities Act of 1933 (commonly referred to as the Securities Act), which sets forth registration requirements for public companies; and the more extensive Securities Exchange Act of 1934 (commonly called the Exchange Act), which sets the disclosure and filing requirements. Securities Act rules are numbered from 100 on up (to the 900s now, if you count shell-type rules reserved under Regulation ST for electronic filers); Exchange Act rules, numbered from 1 on up, are named after sections. So, under Section 10(b) of the Exchange Act, for example, are rules 10b-1 on up.

The basic text of these federal laws has been amended and expanded over time under the aegis of the SEC, the independent federal agency created to promulgate and administer rules and regulations under the Securities Act and Exchange Act. The two main sections of federal securities laws most likely to create liability are Section 11 of the Securities Act, pertaining to the offering of securities, and Section 10(b) of the Exchange Act, pertaining to the exchange of securities. Another very well-traveled legal section in M&A is Section 16(b) of the Exchange Act, which restricts "short-swing" trading—that is, selling stock within six months after receiving it.

The most significant expansion of securities laws affecting mergers was the Tender Offer Act of 1968, known as the Williams Act after its original sponsor. The Williams Act and amendments became Exchange Act Sections 13(d) and 14(d) (discussed later in this chapter).

At the state level, where corporations must incorporate, state laws govern corporate charters and bylaws. There is some uniformity thanks to the influence of Delaware, which is often used as a prototype for state corporate statutes. Another source of influence is the Model Business Corporation Act, a suggested template that is continually updated under the auspices of a committee of the American Law Institute-American Bar Association (ALI-ABA). State corporate statutes set forth minimum requirements for the charters of companies in the state, including the duties and responsibilities of company directors and officers, such as their fiduciary duties of loyalty, care, and good faith in conducting business.

SARBANES-OXLEY AND M&A

How did Sarbanes-Oxley impact mergers?

The Sarbanes-Oxley Act of 2002, and the new disclosure rules and stock exchange listing standards it required, has had a broad impact on business. It focused attention on the importance of internal audit controls, the external auditor, and the audit committee. (In fact, the formal name of the law is the Public Company Auditing and Public Responsibility Act of 2002.) Auditing, in essence, means having something double-checked by an independent expert.

The overall impact of all of these audit-focused rules has been to add more paperwork and cost to everything, but at the same time to reduce the likelihood of business failure due to undetected risk. As mentioned in the previous chapter on due diligence, acquirers have generally benefited from Section 404 of the act, since it increased the level of attention to and documentation of internal controls. This has helped acquirers streamline the financial aspect of their due diligence prior to closing.

Notably, one section in Sarbanes-Oxley (Section 306(a)) requires administrators of corporate pension plans to give 30 days advance notice to plan participants and beneficiaries if there will be any "blackout" period in which no plan use is involved. However, there is a more lenient standard for companies involved in mergers, which may not be required to give such a long advance notice.

DUTIES OF CARE, LOYALTY, AND GOOD FAITH IN M&A

How do the fiduciary duties of loyalty, care, and good faith under state law apply in M&A?

In general, they mean that directors and officers must serve the company's interests, not their own, in approving a transaction; they must exercise care in making the decision to buy or sell; and they must act in good faith to fulfill their responsibilities. Meanings of these three concepts develop over time as various courts make decisions in particular matters.

To elaborate, a director of a corporation owes a *duty of loyalty* to act in the best interests of the corporation and its shareholders, for which he or she is a fiduciary. As such, the director is prohibited from entering into a transaction that is tainted by fraud or bad faith, or in which the director has a personal interest. If it appears that a director has a personal interest in a particular corporate transaction, a court often will shift the burden of proof to the director to show that the transaction is fair and that it serves the best interests of the corporation and its shareholders.

A director also owes a *duty of care,* which means acting on behalf of the company's stockholders by making informed decisions after obtaining all reasonably available information required to make an intelligent decision and after evaluating all relevant circumstances—including arguably whether a company has a workable system for reporting and compliance, as implied in the famous *Caremark* case.[5]

Finally, a director owes a *duty of good faith,* which is a very broad concept that underlies the other two. In the August 2005 Disney case, Chancellor William Chandler wrote, "The good faith required of a corporate fiduciary includes not simply the duties of care and loyalty, in the narrow sense that I have discussed them above, but all actions required by a true faithfulness and devotion to the interests of the corporation and its shareholders."[6]

If directors and officers meet their fiduciary duties of care, loyalty, and good faith, their business decisions, even if flawed, receive protection from lawsuits in state court, under a judicial concept called the business judgment rule, a judicial doctrine applied by courts in cases where shareholders have sued directors for violating their fiduciary duties to the corporation. The rule is that the board of directors will be protected unless the shareholders can prove that in making a business decision a director did not act with due care, good faith, and loyalty to the corporation. The business judgment rule protects directors from liability if they act in a manner consistent with their duties of due care and loyalty.

Nuances of legal interpretation have made fiduciary duties and the business judgment rule complex. The leading legal treatise on the topic is more than 2,000 pages long![7] Most major law firms offer very good guidance on these concepts and the latest cases involving them.

Because fiduciary duties are owed primarily (although not exclusively) to shareholders, most cases alleging failure to fulfill to the duties are brought by shareholders, and most of these cases involve public companies, which have more dispersion of equity ownership than private companies.[8]

What is a recent M&A case involving the fiduciary duty of *loyalty* owed to shareholders of a public company?

In the case of *Oliver v. Boston University* (2006), the Delaware Court of Chancery awarded $4.8 million, plus interest, to plaintiff shareholders for damages suffered from alleged breach of the fiduciary duty of loyalty before and during a merger.

The defendant, Boston University, was the controlling shareholder of Seragen, and the plaintiffs were a group of former minority stockholders of Seragen's common stock. The plaintiffs challenged certain transactions that occurred before Seragen got acquired by Ligan Pharmaceuticals—such as a large stock offering that diluted the value of existing equity. They also challenged the process used to allocate merger proceeds. The plaintiffs contended that the BU defendants breached their fiduciary duties to them by approving various financial transactions that were not fair to all shareholders as a matter of price and process.

What is a recent M&A case involving the fiduciary duty of *care* owed to the shareholders in public companies?

In re CompuCom Systems, Inc. (2005), former minority shareholders alleged that the defendants, CompuCom directors, had "improperly agreed to sell the company for an inadequate price in order to satisfy the majority shareholder's pressing need for cash."[9] Touching briefly on the duty of loyalty (by saying the board appeared to be independent of the majority shareholder), plaintiffs centered on the duty of care.[10] The Delaware Court of Chancery dismissed the plaintiffs' claims on several grounds:

- The board appointed a special committee to examine possible sale transactions.

- The special committee spent over 18 months soliciting bids for the company.
- The special committee hired outside legal counsel and financial advisors that supplied a fairness opinion.
- The plaintiffs and Safeguard ultimately received the same price for their shares.
- The final merger agreement did not contain "any strong lock-ups or other deal protection measures that would unduly impede a bidder willing to pay a higher price from coming forward."

Understanding the CompuCom decision can help selling companies form a good checklist for exercising due care in the sale of a company.

What about the duty of *good faith*? Are there any recent court decisions involving that?

In *Emerging Communications,* the court found that nine directors had breached their fiduciary duties to minority shareholders by approving a particular merger. Nevertheless, the court found that four of the directors were shielded from liability by the company's exculpation provision (in its indemnification agreement with directors and officers). This was because the plaintiffs had failed to present "a prima facie case of bad faith or disloyalty that [those] directors would be called upon to negate or disprove."[11] In other words, as one expert put it in a comprehensive article on the duty of good faith, "a breach of fiduciary duty will not automatically create a presumption of bad faith or disloyalty that the defendant must disprove. Rather, the court will presume that the breach was exclusively the product of a lack of due care until the plaintiffs produce evidence to the contrary."[12]

DIRECTOR RESPONSIBILITIES IN RESPONDING TO UNSOLICITED BIDS

What are the primary responsibilities of a corporate board of directors upon receipt of a takeover bid?

The director's primary responsibility is to evaluate and recommend what action a company should take in the event of an offer to acquire the company. In the landmark case of *Revlon Inc. v. MacAndrews & Forbes Holdings,* the

court described the role of the board of directors as that of a price-oriented "neutral auctioneer" once a decision has been made to sell the company. (In a private company the people making the decision to sell to a particular buyer are themselves the owners, so the Revlon duty would be a moot point.) In general, this means that boards should give preference to the bidder most likely to deliver superior returns to shareholders, to whom directors owe their primary fiduciary duty. There are exceptions, though. State "constituency" statutes and shifting interpretations of the business judgment rule can give boards more decision-making discretion in responding to tender offers.

How does a director's duty of care apply in responding to a tender offer bid?

Under this standard, the directors' duty is not merely to try to arrive at the best possible decision for the corporation but to make their decision only after careful, informed deliberation. Both the process of decision making and the substantive decisions themselves are taken into consideration by courts in evaluating whether directors acted with due care.

The 1985 Delaware case of *Smith v. Van Gorkom* dealt a blow to the business judgment rule when the Delaware court found that the board of directors of Trans Union and, in particular, Trans Union's chief executive officer, Jerome Van Gorkom, were personally liable for actions taken in connection with approving and recommending to shareholders a cash-out merger proposal. The court held that they were not entitled to the protection of the business judgment rule even though Van Gorkom and the other board members may well have been highly qualified to make their decisions and had obtained a substantial premium over the market price for the shares of Trans Union.

Nevertheless, the court found that the following actions by the Trans Union board and Van Gorkom evidenced a lack of due care:

- The CEO did not establish a "fair price" for the company's stock.
- The CEO met with the offeror without consulting his directors or any senior management personnel.
- The CEO did not seek the advice of investment bankers or ensure adequate legal counsel.
- Copies of the proposed merger agreement were not available for review by the board of directors at the meeting convened to discuss the merger.

- The CEO did not tell the directors that it was he who had valued the company's stock and suggested the purchase price to the offeror, together with suggestions on how to finance the purchase.
- The directors did not study the merger agreement before voting on it.
- The directors approved the merger agreement based on representations of several members of the management team.
- Neither the CEO nor the other directors read the merger agreement before signing and delivering it to the offeror.
- The directors approved amendments to the merger agreement in a meeting convened by the CEO without reviewing the documents or attempting to understand the implications of the amendments.
- The directors did not request that any valuation report/study be prepared to evaluate the value placed on the company's stock.
- The directors decided to approve the merger without allowing adequate time to consider its adequacy or its repercussions.
- The company's stockholders were not fully informed of all material facts when the merger was put to a vote.

The unusual element in *Van Gorkom* is that the court did not concern itself primarily with the ultimate decision (which was arguably a very good one for the shareholders of Trans Union) but instead emphasized the importance of the correct decision-making process. Directors must make informed decisions and take careful steps to ensure that they are acting responsibly.

What are "material" facts?

Material facts are those that are important enough to influence the buying or selling decisions of an ordinary investor. Dealmakers involved with public company transactions must understand materiality. This chapter, for example, uses the term "material" as an adjective a few dozen times. Yet like many important concepts in securities law, "material" does not have a hard and fast definition.[13] In its Statement of Accounting Concepts No. 2, the Financial Accounting Standards Boards noted[14]:

> The omission or misstatement of an item in a financial report is material if, in the light of surrounding circumstances, the magnitude of the item is such that it is probable that the judgment of a reasonable person relying upon the report would have been changed or influenced by the inclusion or correction of the item.

As one advisor noted in late 2006, "The materiality of any interest continues to be determined on the basis of the significance of the information to

investors in light of all the circumstances and the significance of the interest to the person having the interest. In that regard, the relationship of the related persons to the transaction, and with each other, and the amount involved in the transaction are among the factors to be considered."[15]

What impact do fiduciary duties have on M&A transactions of public companies?

First, these duties affect timing. The need for the board to act with due care will restrict the board's ability to act quickly even on a friendly offer. It will have to appoint a special committee if the transaction involves an MBO. At the very least, a fairness opinion must be obtained, and the investment banker will need several days, at a minimum, to complete the task.

Second, the duties, as interpreted by the courts, limit the ability of the board to take action that either eliminates the possibility of a competing bid—so-called lockups—or other arrangements (bustup and topping fees and "no shop" clauses) that are designed (in part) to frustrate the efforts of other bidders. These arrangements are among the most negotiated provisions of the public deal.

For the aforementioned reasons, the buyer will try to minimize the risk of a successful competing bid and will look for ways to get compensated if it loses to another bidder. The next several questions deal with these issues in the context of the board's fiduciary responsibilities to the shareholders.

When is it appropriate for a selling company to appoint a special committee of its board of directors to review a proposed transaction?

It is always a good idea to appoint such a committee, especially if the transaction is a major one. In addition, it is critical to do so if some members of the board of directors have or could have a personal interest in the proposed merger (for example, if there are members of management who would benefit personally from buying or selling). A special committee is also appropriate where a proposed transaction is complex enough to require careful study for the board to act responsibly. Having a special committee with adequate authority over the transaction will tend to shift to a plaintiff the burden of showing that the transaction is unfair. If the plaintiff has that burden, this makes it more difficult for it to get a court to hold a hearing and issue "injunctive relief" against the merger (order the companies to refrain from going through with it).

What is the role of counsel to the special committee?

Counsel should advise the members of the special committee about the interpretation of the business judgment rule in the company's jurisdiction of incorporation. In addition, counsel should advise the committee of any potential liability for its actions and the extent to which it may be indemnified or otherwise protected under the company's charter and bylaws and directors' and officers' liability insurance.

Counsel should attend each meeting of the special committee and should prepare or review minutes of each meeting. These minutes should be reviewed for accuracy by each member of the committee. In the event that the proposed transaction may attract other offers, counsel to the special committee should be prepared to advise the committee about the duty of the directors to obtain the best possible price for all shareholders. Counsel should also advise the committee of the extent of its obligations to consider such offers and techniques that it may and may not employ to enhance or limit bidding opportunities.

Which directors are appropriate members of a special committee?

A special committee should consist of independent or disinterested directors. Such directors must not have any financial or personal interest in the proposed transaction that would inhibit their ability to act in an unbiased manner.

What are the benefits of a special committee?

Although there is no guarantee that a special committee will legitimize board action, such a committee may be extremely helpful in, and perhaps essential to, providing directors with the protection of the business judgment rule. It should be noted, however, that courts will closely scrutinize the facts surrounding the actions of the board, and that the mere formation of a special committee will not protect the directors from liability for careless actions.

What steps should a special committee take to ensure that it is acting responsibly?

The special committee should examine all information about the proposed transaction. This examination must be thorough and members of the special committee should question carefully the persons supplying such information to be sure the information is complete and accurate. The committee should

also take care not to act hastily and should make sure that it documents its deliberations. Recent judicial decisions have indicated that directors who make decisions without adequate deliberation may have difficulty in establishing that they acted with the care necessary to provide the protection of the business judgment rule.

Should a special committee retain independent advisers?

In the context of mergers and acquisitions, the special committee of a board of directors should retain independent legal counsel and financial advisers.

Should a special committee obtain a fairness opinion?

Yes, but the opinion must be from a qualified, independent source (such as an investment banking firm, a commercial bank, or an appraiser) and must be supplemented by board deliberations. The fairness opinion can be a useful tool both in determining whether to accept an offer and in obtaining the protection of the business judgment rule. However, when there is a potential or actual conflict of interest in a transaction, courts will also examine the transaction to determine its *intrinsic* fairness.

Because fairness generally depends on the price to be received by the target company's shareholders, having a fairness option from an expert source such as an investment banker can be invaluable to the board. It is, however, necessary for a board of directors to question the experts to determine that they have a reasonable basis for their opinion and that they are free from conflicts of interests. Reliance on a fairness opinion alone may not suffice as proof of the exercise of due care.

What should a fairness opinion say?

A fairness opinion should describe the process the experts used in making their determination of fairness, and should indicate what matters have been investigated and independently verified and what matters have not been verified independently. The opinion should also describe the fee or fees being paid and all possible conflicts of interest. The firm offering the opinion should not accept contingent compensation for the fairness opinion because doing so suggests a lack of independence.

What is the doctrine of "entire fairness"?

It is a legal doctrine that says a transaction must be completely fair to all parties involved, not just majority shareholders. *In re PNB Holding Co. Shareholders Litigation,* C.A. No. 28-N (Del. Ch. August 18, 2006), the Court held that when directors get together to freeze out the other stockholders, the "entire fairness" principle applies even when the directors do not own a majority of the stock. This is because the interests of those directors in remaining shareholders differs from other shareholders who will be frozen out. Unless most of the minority shareholders vote for the merger, the directors have to prove the merger was entirely fair to all shareholders.[16] If the Court completes the entire fairness inquiry and concludes that the transaction was unfair, it must then identify which duty (care, loyalty, or good faith) is the basis for liability.[17]

How can an acquirer increase chances of having its bid favored over bids from other companies?

One mechanism employed by companies to give the favored bidder an edge is a lockup option. The lockup agreement may be granted with respect to stock or assets.

In the stock lockup, the bidder receives an option to purchase authorized but unissued shares. This option favors the bidder in two ways: If the option is exercised, either the bidder may vote the shares in favor of the transaction or, if another bidder wins the contract for the company, the favored bidder may realize a profit by tendering the stock to the higher bidder. A variation on the lockup is the reverse lockup, where stockholders or management agree not to tender their shares to a rival bidder. For the same reason, a buyer will attempt to obtain options to acquire the stock of stockholders, typically those that have significant holdings. Such options are not subject to scrutiny under the business judgment rule because they are not acts of the board of directors. (See the following discussion of lockup arrangements with stockholders.)

Stock lockup agreements with the target have received mixed results from courts applying the business judgment doctrine. The courts' main concern is that the lockup may prevent competitive bidding and thereby limit the premiums stockholders would otherwise receive from buyers.

For example, in April 2003, the Delaware Supreme Court determined that absent an effective "fiduciary out clause," the "coercive" agreements that resulted in the locked-up merger of troubled NCS Healthcare Inc. with competitor Genesis Health Ventures Inc. were invalid and unenforceable.

Courts are most likely to approve lockups granted at the end of the bidding process rather than at the beginning, particularly if there are no other bidders contending for the company.

In the asset lockup (or "crown jewel" lockup), the company grants the bidder the option to acquire a particularly attractive asset at a price that may or may not be commensurate with its full market value. Such an option may discourage other bidders if they were also interested in the crown jewel or if the loss of the asset would considerably change the financial position or prospects of the company. Asset lockup agreements have received generally negative treatments from courts, as discussed next.

Can directors adopt a lockup agreement without violating their fiduciary duties?

Yes. A lockup agreement is not illegal per se. However, court decisions hold that a lockup arrangement generally must advance or stimulate the bidding process, not retard it or cut it off. That is, a board can tilt the playing field toward a bidder if the purpose is to elicict a higher bid from that bidder or to otherwise stimulate the competition.

If the purpose of the lockup agreement is to completely stifle competitive bidding by definitively preferring one bidder over another, however, the board will likely be found to have breached its duty of loyalty to the shareholders. In *Revlon, Inc. v. MacAndrews & Forbes Holdings* (1986), Revlon was faced with a hostile tender offer from Pantry Pride. Having determined that Pantry Pride's initial bid was inadequate, the board advised the shareholders to reject the bid and began the search for a white knight, which it found in the leveraged buyout firm of Forstmann Little and Co.

Revlon then began negotiating with Forstmann Little to the exclusion of Pantry Pride. It did not invite Pantry Pride to participate in any negotiations, nor did Revlon share financial data with Pantry Pride as it did with Forstmann Little. Eventually, an increased bid from Pantry Pride prompted an increased bid from Forstmann Little that was conditioned upon, among other things, the receipt by Forstmann Little of a lockup option to purchase two Revlon divisions at a price substantially lower than the lowest estimate of value established by Revlon's investment banker, plus a "no shop" provision that prevented Revlon from considering bids from any third party. The board immediately accepted the Forstmann Little offer even though Pantry Pride had increased its bid.

The court held that when the focus of the directors changed from keeping the company intact to maximizing the return from a sale of assets,

the board assumed the role of auctioneer obligated to obtain the best price for the shareholders. The court then determined that by stifling competitive bidding through the lockup agreement with Forstmann Little, the Revlon board had violated its duty of loyalty to the company and its shareholders. Cases after *Revlon* have indicated clearly that a court will not permit a board to grant a crown jewel lockup option to one bidder that would have the effect of cutting other bidders out of the process while bidding is still active.

Is a lockup that shuts off the process never permissible?

Case law has yet to present the best case for upholding a lockup. In certain cases, where lockup options were defeated, the lockups favored an insider group or were designed to favor a friendly bidder—even one bidding at the low end—instead of one that was hostile to the board. The courts, however, have not addressed a case where the board acts in a truly disinterested manner, granting the lockup to secure the highest bid.

In such a case, the business judgment of the board logically should be respected, particularly if the company has been shopped to other bidders who have had a chance to evaluate the company. Even in the absence of a shopping expedition, a strong argument can be advanced under the business judgment rule that the judgment of a well-advised and disinterested board should be respected. The practical problem is that the case probably won't arise unless another higher bid surfaces after the lockup is granted. If such a bid does arise, it will usually be conditioned on the court's invalidating the lockup, so a court will be hard pressed to find a reason to deny the shareholders the chance of getting the highest possible bid.

Will a lockup agreement subject the bidders to liability for short-swing trading profits?

As previously mentioned, short-swing trading is not permitted under Section 16(b) of the Exchange Act. A bidder's profits will not be subject to short-swing restriction under Section 16(b) unless the bidder "beneficially owned" more than 10 percent of the target's stock prior to the purchase of the stock pursuant to the lockup agreement. Once a bidder achieves insider status as a beneficial owner of more than 10 percent of the stock, all subsequent transactions will be subject to Section 16(b).

What is a beneficial owner?

A beneficial owner of equity is a person or group of persons possessing "voting power" or "investment power" over a security as defined in Rule 13d-3 of the Exchange Act. Thus shares beneficially owned include not only shares directly owned but all shares with respect to which a person has or shares direct or indirect power to vote or sell. For instance, all shares subject to a shareholders' voting agreement become beneficially owned by each person who is a party to the agreement. The concept of beneficial ownership is especially important in view of the 5 percent threshold to the filing requirements. Thus, if each member of a group of five persons owns 1 percent of the shares of a class of a company, that group must file a Schedule 13D or 13G if the group has agreed to vote or dispose of those securities as a block. Also, a person is deemed to own beneficially any security that he or she, directly or indirectly, has the right to acquire within 60 days, whether such acquisition is pursuant to a purchase contract, exercise of a warrant or option, or conversion of a convertible security (Rule 13d-3).

Ironically, companies have no absolute right to know who their beneficial owners are. When individuals or institutions buy stock through a broker, they have an opportunity to sign a form saying whether they want their identity to remain private. Unless they specifically indicate that they are Non-Objecting Beneficial Owners (NOBOs), they are treated as Objecting Beneficial Owners (OBOs) and their identities remain private. (Brokers reportedly check the "objecting" box for their clients, to make sure brokers stay in the loop.) Owners then receive any communications from the broker rather than the company, which does not have their direct contact information. As of late 2006, the Business Roundtable, National Investor Relations Institute, National Association of Corporate Directors, and other groups have requested that the SEC review this policy, which prevents effective relations between companies and their owners.

What should be considered when selling a large block of stock?

One of the most important considerations to a selling stockholder when selling a large block of stock is the duty of due care that such stockholder must exercise, which includes reasonable investigation of the potential purchaser. The courts have imposed liability on a controlling stockholder in circumstances in which such stockholder could reasonably foresee that the person

acquiring the shares would engage in activities that would clearly be damaging to the corporation, such as looting, fraud, or gross mismanagement of the corporation. In planning a sale, a potential seller should fully investigate the potential purchaser's motive, resources, reputation, track record, conflicts of interest, and any other material items relevant to the transaction and the corporation.

A second consideration is the duty of loyalty that a controlling stockholder owes to the minority stockholders. This duty generally arises when a controlling stockholder is selling shares at a premium. For example, if a corporation owns a large quantity of a product that is in short supply and could be sold at above-market rates, a controlling stockholder may have a fiduciary obligation to refrain from selling shares at a premium on the theory that the shareholder's receipt of the premium would constitute a misappropriation of a corporate opportunity (that is, the stockholder would be appropriating a certain amount of the corporate goodwill).

In addition, a few courts have imposed a requirement of "equal opportunity" on a controlling stockholder. This requires a controlling stockholder to offer all of the other stockholders an opportunity to sell the same proportion of their shares as the controlling stockholder. Most courts have refused to apply this unwieldy principle.

Accordingly, if a block purchase is challenged, the courts will review the particular facts surrounding the purchase to determine its fairness.

If a merger or acquisition involves the issuance of securities to the target's shareholders, may such securities be resold freely, or are sales restricted?

Generally, such securities are similar to restricted securities in that Rule 145 under the Securities Act states that any party to a merger or acquisition transaction receiving securities is deemed to be engaged in a distribution and therefore to be an underwriter.

Because of this underwriter status it is necessary to register securities issued to the target's security shareholders. This form (Form S-4, described in the section on forms) is basically a wraparound of the proxy statement and permits the shareholders of the target who are noncontrol persons to sell without restriction. Control persons or "affiliates" must sell, however, either under the registration statement or in accordance with restrictions in Rule 144 under the Securities Act.

What are topping and bustup fees?

Although these terms are used interchangeably, they each have a special meaning:

- *Topping* fees are agreements with the target to compensate the buyer for potential losses if a new bidder usurps the deal. Because these fees are liabilities of the target, the winning bidder will have to bear their economic burden. This burden has the effect of increasing the cost of, and thus discouraging, other bids.
- Another arrangement is for the payment of *bustup* or breakup fees payable if the transaction is terminated by the target (other than for cause).

The fees are designed, at the very least, to reimburse the buyer for all of its out-of-pocket expenses. More often, the arrangements include an additional payment for lost time and opportunity. The fees can be quite high—in the $20 to $30 million range. In a large transaction (over $1 billion), usually they are in the range of 1 to 5 percent of the purchase price. The higher percentages apply to smaller and medium-sized public transactions ($50 million to $500 million).

Aren't bustup fees subject to legal challenge?

Yes. The size of the fee must not be so large that it substantially discourages other bidders or it may be struck down by a court as a disguised lockup arrangement. Provided that the fee is not excessive, under current case law it is very likely to withstand judicial scrutiny if the agreement to pay the fee is viewed as reasonably necessary to attract the bidder or keep it interested in the target in the face of competition. The defensibility of the fee will be enhanced if it is granted by the target in exchange for a "fiduciary out" clause (discussed later) or if the buyer permits the board to "shop" the company for a period of time, that is, to try and find other bidders. Note also that creditors—particularly in the case of companies that are in bankruptcy proceedings—may challenge such fees in court.

What is a no-shop agreement, and when can it be used?

A no-shop agreement is a provision either in the acquisition contract or in a letter of intent that prohibits the board of directors from soliciting or encouraging other bids. It is always found in private company acquisition

agreements and, far more often than not, in the acquisition agreement for public company transactions.

The buyer should always be expected to request such an agreement at the letter of intent stage, and the seller will usually agree to it if it has chosen the bidder as the result of either an auction process or a completed bidding war. Under certain circumstances, however—such as when the buyer is the first on the scene or is a member of management or a white knight whose bid was solicited to fend off a hostile takeover—such an agreement should be avoided or at least mitigated by adding a "fiduciary out" clause in the agreement.

Although there is no legal requirement that a company be shopped before a definitive agreement to sell is executed, the courts do not look kindly on no-shop provisions, alone or as part of a package (such as with lockups), when the effect of such provisions is to frustrate the role of the board as a neutral auctioneer or where they may result in a bargain price to corporate insiders, such as management. (See the previous discussion of management buyouts.) The absence of shopping, coupled with the existence of such provisions, may provide the basis for an argument that the price was not determined fairly, with the result that the transaction could be enjoined by a court at the behest of a competitor or an aggrieved stockholder.

In especially egregious situations, members of the board of directors can be subject to personal liability if the price is too low or the board has not performed its duties. (See *Van Gorkom* in the landmark legal case summaries in the back of the book.) When a board is required to defend the process and result as fair to the stockholders, the fact that it has unsuccessfully solicited better offers is telling evidence of the fairness of the transaction.

The buyer, of course, will argue that it needs the no-shop provision to avoid incurring expenses for a deal that doesn't succeed because the board attracts a higher bidder. The response: give the buyer a bustup fee.

Finally, the board must determine whether the bidder will refuse to enter into the transaction without the no-shop clause. If so, and if the board is comfortable with the fairness of the price, the no-shop agreement may be advisable to secure for the shareholders the benefit of a good sale price.

Once the letter of intent stage is passed, the buyer certainly should expect a no-shop clause in the definitive agreement. Otherwise, why sign an agreement? Notwithstanding the clause in the agreement, because of its fiduciary responsibilities the board should avoid agreeing that it may not provide a competing bidder with the same information given to the buyer.

It is worth reiterating that the decision about whether to grant a no-shop agreement falls within the purview of the business judgment of the board of directors. Thus, the timing of the offer, the surrounding circumstances (hostile

bidders, management buyers, and the like), other evidence of fairness, and the necessity of the clause to get the best deal for the stockholders all must be considered. There is no hard and fast rule.

What is a fiduciary out clause?

A fiduciary out clause is a provision in an agreement that enables the target to terminate a merger agreement in the event that a more favorable offer is made. In some cases the clause merely allows the board to back out of its obligation to recommend the agreement in the face of a more favorable offer. Although the law is unclear, the latter provision may be unnecessary because the board may have a fiduciary duty to refuse to continue its recommendation if a more favorable offer has been made. Furthermore, from a buyer's perspective, the insertion of a fiduciary out clause in an agreement may not matter, because if a clearly more favorable bid is made, the chances are great that the stockholders won't approve the buyer's offer or will refuse to tender their shares to the buyer in its tender offer.

Fiduciary out clauses are subject to close legal review, and issues are far from clear. In April 2003, when the Delaware Supreme Court issued its opinion in *Omnicare v. NCS HealthCare* (2003), its close (3–2) vote showed a difference of judicial opinion. The majority held that a target company board violated its fiduciary duties by approving a merger agreement with no fiduciary out because in combination with other factors, such as a lock-up agreement, the absence of a fiduciary out ensured stockholder approval of the transaction.[18]

M&A FORMS

What forms must an acquirer of a public company file?

The following list includes the major forms or "schedules" (hence SC label):

For a Current Report of Significant Events

8K, Item 2. Public companies are required to file an 8K within 1–3 business days of "significant events." One of those is the acquisition or disposition of assets.

For a Tender Offer or Acquisition

SC 13D. This form discloses "beneficial ownership" of a public company's stock (defined earlier in this chapter). Any person or group of persons who acquires 5 percent or more of a class of equity

securities—whether through a tender offer or through other means—must file it.

SC 14D-1. Any person, other than the issuer itself, making a tender offer for equity securities that would cause that person to own over 5 percent of that class of the securities, must file this schedule at the time of the offer. It's filed by a company when it seeks control of another company.

SC 14D-9. Filed with the SEC when an interested party, such as an issuer, a beneficial owner of securities, or representative of either, makes a solicitation or recommendation to the shareholders with respect to a tender offer which is subject to regulation 14D; target company's response to a tender offer.

For Going Private

SC 13E-4. This schedule, called an Issuer Tender Offer Statement, must be filed by certain reporting companies that make tender offers for their own securities; a self-tender offer filed by a company buying back its shares.

Stock Offerings Resulting from a Tender Offer or Other Transactions

S-3. This form is used to register securities offered pursuant to certain types of transactions.

S-4. This form is used to register securities in connection with business combinations and exchange offers.

TENDER OFFER BASICS

Technically speaking, what is a tender offer?

A typical or conventional tender offer has been defined as a general, publicized bid by an individual or group to buy shares of a publicly owned company at a price significantly above the current market price.[19]

One problem for a company seeking to gain control of a public company through open market purchases of stock is that such purchases may, under certain circumstances, be deemed to constitute a tender offer.

Although the SEC has never formally adopted a rule defining a tender offer, on November 29, 1979, the SEC proposed the following definition of a tender offer:

> The term "tender offer" includes a "request or invitation for tenders" and means one or more offers to purchase or solicitations of offers to sell securities of a single class, whether or not all or any portion of the securities sought are purchased, which (i) during any 45-day period are directed to more than 10 persons and seek the acquisition of more than 5 percent of the class of securities, except that offers by a broker (and its customer) or by a dealer made on a national securities exchange at the then current market or made in the over-the-counter market at the then current market shall be excluded if in connection with such offers neither the person making the offers nor such broker or dealer solicits or arranges for the solicitation of any order to sell such securities and such broker or dealer performs only the customary functions of a broker or dealer and receives no more than the broker's usual and customary commission or the dealer's usual and customary mark-up; or (ii) are not otherwise a tender offer under [clause (i)] of this section, but which (A) are disseminated in a widespread manner, (B) provide for a price which represents a premium in excess of the greater of 5 percent of or $2 above the current market price and (C) do not provide for a meaningful opportunity to negotiate the price and terms.[20]

This proposed rule has been neither adopted nor withdrawn.

In the absence of an official definition of tender offer, the courts have had to come up with their own interpretations. In general, the courts have used an eight-factor test first adopted in *Wellman v. Dickinson* to determine the existence of a tender offer.[21]

1. Active and widespread solicitation of public shareholders for shares of an issuer
2. Solicitation made for a substantial percentage of an issuer's stock
3. Offer to purchase made at a premium over the prevailing market price
4. Terms of the offer being firm rather than negotiated
5. Offer contingent on the tender of a fixed number of shares and possibly specifying a maximum number of shares
6. Offer open for only a limited time period
7. Offeree subject to pressure to sell stock
8. Public announcements of a purchasing program that precedes or is coincident with a rapid accumulation of shares

In general, however, determining the existence and duration of a tender offer requires a fact-specific inquiry.

How exactly is control transferred in a tender offer or other type of public company acquisition?

A public company acquisition can be accomplished through either a *one-step* or a *two-step* transaction.

In the one-step acquisition the buyer organizes an acquisition subsidiary that will merge into the target. Upon consummation of the merger, the stockholders of the target receive cash (and possibly notes promising additional cash) and the stockholders of the acquisition subsidiary receive all the stock of the target. The merger will require the approval of the stockholders of the target; the exact percentage of stockholder approval required will depend upon the articles of incorporation of the target and could be as low as a majority of the voting power of the common stock. To effect the approval, the target will be required to solicit proxies from the stockholders and to vote the proxies at a stockholder's meeting called for the purpose of voting on the transaction. The proxy solicitation must comply with the federal securities laws.

A two-step acquisition involves a tender offer followed by a merger. In the first step, the buyer organizes an acquisition subsidiary that makes a tender offer for the shares of the target. The acquisition subsidiary may or may not be recognizable as the buyer. Usually, the offer is conditioned upon enough shares being tendered to give the buyer sufficient voting power to ensure that the second-step merger will be approved. For example, if approval by a majority of the voting stock of the target is required, the offer is conditioned on the buyer obtaining at least a majority of the target stock in the tender offer. In the second step, the buyer obtains stockholder approval, the acquisition subsidiary is merged into the target, the stockholders of the acquisition subsidiary become stockholders of the target, and the original stockholders of the target who did not tender their shares receive cash. If the buyer obtains sufficient stock of the target (90 percent in Delaware), the merger will not require approval of the target's remaining stockholders (a "short form merger").

Is the two-step approach the same as the so-called two-tier tender offer?

No. A two-tier offer is one in which the bidder, generally a hostile one, sets a deadline for an initial, high price. Those who sell their stock to the bidder after the deadline get a second, lower price. This was a popular technique in the 1980s, but it has met with legal challenges (for example, the

1991 decision in *USX v. Marathon,* a case that originated in 1982) and has become relatively rare.

In a public transaction, must the stock be acquired only through a tender offer or a merger?

No. The buyer may precede its tender offer or the merger with ordinary purchases through the stock market (open market purchases) or may acquire, or enter into arrangements to acquire, stock from the target or from some of its major stockholders (lockup arrangements). The timing and method of such purchases, however, must respect federal securities laws, which preclude certain transactions after a tender offer begins and also may characterize certain open market purchases as tender offers.

What are the major advantages and disadvantages of the tender offer vs. a proxy solicitation?

Timing is the major advantage. The tender offer can close as early as 20 business days from the date of commencement, and there is no requirement that the tender offer documents be filed with the SEC prior to commencement. At the conclusion of the tender offer, the buyer will have control of the target.

This contrasts sharply with a proxy solicitation. Proxy materials must be submitted for review by the SEC; the review takes from 10 to 30 days. The materials are rarely sent to shareholders before completion of the SEC review. The shareholder's meeting usually won't occur until at least 20 days (depending upon state law and the bylaws of the target) after the proxy materials are sent out. Twenty days is usually a minimum to ensure that the shareholders get the material and have a chance to review it and to submit their proxy. Generally, the time to gain control is 45 to 60 days after the proxy materials are initially submitted to the SEC.

In the friendly two-step transaction, at what point do the parties enter into the merger agreement?

The merger agreement is entered into before the tender offer is commenced. There are several reasons for this. First, if the merger agreement is entered into before commencement of the tender offer, the acquisition subsidiary will

be able to utilize certain types of unsecured loans to finance the transaction that would otherwise be unavailable. Second, the buyer often wants to finalize agreements relating to expense reimbursement, bustup fees, lockup arrangements, and so on, before incurring the expense and risk of a tender offer. Also, under the target's articles of incorporation the percentage of stockholder votes required for approval of the second-step merger may depend upon board approval prior to the tender offer. The board approval, in turn, may hinge upon the buyer's agreeing to make the same payments to all stockholders in the tender offer and the second-step merger. Third, the target board would like to ensure fair treatment for all stockholders by binding the buyer to accomplish the merger promptly after the tender offer.

Generally, how long after the closing of the tender offer will the second-step merger occur?

If the parties are Delaware corporations, and the buyer acquires at least 90 percent of the stock of the target, the merger usually can be accomplished shortly after the tender offer closes. If less stock is acquired, the buyer must cause a stockholders' vote to be taken to approve the merger.

In almost every case, the buyer will not require any favorable votes from the other stockholders because it will own enough stock to assume approval after the tender offer, so no proxies will be solicited. Nevertheless, the buyer must submit an "information statement" to the SEC and cause it to be distributed to the stockholders. The distribution cannot occur until 10 days after the information statement is sent to the SEC. The stockholders must receive the information statement at least 20 calendar days before the corporate action approving the merger. The result is that the minimum waiting period for a merger following a tender offer is 30 days.

What are tender offer premiums, and how are they measured?

A tender offer premium is the "plus factor" in an offer—it is the incremental amount paid for securities in excess of an established market price as of a stated date. Traditionally in academic practice, premiums were measured five days before announcement. This was to prevent distortions based on trading in the stock based on rumors, guesses, or nonpublished inside information (that is, illegal insider trading). Such trading tends to boost the target's stock price prior to a merger, so premiums—unless measured well in advance—can appear to be smaller than they really are.

What is considered to be an acceptable premium for a company?

In a perfect market, an acceptable premium would be whatever the market will bear. More reasonably, it would be one that exceeds target management's own projections for share price appreciation in the reasonably near term.

Why would a shareholder care about promises later when he or she could get cash now?

Whereas short-term, speculative holders and some individual investors might not have the patience to wait a year or more for such appreciation, institutional investors prefer to hold on to stocks. Since they own over half of all publicly traded equities, this means that strategically minded managements have less to fear from raiders than in the past.

But aren't most institutional investors indexed?

Good point. Many are indexed, buying and selling according to a preset computer program based on an index such as the S&P 500. But there is a strong trend away from this and toward holding higher percentages of fewer stocks and selecting them carefully with the help of proxy advisory firms.

So much for premiums paid for target company stock—what about the acquirer's stock?

Sad to say, this typically declines in value following a tender offer, especially if the offerer has taken on too much debt or incurred other obligations.

What are some of the practical considerations in commencing a tender offer?

The first steps in commencing a tender offer are the formation of a team and the creation of a timetable indicating each planned activity and the person responsible for it.

The formation of the team should begin with the retention of a dealer-manager/investment banker and an independent accountant. Initially, the dealer-manager and accountant will help in the review of the target company's

financials and business and advise as to the desirability/feasibility of the proposed transaction. The dealer-manager will also be responsible for the solicitation of large stockholders and for the communications with the financial community and may also assist the buyer in accumulation of a significant stock position prior to the commencement of the actual tender offer.

Experienced lawyers who will prepare the many legal documents required in conjunction with the tender offer are essential members of the team. The lawyers should be familiar with federal and state securities laws, antitrust laws, and numerous other areas of the law that may apply to a specific transaction.

Additionally, as litigation is often a by-product of tender offers, the lawyers on a tender offer team should come from a law firm with a strong, experienced litigation department.

Other members of the team will generally include a shareholder solicitation firm that will arrange for delivery of tender offer materials and will contact shareholders to solicit their shares, and a depository bank that will receive and pay for tendered securities.

Tender offer teams also usually include a forwarding agent that will receive shares as an agent for tendering stockholders and a financial printer with the ability to prepare tender offer documents quickly and provide the confidential treatment necessary to avoid premature disclosure of the proposed transaction.

Must the bidder contact the target company's management prior to commencement of a tender offer?

Not necessarily—although failure to do so moves a transaction out of the friendly or neutral category and into the hostile camp. Although a tender offer can be commenced with no prior disclosure to the target company's management, this approach puts significant pressure on the target by allowing it the least amount of time to respond to the offer or to develop a workable defense strategy.

A tender offeror may also choose to contact the target's management and request a meeting at the same time it makes a public announcement of its intention to commence a tender offer. At this meeting, the tender offeror may attempt to obtain the approval and cooperation of the target company's management for the proposed transaction and may also apply additional pressure by indicating that, unless the management of the target company approves the transaction, the tender offer will be made at a lower price. In any event, making a public announcement that a tender offer will be made requires the offeror to proceed with or abandon the offer within five days of its announcement.

When does a tender offer begin?

A tender offer commences at 12:01 A.M. on the date when the bidder does one of the following:

- Publishes a long-form publication of the tender offer, containing required information, in a newspaper or newspapers
- Publishes a summary advertisement of the tender offer, disclosing certain information, in a newspaper or newspapers
- Publishes, or provides to shareholders of the target, definitive copies of tender offer materials
- Publicly announces certain information: the identity of the bidder, the identity of the target, the amount and class of securities sought, and the price or range of prices being offered. An offer, however, will not be deemed to be given to the shareholders on such date if, within five business days of the public announcement, the bidder does one of the following:

  Publicly announces its decision not to proceed with the tender offer.

  Files a required disclosure form, in which event the commencement date will be deemed to be the date on which the required disclosures are first published, sent, or given to shareholders.

In almost all cases, the tender offer is commenced by the use of the summary advertisement, the type so often seen in the financial pages of the *Wall Street Journal.* Copies of the pertinent tender offer materials are sent to the shareholders on the date that the advertisement is published. The date of the commencement is important because it begins the 20 business days that the tender offer must remain open and because certain activities, particularly purchases of shares by the acquirer other than through the offer, are prohibited after the offer has started.

What disclosure form must the bidder file?

With the exception of those claiming that they are exempt from a filing obligation, bidders must file a Form 13D, which in effect discloses an intent, or reserves the right to engage in, a control transaction.

When must an acquirer file a Schedule 13D?

The Exchange Act provides for disclosure concerning the accumulation of blocks of voting equity securities if that accumulation might represent a potential change in corporate control regardless of how such securities are

accumulated. Any person who is the "beneficial owner" of 5 percent or more of the shares of a class of voting equity securities registered under Section 12 of the Exchange Act is required to file a Schedule 13D with the SEC (and each securities exchange on which the securities are traded) containing specified information concerning the filing person. Schedule 13D must be filed with the SEC and sent to the issuer and to each exchange where the security is traded within 10 days after a person acquires 5 percent or more of an outstanding voting equity security.

This requirement is somewhat relaxed for certain institutional investors (such as banks, broker-dealers, or insurance companies) whose purchases are made in the ordinary course of their business without the purpose or effect of changing or influencing the control of the issuer, and for investors that owned their shares prior to the time the company became subject to the Exchange Act. Such investors need only file a Schedule 13G, which is a substantially shorter form than Schedule 13D, 45 days after the end of the calendar year in which the threshold ownership interest was acquired.

If, however, such an institutional securityholder changes its intention and decides to influence control of the company, it must file a Schedule 13D within 10 days of making that decision. During the 10-day period, the shares already owned may not be voted, and the owner may not buy any additional shares of the target company.

Is a written agreement necessary for a group to exist?

No. The existence of a written agreement is not required; circumstantial evidence of an agreement in itself may be enough. Section 13(d) states, in part, that "when two or more persons act as a partnership, limited partnership, syndicate, or group acquiring or disposing of securities of an issuer, such syndicate or group shall be deemed a person for the purposes of this subsection."[22]

At what stage of an acquisition is a group formed?

It can be formed as soon as the members of the group reach an agreement, even if the agreement is merely preliminary. In at least one case the court compared an agreement in principle to act in concert to the final agreement and, finding the two agreements substantially similar, declared that a group had been formed as of the first agreement.

Is an agreement to acquire additional shares necessary to form a group?

No. An agreement among shareowners who together hold a total of 5 percent or more of a class of voting stock to act together in the future to further the group's purpose may be enough to form a group regardless of whether acts to carry out the agreement (such as voting and acquiring stock) occur after the date of the agreement.

Does the management of the company to be acquired constitute a group subject to Section 13(d)?

Yes. The target's management could be considered a group if it acts as such to acquire shares and if its members own more than 5 percent of the company. A management group would have to comply with all reporting requirements.

Must members of a group file jointly, or may individual members file separately?

A group may file one joint Schedule 13D, or each member may file individually. An individual filing jointly is not responsible for the information concerning other members of the group unless the individual knows or has reason to know that the information pertaining to another group member is inaccurate.[23]

What information is required to be disclosed in a Schedule 13D?

A Schedule 13D filed by an individual must disclose information about the filing person's identity and background. A Schedule 13D filed by a group must disclose the identities and employment of each group member. The filing person or group must disclose the number of shares of the company to be acquired that it beneficially owns; its purpose in acquiring those shares; any plans or proposals to acquire or dispose of shares of the target company; any plans for an extraordinary corporate transaction (such as a merger, reorganization, or liquidation) affecting the target company or any of its subsidiaries; any proposed change in the target's directors or management, in the target's capitalization or dividend policy, or in its business or corporate structure; any

past involvement of the individual or group members in violation of state or federal securities laws; the source and amount of funds or other considerations for the acquisition; and any contracts, arrangements, understandings, or relationships that it has with any other person concerning the shares of the company to be acquired.

When must a Schedule 13D be amended?

A Schedule 13D must be amended "promptly" upon the occurrence of any "material change" in the information contained in the original Schedule 13D. Although the SEC has not officially defined the terms *promptly* and *material change,* Rule 13d-2 provides that the acquisition or disposition of beneficial ownership of 1 percent of a class of securities is material and requires the amendment of a previously filed Schedule 13D. Furthermore, the acquisition or disposition of a smaller amount may also require an amendment depending on the surrounding facts and circumstances. Changes in intention regarding the acquisition or disposition of securities also must be disclosed promptly.

The SEC has indicated that "promptly" means as soon as the facts requiring the amendment are important to the market. The current interpretation of prompt is within a few days.[24] The SEC has stated that:

> Whether an amendment to a Schedule 13D is "prompt" must be judged, at least in part, by the market's sensitivity to the particular change of fact triggering the obligation to amend, and the effect on the market of the filing person's previous disclosures. Although the promptness of an amendment to a Schedule 13D must be judged in light of all the facts and circumstances of a particular situation, [any] delay beyond the time the amendment reasonably could have been filed may not be deemed to be [prompt].[25]

What can happen if the buyer fails to comply with Section 13(d)?

In most cases, both shareholders and target companies may sue for damages for violations of Section 13(d). There are, however, some district court decisions holding that a target does not have an implied right to sue under Section 13(d) because the target's shareholders, not the target, were the intended beneficiaries of that section of the statute.

A few more legal points: The remedies or relief given for violations of Section 13(d)—that is, what the defendant company must pay if it loses—generally is equitable rather than compensatory. That is, it pays what is intrinsically fair rather than getting involved in what damages are involved. This is

because the purpose of the law is to provide disclosure, not to prevent takeovers, and once full disclosure is made, any prior misleading statements or omissions of material facts usually will not even result in an injunction. Other remedies for Section 13(d) violations include injunctions designed to prevent voting or further purchases of an issuer's securities until the filer has amended its Schedule 13D to correct any false statements or omissions. Some courts also require a cooling off period to provide adequate time for the newly disclosed information to reach the public.

Finally, the SEC may bring an enforcement action that may lead to a rescission (order to rescind the transaction) or a forced divestiture; however, the SEC usually will not take such action while corporate control is being contested.

What materials are sent to shareholders?

The shareholders receive an "offer to purchase" that sets forth the material terms of the offer, and a "letter of transmittal" that the shareholder sends back to accept the offer. The contents of the offer to purchase must reflect the requirements of Rule 14d-6. The bidder is also required to publish, send, or give to shareholders notice of any material change in the tender offer materials.

When must the Schedule 14D-1 be filed, and what does it ask?

On the day that the tender offer starts, the buyer must file a Tender Offer Statement on Schedule 14D-1 with the SEC, and hand-deliver copies of the statement to the target and other bidders. It must also mail a copy of the statement to stock exchanges on which the target's stock is traded (or the NASD if the securities are traded over the counter) after giving them telephonic notice of certain required information.[26]

The 14D-1 filing usually includes the offer to purchase, which contains most of the information required in the schedule. This includes the following:

- The name of the target and the address of its principal executive offices; the title and exact amount of the securities being sought; the consideration being offered for the securities; and certain information about the market for such securities, including the stock's current market value
- The identity and background of the buyer

- A description (including the appropriate dollar amount) of any contracts, transactions, or negotiations between the buyer and the target and its affiliates that occurred during the three fiscal years of the target preceding the date of filing of the Schedule 14D-1
- The source and amount of funds or other consideration for the offer and, if any part of such funds will be borrowed, a summary of the loan arrangements
- The purpose of the tender offer and any plans or proposals that the buyer has to sell or trade assets of the target or change the target's corporate structure, board of directors, management, or operations
- The number and percentage of shares of the target held by the buyer and a description of any transactions by the buyer involving the target's securities during the 60 days preceding the filing of the Schedule 14D-1
- Any contracts, arrangements, understandings, or relationships that the buyer has with any person concerning any shares of the target
- The identities of persons retained, employed, or to be compensated by or on behalf of the buyer to make solicitations or recommendations in connection with the tender offer, and the terms of compensation for such persons
- The buyer's compliance with regulatory requirements, including antitrust laws and margin requirements, and any material legal proceedings relating to the tender offer

Finally, the following are included if they are material to a decision by a securityholder whether to sell, tender, or hold its securities:

- The financial statements of the buyer (or its parent[s])
- Information concerning arrangements between the buyer and the target company not otherwise disclosed in the Schedule 14D.

Do the tender offer materials need to disclose any projections that may have been provided by the target to the acquirer?

The courts that have considered this question have taken different approaches, but generally they have held either that there is no duty to disclose projections in tender offer documents or that there is a duty to disclose only when the projections are substantially certain. Because projections are

inherently uncertain, this latter test may in practice result in no duty to disclose financial projections. However, the SEC staff has taken the position that the purchaser must disclose any financial projections it receives from the seller in its tender offer documents. As a result, most buyers make some disclosure of projections furnished by the target in the offering materials.

What are the requirements for updating a Schedule 14D-1?

If a material change occurs in the information contained in a Schedule 14D-1, the buyer must file an amendment with the SEC disclosing the change, hand-deliver it to the target and other bidders, and mail it to the NASD or the stock exchanges on which the target's shares are traded promptly after the date such tender offer material is first published or sent or given to securityholders.[27] Each material amendment should also be the subject of a press release to be issued promptly upon the occurrence of the material change.

Is there a way to avoid filing certain documents with the SEC?

No. However, it is possible to avoid the public disclosure of certain material if it can be demonstrated that the disclosure of such material would be detrimental to the operations of the company and that the disclosure of the material is unnecessary for the protection of investors. A company seeking to avoid the public disclosure of such information must seek an Order of Confidential Treatment from the SEC. Generally, if appropriate grounds for relief are asserted, the SEC will grant confidential treatment of such information for a limited period of time.

What kind of disclaimers should an offeror run in announcing its offer?

A typical disclaimer, often appearing in italics at the top of a tender offer announcement, reads as follows:

> *This announcement is neither an offer to purchase nor a solicitation of an offer to sell Shares. The Offer is made solely by the Offer to Purchase dated_____ and the related Letter of Transmittal, and any amendments and supplements thereto, and is being made to all holders of Shares. Purchaser is not aware of any jurisdiction where the making of the Offer is prohibited by administrative*

or judicial action pursuant to any valid statute. If Purchaser becomes aware of any valid statute prohibiting the making of the Offer or the acceptance of Shares pursuant thereto, Purchaser will make a reasonable good faith effort to comply with such statute. If, after such reasonable good faith effort, Purchaser cannot comply with such statute, the Offer will not be made to nor will tenders be accepted from or on behalf of the holders of the Shares in such jurisdiction. In any jurisdiction where the securities, blue sky or other laws require the Offer to be made by a licensed broker or dealer, the Offer shall be deemed to be made on behalf of Purchaser by one or more registered brokers or dealers licensed under the laws of such jurisdiction.

How long must a tender offer remain open?

A tender offer must remain open continuously for at least 20 business days. This 20-day period commences upon the date the tender offer is first published, sent, or given to the target company's shareholders.[28] Once an offeror has made a public announcement that it intends to commence a tender offer, the tender offer must commence or be abandoned within five days.

Additionally, a tender offer must remain open for a least 10 business days following an announced increase or decrease in the tender offer price or in the percentage of securities to be bought.[29]

If any other change in the tender offer terms is made, the offeror should keep the offer open for five business days to allow dissemination of the new information in a manner reasonably designed to inform shareholders of such changes. If there are fewer than five days left before the scheduled expiration of the 20-day period, this will cause the tender offer period to be open longer than 20 business days.

May the offering period be extended?

Yes, but the buyer must announce the extension not later than 9:00 A.M. on the business day following the day on which the tender offer expires, and the announcement must state the approximate amount of securities already purchased.[30]

Once a shareholder tenders his or her shares, may the shareholder withdraw them?

Shareholders who tender shares may withdraw them at any time during the tender-offer period unless the shares are actually purchased.[31]

Tendered shares may also be withdrawn at any time after 60 days from the date of the original tender offer if those shares have not yet been purchased by the bidder.[32]

When must payment for tendered securities be made?

An offeror must either promptly pay the consideration offered or return the tendered securities.[33]

May a bidder make an offer for less than all of the outstanding shares of a target company?

Yes. However, if more shares are tendered than the offeror wishes to purchase, the offeror must purchase the desired amount of shares on a pro rata basis from among those shares tendered.

May an offeror quickly acquire control of the target's board of directors after purchasing shares in the tender offer?

Yes. The tender offeror and the target frequently agree that, after a successful tender offer, the offeror may elect a majority of directors to the board of the target. Such an agreement permits the offeror to obtain control of the target's board of directors without holding a meeting of shareholders. Ten days before the newly elected directors are permitted to take office, the target company must file with the SEC and transmit to the holders of its voting securities information about such directors that would be required to be provided to shareholders if such persons were nominees for election as directors at a meeting of the target's shareholders.[34]

Must all shareholders in a tender offer be treated equally?

Yes. The same consideration must be paid to all tendering shareholders. The offer must be open to all shareholders of the class of securities subject to the offer. However, while the bidder does not need to pay the same type of consideration to each shareholder, it must afford each the opportunity to elect among the types offered. In addition, each shareholder must receive the

highest consideration paid to any other shareholder receiving the same type of consideration. Therefore, if the tender price is increased at any time during the period the increased amount must be paid to all tendering shareholders, including those who tendered before the price increase and those whose shares have already been purchased.

What is "short tendering" during a tender?

Short tendering is short selling during a tender offer. It occurs when a shareholder in a partial tender offer tenders more shares than he or she actually owns in the hope of increasing the number of shares that the bidder actually will accept pro rata.

A person is prohibited from tendering a security unless that person, or the person on whose behalf he or she is tendering, owns the security (or an equivalent security) at the time of the tender and at the end of the probation period. A person is deemed to own a security only to the extent that he or she has a net long position in such security. SEC rules also prohibit "hedged tendering." Hedged tendering occurs when a shareholder tenders securities in response to more than one offer or tenders some securities while selling others in the open market.

How do risk arbitrageurs work, then?

Risk arbitrageurs buy, sell, borrow, or tender shares or options on shares in the hope that a change in their price, typically through an offer or a rumor of an offer, will yield a profit. They must work within securities laws. Some, however—notably Ivan Boesky—have gained an unfair and illegal advantage from receipt of inside information concerning specific offers. He and others have served prison sentences because of such insider trading, as discussed later.

May an offeror purchase shares during a tender offer other than pursuant to the tender offer?

No. During a tender offer, the offeror may not directly or indirectly purchase or arrange to purchase, other than pursuant to the tender offer, securities that are the subject of that offer.[35] This prohibition also includes privately negotiated purchases until the tender offer is concluded or withdrawn.

Purchases made before a public announcement are generally permissible, even if a decision has been made by the purchaser to make the tender

offer, but purchase agreements scheduled to close during the offering period are illegal no matter when they were or are made.

PROXY SOLICITATIONS

What information must be disclosed to stockholders if the form of the acquisition is a merger?

Regulation 14A under the Exchange Act requires that stockholders be provided with a proxy statement that includes the information set forth in Schedule 14A.

Although information required for the proxy statement varies depending on the level of information available about the parties, such information generally includes the following:

1. The mailing address and telephone number of the principal executive offices of each party.
2. A brief discussion of the general nature of the business conducted by each party.
3. A summary of the material features of the proposed transaction, including (i) a brief summary of the transaction agreement; (ii) the reason for engaging in the transaction; (iii) an explanation of any material differences in the rights of securityholders as a result of the transaction; (iv) a brief statement as to accounting treatment; and (v) federal income tax consequences.
4. A statement as to the effect of the transaction on dividends in arrears or defaults in the payment of the principal or interest on the securities of any party.
5. Selected financial data relating to the target company and the acquirer.
6. If material, such financial information in item 5 above on a pro forma basis.
7. Certain historical and pro forma per share data of the target company and the acquirer.
8. Detailed pro forma financial information as required by Article 11 of Regulation S-X.
9. A statement as to the status of any federal or state regulatory approval that must be obtained in connection with the transaction.

10. Detailed information concerning any report, opinion, or appraisal materially relating to the transaction.
11. A description of any past, present, or proposed material contracts, arrangements, understandings, relationships, negotiations, or transactions between the target company and other persons and any of their affiliates.
12. The high and low sale prices of the relevant securities as of the date immediately prior to the public announcement of the transaction.
13. A statement as to whether representatives of the principal accountants for the current year and for the most recently completed fiscal year are expected to be at the meeting and will have the opportunity to make a statement if they desire to do so and are expected to be available to respond to questions.

Schedule 14A also requires detailed information relating to material changes in the affairs of the company being acquired that have occurred since the end of the latest year for which audited financial statements were included in the latest annual report to securityholders.

Any action to be taken with respect to any amendment of the registrant's charter, bylaws, or other documents must be described and the reasons for and general effect of such amendment must be disclosed. The vote required for approval must be described.

What about groups seeking control through a proxy fight?

They must adhere to the proxy rules promulgated under Section 14 of the Exchange Act, which defines solicitation, requires companies to give copies of their shareholders' lists to dissidents (candidates running for board seats that have not been nominated by the board), and requires disclosure of voting results. Section 14 includes several exemptions.

How is solicitation defined under proxy rules?

Narrowly. The rule says that a shareholder can publicly announce how he or she intends to vote and why, without necessarily having to comply with proxy rules.[36] Major institutional investors, such as the California Public Employees' Retirement System (CalPERS), have used this technique to encourage other shareholders to follow their lead. Prior to this exemption, even signing an op-ed in a newspaper could trigger proxy rules.

What shareholders are exempt?

The current rules offer a broad exemption from the proxy statement "delivery and disclosure" requirements for shareholder communications—unless the person soliciting is seeking proxy authority and has a substantial interest in the matter subject to a vote or is otherwise ineligible for the exemption. On the other hand, public notice—through publication, broadcast, or submission of written materials to the SEC—of soliciting activity is required of all beneficial owners of more than $5 million worth of stock. For example, the new exemption would apply to proxy advisers such as Institutional Shareholder Services, a Rockville, Maryland-based group that advises institutional shareholders on proxy voting matters.

May shareholders solicit proxies via the mass media? May they bypass the SEC altogether?

Yes to the first question; no to the second. A person who has a proxy statement on file with the SEC is permitted to solicit votes without delivering a copy of the proxy statement to all shareholders in the audience.[37] Soliciting parties can start a solicitation on the basis of a preliminary proxy statement publicly filed with the SEC, as long as they don't send a proxy to the solicited shareholders until after the dissemination of a definitive proxy statement.

Can shareholders vote for both dissident and management candidates as individuals, or do they have to take sides with slates?

Shareholders voting for dissident candidates for minority representation on the board of directors can also vote for one or more of management's nominees. The dissident's proxy form and proxy statement may not include the names of management's nonconsenting nominees.[38]

Under what circumstances must companies give dissidents their shareholder lists?

Registered companies engaged in rollups or going private transactions must provide shareholders, under certain conditions and upon written request, with a list of shareholder names, addresses, and positions, including names of consenting beneficial owners, if known.[39] In all other cases, registrants can either give such a list to the requesting shareholders or mail materials for them.

What is the current status of proxy voting disclosure?

Several forms—including 10-K, 10-Q, and Schedule 14A—require disclosure of voting results and of the vote needed for passage of resolutions presented to shareholders. This disclosure must include the number of abstentions on resolutions and on votes for director elections, and a statement of how exemptions are treated under applicable state law charter and bylaw provisions.

Don't all of the above rules tilt the "control panel" of the playing field to the advantage of dissident investors rather than incumbent managements?

Many in the corporate community certainly think so. In response to corporate concerns about secrecy, the SEC stipulated that, with certain exceptions, a new form must be furnished or mailed to the SEC (but not formally filed) by those claiming exemptions from the filing requirements under Section 14. The new form requires disclosure of the person's name and address, with any written solicitation materials attached. The form must be mailed within three days of the first use of such materials.

Note, however, that no notice is required if the solicitation is only made by radio or television broadcast; by publication, such as in a newspaper interview or advertisement; or in "speeches in a public forum." Most significantly, no notice is required for solicitations made solely by oral means, such as those made at meetings or in telephone conversations.

What is "going private"?

Going private means getting out of public equity markets. More technically, it is a Rule 13e-3 transaction in which certain of the existing stockholders or affiliates of a public target become stockholders of the entity surviving the acquisition of the target and the target is no longer subject to Section 12(g) or Section 15(d) of the Exchange Act. Because certain stockholders may be on both sides of the transaction, Rule 13e-3 requires additional disclosures to the public stockholders in order to demonstrate the overall fairness of the transaction. These disclosures include full-blown discussions of any fairness opinions and appraisals obtained in connection with the transaction and statements by the target as to the fairness of the transaction.

In addition, if anyone buys a public company and takes it private it needs to file a schedule SC 13E-3, mentioned earlier in the list of forms. This schedule must be filed by certain persons engaging in "going private" transactions. The schedule must be filed by any company or affiliate of a company who engages in a business combination, tender offer, or stock purchase that has the effect of causing a class of the company's equity securities to be held by fewer than 300 persons, or delisted from a securities exchange or market.

Determining whether a particular transaction may constitute a 13e-3 transaction largely depends upon the percentage of stock that the existing stockholders own in the target or the relationship of such affiliates to the target and the percentage ownership that such persons may have in the surviving entity.

- Section 13(d) requires any person or group that acquires 5 percent or more of the shares of a corporation to file a Form SC 13D. The acquirer must file within 10 days to the corporation, the relevant stock exchange or market, and the SEC. One significant disclosure requirement is to state "if the purpose of the purchases or prospective purchases is to acquire control of the business of the issuer of the securities."
- Section 14(d) requires a person or group that intends to buy a public company via a tender offer to file a Form 14D-1.

MERGER DISCLOSURE ISSUES

Under what circumstances may a public company deny that it is engaged in merger negotiations?

Only if it is not so engaged. That was the gist of the Supreme Court's 1988 decision in *Basic Incorporated v. Levinson.* In this landmark case, the Court said that outright denial of negotiations is improper even if the negotiations in question are discussions that have not yet resulted in an agreement on the price and structure of a transaction. The appropriate response to inquiries about such a matter is either "no comment" or a disclosure that negotiations are, in fact, taking place.

Prior to the *Basic* decision, the court of appeals for the Third Circuit had held that merger proposals and negotiations were not "material" until the parties had reached agreement in principle on the price and structure of a transaction. In *Basic,* the Supreme Court rejected this so-called bright line test and

held that the materiality of merger negotiations must be evaluated on a case-by-case basis after considering all relevant facts and circumstances.

Since *Basic,* courts seem to have backed down on this issue, but the SEC has been active. In appealing a dismissal of its case against Amster & Co. in mid-1991, the SEC applied the Basic doctrine to preliminary plans to wage a proxy contest. But it admitted that it was not trying to "suggest that every consideration or thought given to a plan must be disclosed; at an early enough stage, possible plans or proposals may simply be too ephemeral to require disclosure."[40]

The Regulation Fair Disclosure (Regulation FD) has drawn a bright line with respect to the timing of disclosures. If a person who knows an important or "material" fact about the company that the public does not yet know—and if this person then tells this to another person, then the company must make immediate public disclosure of the fact. This principle would obviously apply to any statements about a possible merger.[41]

When does a company have a duty to disclose merger negotiations?

Generally, the timing of disclosure of material information is at the discretion of the company and will be protected by the business judgment rule. Nevertheless, a company that is the subject of takeover speculation or whose stock is trading erratically typically finds itself pressured by brokers, news services, exchange or NASDAQ officials, securities analysts, and others to disclose merger proposals and negotiations. The *Basic* decision accelerated the trend toward voluntary disclosures in these circumstances, although it is still acceptable under certain circumstances for a company to adopt a policy of silence or state that no comment will be made with respect to merger proposals or rumors.

However, a company may not remain silent where (1) there is an affirmative disclosure rule (such as the tender offer regulations), (2) the company is about to purchase its own shares in the public market, (3) a prior public disclosure made by the company is no longer accurate (such as when a company has publicly denied that merger negotiations with a party were occurring), or (4) rumors that have been circulating concerning the proposed transactions are attributable to a leak from the company.

Disclosure may also be appropriate when it is apparent that a leak has occurred, even if the leak is not from the company. In such a situation, consideration should be given to a variety of factors, including the requirements of any agreement with a stock exchange or NASDAQ, the effect of wide price

fluctuations on shareholders generally, and the benefits to the market provided by broad dissemination of accurate information. If the company does elect to disclose either the existence or the substance of negotiations, it must take care that its disclosures are neither false nor materially misleading.

It should be noted that if the company refuses to respond to a stock exchange's request for disclosure or issues a "no comment," it may be subject to disciplinary action by the exchange. This disciplinary action may include public notice of a violation, temporary suspension of trading in the corporation's stock, or delisting.

Is management required to disclose inquiries about a possible merger or acquisition?

There is no specific obligation to disclose mere inquiries or contacts made by those interested in acquiring the corporation or its stock. If they are pursued, however, the aforementioned complexities apply.

What if an advisor recommends a disclosure stance that comes under challenge?

Then not only will the issuing company be exposed to liability, but so will the advisor. This was the case with George C. Kern, Jr., an attorney subjected to over four years of harrowing SEC administrative proceedings after advising his client, Allied Stores Corporation, to delay disclosure of pending negotiations to sell its shopping center holdings. In June 1991, the SEC dropped the matter.

INSIDER TRADING

Who or what is an insider, and what is insider trading?

An insider is an officer, a director, or a principal shareholder (generally, any beneficial owner of more than 10 percent of the company's equity securities). An insider may also include any employee who, in the course of his or her employment, acquires material nonpublic information about a publicly traded corporation. These individuals owe a fiduciary duty to the employer and its securityholders not to trade on this information prior to its release and

absorption by the market. In addition, outsiders may become temporary insiders if they are given information in confidence solely for a corporate purpose. Attorneys, accountants, consultants, investment bankers, financial printers, and underwriters are examples of temporary insiders who are involved in a merger or acquisition.

Insider trading is trading on inside information. A common type of insider trading involves trading on knowledge of mergers and acquisitions. This may be closely scrutinized by the SEC and may result in criminal prosecutions and very substantial civil penalties. The first major crackdown in insider trading occurred in the 1980s in New York courts under then District Attorney Rudolph Giuliani, who later became the city's mayor. Books written about this era remain bestsellers for their insights into the dark side of equity markets.[42]

What U.S. laws prohibit insider trading?

Most insider trading cases are covered by one well-known rule promulgated by the SEC under authority of the Exchange Act, Rule 10b-5, which prohibits fraudulent or manipulative conduct in connection with the purchase or sale of securities.[43] The reach of 10b-5 on "Employment of Manipulative and Deceptive Devices" is very broad, but its text is extremely short. In its entirety it reads as follows:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange:
>
> (**a**) To employ any device, scheme, or artifice to defraud,
>
> (**b**) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (**c**) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Additional interpretation of this rule appears in Insider Trading and Securities Fraud Enforcement Act of 1988, passed by Congress as part of a crackdown against insider trading over merger information. Relevant guidance is also found in the Securities Litigation Uniform Standards Act of 1998 (SLUSA).

Which has priority in a securities class action lawsuit, federal or state law?

On March 21, 2006, in *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit,*[44] the Supreme Court ruled that SLUSA preempts "covered class actions" purportedly brought under state law on behalf of persons who neither purchased nor sold securities, but instead claim that they were defrauded into refraining from purchasing or selling securities. In doing so, the Supreme Court reaffirmed long-standing policy considerations underlying the application and interpretation of the federal securities laws which recognize that "litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general."

What other laws prohibit insider trading in a tender offer?

Rule 14e-3 prohibits trading on the basis of inside information in the context of a tender offer, whether as an insider or as the "tippee" of an insider. Also, Section 16(b) of the Exchange Act prohibits any officer or director, or any shareholder owning more than 10 percent of the issuer's stock, from profiting from a purchase and sale or a sale and purchase (a short sale) of securities of the issuer within a six-month period. (Not that this rule applies only to insiders; it is not to be confused with short-selling.) This is known as the short-swing profit rule. Any profits from such a purchase and sale or sale and purchase must be paid to the issuer. The short-swing profit rule applies whether or not that person was in possession of material inside information.

Can a shareholder who has exchanged his or her stock in a company for the stock of the company's acquirer sue for Section 16(b) violations?

Yes. In the 1991 case of *Gollust v. Mendell,*[45] the U.S. Supreme Court affirmed the legal standing of the plaintiff, a shareholder of Viacom International, Inc., to sue Coniston Partners for alleged 16(b) violations in connection with its 10 percent holding in the company, which was later merged into Viacom, Inc. (today part of Paramount, Inc.). The court ruled that the plaintiff's ownership of stock in the parent corporation, whose only asset was the stock of the issuer, gave it standing to sue. Securities tax specialists

have noted, however, that "the Court's reasoning could result in the opposite outcome if a merger were solely for cash."

Must a tender offeror file under Section 16 of the Exchange Act?

Yes. Once a tender offeror becomes a beneficial owner of 10 percent of the target's securities, it is an insider for purposes of Section 16 and must file a Form 3 with the SEC within 10 days of becoming an insider. The amount and type of ownership interest of the offeror must be disclosed on Form 3. An offeror must file a Form 4 upon any subsequent change in its beneficial ownership of the target's securities. The Form 4 must be filed within 10 days after the end of any month in which change in beneficial ownership occurred. Forms 3 and 4 must be filed with the SEC and the exchange on which the target securities are traded. All persons required to file Forms 3 and 4 are subject to Section 16(b).

Are there any exemptions from Section 16(b) liability that apply to mergers and acquisitions?

Yes. Under Rule 16b-7 an insider is exempt from liability under Section 16(b) if it acquires or disposes of shares pursuant to a merger or consolidation of companies and one of the companies owns 85 percent or more of the combined assets of the other. Rule 16b-7 usually applies to second-stage mergers after completion of a partial tender offer. Also, a transaction that does not follow a typical sale-purchase or purchase-sale sequence may be exempt from the automatic liability provisions of Section 16(b).

Unorthodox transactions, such as option transactions, stock conversions and reclassifications, and mergers of a target into a white knight and other corporate reorganizations are frequently judged by a pragmatic or subjective test that may enable an insider to avoid liability when the automatic rules of Section 16(b) might otherwise apply. Under this alternative test, liability may be avoided if the insider did not have access to inside information or if the insider did not have a control relationship with the issuer of the securities.

Private lawsuits (as opposed to lawsuits from regulators) are far more common in cases of Section 16(b) violations than Rule 10b-5 violations. The SEC does not enforce Section 16(b); rather, the statute gives the issuing corporation or a shareholder suing derivatively on behalf of the corporation the right to recover any profit made by an insider from purchases and sales, or

sales and purchases, made within six months of each other. Section 16(b) provides for strict liability; that is, it requires that profits be disgorged without regard to whether the insider possesses any material nonpublic information.

What is the "disclose or abstain" theory and how is it applied?

The disclose or abstain theory applies when an individual possesses material nonpublic information about a corporation to which he or she owes a fiduciary duty. The individual must either disclose the information to the market or abstain from trading in securities of the affected company. In the classic *Texas Gulf Sulfur* case of 1968, the Second Circuit Court of Appeals in New York ruled that anyone who possesses material inside information must either strive to tell all (and trade if they wish) or tell nobody and refrain from trading.

In practical terms, disclose or abstain means *abstain.* To be effective, disclosure of a material development affecting a security must result in dissemination broad enough to inform the entire public trading in that security. Most individuals cannot adequately disseminate such information themselves and disclosure itself may constitute a breach of fiduciary duty. If the inside information is incomplete or inaccurate, disclosure could be misleading to other investors and result in separate liability under other SEC disclosure rules.

What is the misappropriation theory, and how is it applied?

The misappropriation theory of liability holds that an individual violates the securities laws when he or she secretly converts information given to him or her for legitimate business or commercial purposes by trading on the information for personal benefit.

For example, in one highly publicized case, Dennis Levine, an investment banker who received material information concerning a client and traded in securities of that client on the basis of that information, was found to have violated a duty to his employer and to the client not to use that information for his personal benefit. Under the misappropriation theory, Mr. Levine traded illegally on insider information.

The Supreme Court upheld the misappropriation theory of liability in a case involving *Wall Street Journal* reporter R. Foster Winans. Winans was charged with, among other offenses, violating the securities laws by misappropriating information from his employer, even though the information was not about his employer and was not used to trade in his employer's securities.

In the Winans case, the misappropriated information was the content and timing of publication of Winans's influential "Heard on the Street" column in the *Wall Street Journal* about market information.

How do Rule 10b-5 and Rule 14e-3 relate?

Rule 10b-5 has been used alone or with other rules such as Rule 14e-3 to prosecute insider trading cases. Until recently Rule 14e-3 was never used alone. In September 1992, however, the SEC filed 14e-3 charges against seven people who allegedly traded in Pillsbury Co. stock during a bid by Grand Metropolitan in 1988. This was the first case in which 14e-3 was used apart from 10b-5.

What if a tippee has no fiduciary relationship to the source of confidential information—does this mean that he or she can still be charged with insider trading?

That is correct. Traditionally, the more distant tipping was, the harder it was to prosecute, in part because of the lack of an implied fiduciary duty. Two landmark cases exemplified this principle.

In *Chiarella v. The United States* (1980), the Supreme Court reversed the insider trading conviction of Vincent L. Chiarella, a financial printer who construed target names from confidential documents and traded on that information. The Supreme Court cleared Chiarella because, it said, there must be a confidential relationship, or fiduciary duty, between a defendant and another person, and that Chiarella had no duty to the sellers of the stock he had bought.

In *Dirks v. SEC* (1983),[46] the Supreme Court ruled that financial analyst Raymond Dirks did not commit illegal insider trading by advising clients to take actions based on inside information. The court said that the duty of a tippee depends on whether the source of the tip has breached a legal duty to the shareholders in communicating the information. Both of these decisions have helped defense attorneys to protect fourth- and fifth-level tippees.

Can an insider be convicted of insider trading if the insider is unaware that information he or she is trading on is material and confidential?

Traditionally, the answer has been no. Section 10(b) has a *scienter* requirement. This means that to be found liable for violating Rule 10b-5, an insider must have either "actual knowledge" of the fraud or omission or have acted with "recklessness and disregard of the truth." Furthermore, judicial interpretation

of 10b-5 has often centered on the issue of fiduciary duty of the tipper to the issuer of the securities or some other party. But another key insider trading rule, Rule 14e-3, does *not* contain such a requirement.

How does Rule 14e-3 operate?

Rule 14e-3(a) prohibits an individual from trading while he or she possesses material nonpublic information concerning a tender offer if the individual knows or has reason to know that such information is nonpublic and has been obtained, directly or indirectly, from any of the following: the entity making the tender offer, the corporation that is the subject of the tender offer, any persons affiliated with these entities, or any person acting on behalf of either entity. The transfer of such information from a tipper to a tippee violates laws against tipping.

What is tipping and what laws prohibit it?

Tipping is the selective disclosure of material nonpublic information for trading or other personal purposes. Courts have interpreted Rule 10b-5 to prohibit tipping, although the rule does not address the issue directly. Rule 14e-3, which supplements Rule 10b-5, does contain an antitipping provision that applies in the context of a takeover. However, neither of these Rules contains the term tipping. The Insider Trading Sanctions Act of 1984 expressly imposes civil penalties for tipping.

What is a tipper?

A tipper is a person who, in return for some direct or indirect benefit, provides material nonpublic information to another person who then trades in that security.

What is a tippee?

A tippee is a person who receives material nonpublic information about a security and then trades in that security. Note that a tippee may also become a tipper if he or she then divulges the information to another person (who becomes a second-level tippee, and who might then tip to another person, and so on).

How does Rule 10b-5 treat tipping?

Tipping is only prohibited by Rule 10b-5 if two tests are met: (1) The tipper has breached a duty that he or she owed to the corporation or its shareholders

(for example, a fiduciary duty to a company and its shareholders as an officer and director); and (2) the insider will receive a personal benefit, directly or indirectly, from the disclosure.

If the tipper gains no personal benefit, can he or she still be accused of tipping?

No. But, the interpretation of "benefit" is very broad. Obvious examples of personal benefit include not only monetary gain but also any enhancement of the tipper's reputation that might translate into increased future earnings. However, the Supreme Court has stated that divulging inside information to a relative or friend who then trades and returns a gift or a portion of the proceeds resembles trading by the tipper himself.

Under Rule 10b-5, must a tippee have such a fiduciary relationship with the tipper?

No, the typical tippee has no such relationship. However, if the tippee knows or should have known of the tipper's breach of duty and participates in the violation through silence or inaction, the tippee becomes liable as an aider and abettor if he or she then trades or divulges the information to one who trades.

How does Rule 14e-3 treat tipping?

In contrast to Rule 10b-5, Rule 14e-3(d) contains clear antitipping provisions in the context of tender offers (although even in Rule 14e-3, the word "tipping" is not used). Rule 14e-3(d) makes it unlawful for certain persons to "communicate material, nonpublic information relating to a tender offer . . . under circumstances in which it is reasonably foreseeable that such communication is likely to result in [improper trading or tipping]." This portion of the rule expressly excludes communications "made in good faith to certain individuals."

When are the antitipping provisions of Rule 14e-3 triggered?

Rule 14e-3 is triggered when any person has taken a "substantial step" to commence a tender offer, even if the offer never actually begins. A substantial step includes the offeror's directors voting on a resolution with respect to

the tender offer; the offeror's formulation of a plan to make an offer; arranging financing for a tender offer; authorizing negotiations for a tender offer; and directing that tender offer materials be prepared.

What penalties may be imposed for insider trading?

Damages for violation of Rule 10b-5 are limited to actual damages. However, additional charges are usually made in insider trading cases. In general, insider trading may result in criminal penalties of up to $100,000 and five years in jail, or both, if the trading is found to be a willful violation of the Exchange Act or of SEC rules and regulations promulgated under the act. In addition, the SEC has authority to seek a civil money penalty of up to three times the amount of profit gained or loss avoided by insider trading on a national securities exchange or through a broker or dealer in violation of federal securities laws. Damages are limited to actual damages.

In addition to the civil penalty for insider trading, the SEC may seek ancillary relief, including a court order enjoining the violator from future violations, plus disgorgement of profits resulting from the illegal trading. The disgorged funds may be paid into an escrow account so that private parties damaged by the insider trading can be compensated for their losses.

Suppose a tipper or tippee doesn't make money?

This can make a court more lenient, since the amount earned is one factor that courts, particularly appellate courts, weigh in rendering decisions.

Who typically engages in illegal insider trading?

Insider traders—both tippers and tippees—come from all walks of life. Anyone with access to confidential inside information can tip, be tipped, or act alone. Insider trading case defendants indicted in recent years include not only participants in the M&A process, such as investment bankers, arbitrageurs, consultants, and attorneys, but also their assistants, such as secretaries and paralegals. Corporate chief executives and their outside directors are also occasionally found guilty of this practice, along with their tippee relatives and in-laws. In one case, men installing a security system to protect

confidential files used such confidential information to trade. Financial printers are another susceptible group.

Perhaps the most unusual—and egregious—case of insider trading was that of a psychiatrist who enriched himself through information provided unwillingly by an executive's wife under his "care."

Are all securities laws cases brought under the Securities Act and Exchange Acts?

No. Other laws may be applied in securities cases. For example, RICO can be applied.

What is RICO?

The Racketeer Influenced and Corrupt Organizations Act (RICO) was passed as part of broad anticrime legislation in 1970. RICO sets steep penalties, which includes asset freezes, treble damages, and up to 20 years in jail, for those who engage in a "pattern" of crime. It was first applied in securities fraud cases in the late 1980s. More recently, the Department of Justice has succeeded in a RICO case against several U.S. tobacco companies.[47] In general, however, judges have shown restraint in applying the law.

For example, in June 2006, the U.S. Supreme Court declined to apply RICO in two cases. In *Hybne Mohawk Industries v. Williams,* the court sent the case back to circuit court[48] and in *Anza, et al. v. Ideal Steel Supply Corp.* the court revisited the question of indirect versus direct harm. As in previous court decisions, they said there must be "some direct relation between the injury asserted and the injurious conduct alleged."[49] For the time being, then, RICO does not appear to be a concern for transactions involving the purchase of public company securities.

FINANCING THE PUBLIC TRANSACTION

Is the financing of a public company acquisition very different from the financing of the acquisition of a private company?

The financing of a one-step transaction, involving the merger of an acquiring company into the target, is essentially the same as the financing of any other acquisition (see Chapter 4). The financing of a two-step acquisition (a tender

offer followed by a merger of the acquiring company into the target) is somewhat different.

How is the financing of a two-step transaction different?

The financing of the first step, the tender offer, is subject to Federal Reserve margin rules. These rules generally prohibit lenders, including banks, brokers, and others, from making loans secured directly or indirectly by margin stock (most publicly traded stock) if the loan exceeds a specified percentage of the value of the collateral (generally, 50 percent).

For example, if the acquisition subsidiary intends to acquire stock of a target worth $100 million in a tender offer, the maximum secured loan that can be made would be $50 million. This means that the other $50 million has to be financed by other than secured loans, such as unsecured debt or equity investments. The unsecured loans may be, for example, bridge loans from investment bankers or privately placed debt. Assets of the target are, of course, not available to secure the financing until after the merger.

It is important to know that the margin rules apply even to indirectly secured debt; the substance, not the form, of the transaction will govern the application of the rules. Therefore, if the borrower has no assets other than the target stock and has agreed with the lender not to pledge the stock to any other lender, the loan may be deemed to be indirectly secured by the stock.

If the acquisition subsidiary is a shell corporation, can it freely incur unsecured debt and not violate the margin rules?

No. The position of the Federal Reserve is that if lenders make unsecured loans to a shell subsidiary for purposes of a tender offer, the loan will be presumed to be secured by margin stock subject to the 50 percent of value limitation. There is an important exception to this rule: The presumption does not apply if a merger agreement with the target is signed prior to the closing of the tender offer. Thus, in the case of a friendly two-step transaction, it is important that a merger agreement be signed *before* the tender offer in order to facilitate the financing of the tender offer. If there is no merger agreement, the amount that can't be financed under the margin rules may have to be financed by preferred or common equity or by loans guaranteed by other entities that have substantial assets.[50]

TAKEOVER DEFENSES

What does the directors' duty of loyalty require when responding to an unsolicited tender offer?

When considering the response to an unsolicited tender offer, the board of directors of a target corporation owes a duty of loyalty to the corporation's shareholders to adopt defensive measures to defeat a takeover attempt that is contrary to the best interests of the corporation and its shareholders. However, the board must be careful to adopt defensive measures only when motivated by a good faith concern for the welfare of the corporation and its shareholders.

Does it violate the duty of loyalty if a board adopts a defensive tactic in part to retain management control?

No. Defending a corporation against hostile takeovers to maintain control, among other motives, does not violate the duty of loyalty. However, it is improper if a director's sole or primary motive for implementing a defensive tactic is to retain control of the company.

What factors should a board of directors consider before it decides to defend itself against a tender offer?

Before deciding to defend a company against a potential tender offer, directors should take into account the following considerations:

- The attitudes of existing major shareholders about the defenses
- The present and future impact of defenses on the value of the company's stock
- The ability of the company to pursue a negotiated transaction with friendly bidders (white knights) if the defensive measures are implemented
- The reasonableness of the defenses in relation to the threat posed

It is very important to document the decision-making process in this regard. Annual surveys from Tillinghast-Towers Perrin show that companies with a history of merger, acquisition, or divestiture activity are more likely to

experience a claim against their directors and officers than companies that have not engaged in such activity.[51]

On what basis can directors reject an acquisition offer?

There are generally three reasons why an offer can be rejected and defenses implemented: (1) The offer is inadequate (that is, the target company's directors have information that enables them to make a reasonable judgment that the company's outstanding capital stock is worth more than what is being offered); (2) the offer is unfair in that those stockholders not tendering their shares will receive less consideration at a later date (such as in the case of a front-end loaded, two-tier offer); or (3) the company determines that it is better served by remaining independent.

What defenses are commonly adopted against hostile takeovers?

Of the some 40 varieties of defenses available to companies, the most common are antitrust defenses, restructuring defenses, "poison pills," charter and bylaw amendments, defensive sales or acquisitions, and defensive payments. State antitakeover statutes can also play an important role in defending against a hostile takeover.

What is an antitrust defense?

In a typical antitrust defense, the target accuses a bidder of violating antitrust rules by tendering for it. For example, target Square D Company obtained a delay in a takeover bid by Schneider S. A. of France by claiming the two companies were in the same market segment—electrical products.

What are the main types of restructuring defenses?

Common restructuring defenses include recapitalizations, self-tenders, and master limited partnerships.

How do recapitalizations work?

A recapitalization substitutes portions of the outstanding capital stock held by the public with cash, debt instruments or securities, or preferred stock.

These transactions may increase the percentage of voting stock held by management and employee benefit plans. They may also increase ownership levels of individual stockholders who retain their stock instead of selling into the company buyback. (Indeed, a recapitalization has been likened to a public leveraged buyout because the number of outstanding shares decreases as they are purchased by the company, thereby increasing the percentage holdings of remaining stockholders.)

There are basically three ways to accomplish a recapitalization:

- Through a tender offer for the company's own stock
- Through a transaction such as a merger, where a subsidiary merges into the company when the plan becomes effective
- Through a reclassification amendment of the company's charter (This requires shareholder approval and may involve the issuance of options to shareholders to purchase shares of the recapitalized company upon the occurrence of certain events.)

It is also sometimes possible to issue massive dividends to stockholders, financing such a transaction through debt. Any one of these actions can cool off even the most ardent of pursuers.

Each type of recapitalization has its advantages and disadvantages. In a tender offer situation, speed is the primary advantage because no stockholder vote or proxy statement is required. The company may also issue securities without filing a registration statement with the SEC because Section 3(a)(9) of the Securities Act permits the exchange of securities without registration if it only affects existing securityholders, and no remuneration is paid for soliciting the exchange.

Recapitalizations have generally withstood court challenges. However, courts will not uphold recapitalizations that appear coercive, that is, leave the stockholders without a real option to decline participation.

How can a company recapitalize using an employee stock ownership plan (ESOP)?

An ESOP may be used as a tool in a recapitalization. An ESOP purchases stock in the open market or from the company, allowing its employees and management to own part of the company. By borrowing to acquire the shares, an ESOP can help finance a recapitalization; it can also purchase shares directly from unrelated parties at a premium, which allows it to purchase shares from a hostile bidder. The disadvantage of ESOP participation is this: it can

dilute the public's percentage of ownership in the company if the company issues new shares to the ESOP.

An ESOP is managed by trustees who have the duty to act in the best interests of its beneficiaries. If the trustees are also the company's directors, a hostile bidder may assert a conflict of interest by the directors and question their motives for initiating an ESOP during a takeover attempt. The suggestion would be that the directors, as trustees, implemented the ESOP not in the interest of the beneficiaries, but to fend off the bidder and preserve management.

There may also be a conflict of interest issue when the ESOP is in place before a hostile bid, if the trustees decide to purchase more of the company's stock immediately preceding or during such a bid. However, if the trustees can justify their decisions on the basis of acting in the best interests of all the ESOP's participants and demonstrate the requisite detached judgment, legal challenges can be overcome.

What are some of the concerns involved in a recapitalization?

A company that has undertaken a recapitalization that has caused it to become highly leveraged or cash poor may no longer have the financial resources to weather unexpected economic conditions or even to carry on its intended business. The recapitalization plan that engenders such consequences is subject to the federal fraudulent conveyance and transfer laws, the Federal Bankruptcy Code, and state laws (see Chapters 4 and 11). Creditors and stockholders alike may contend that the company has become insolvent or is no longer able to function with the remaining working capital, or that the company has incurred debts that are beyond its capacity to repay.

Most states impose limitations upon a company's ability to make dividend distributions and to repurchase or redeem its own stock if such transactions would impair the company's capital. These corporation statutes may affect the kind of recapitalization a company might initiate.

How do self-tenders work?

A self-tender is a defensive measure implemented to defeat an unsolicited tender offer or at least to obtain a higher price. The company announces its intentions to repurchase its own outstanding stock, or a portion thereof, to prevent the offeror from acquiring a controlling interest in the company.

Stock repurchases are seldom effective as a defensive tactic if not combined with other techniques, such as stock purchases by management, by ESOPs, or by other major stockholders, which tend to lock up substantial blocks of stock in friendly hands.

Self-tenders, like other tender offers, are regulated by the federal securities laws. Rule 141-10 requires that all holders of the same class of stock be treated in the same way; that is, the same offer must be made to all stockholders, whether they are hostile bidders or not. The company is also required to accept all shares tendered to it, including a hostile bidder's shares.

How can open market repurchases dissuade hostile takeovers?

By repurchasing its own shares on the open market without making a formal tender offer, a company can not only boost its level of ownership, crowding hostile acquirers, but it can also maintain or increase its stock prices and thereby make itself less attractive to a bidder. Such purchases, whether financed by cash flow, asset sales, or borrowing, tend to reduce the benefits of a potential buyer while increasing the burdens.

What legal considerations are there in a repurchase?

In implementing a repurchase plan, directors must satisfy the business judgment rule and comply with various other state and federal laws, including, in particular, Rule 10b-18, which regulates the purchase of registered equity securities by an issuer.

How do poison pills work?

A poison pill, the nickname for what is technically called a shareholders' rights plan, involves the issuance to stockholders of rights to acquire securities. These rights can be exercised only under certain circumstances (such as a takeover attempt) and may be redeemed by the company at a nominal price until the occurrence of such events. The primary objective of poison pills is to give management leverage in negotiating bids in order to avoid unfair treatment of stockholders (in coercive two-tier takeovers or partial tenders) and ensure a minimum price in any takeover.

Although poison pills normally do not require stockholder approval, shareholders at some companies have put forth successful proxy resolutions

recommending a change in company bylaws to require shareholder approval of their company's shareholders' rights plan, or redemptions in full. These proposals wax and wane in popularity. In 2004, more than 100 resolutions were proposed to ban pills; in 2006, only about 25 such resolutions made it to a vote.[52]

There are two common kinds of poison pills: flip-over and back-end. These may be combined in one defensive plan. Less frequently seen, and not described here, are flip-in, convertible preferred stock, and voting rights poison pills.

The use of poison pills as a defensive measure has generally been upheld by courts, but some plans have been enjoined because of their specific provisions and purposes. In implementing these plans, directors must be able to prove that the measure was adopted in good faith after reasonable investigation and is reasonably related to the threat posed.

What are flip-over plans?

In this plan, each common stockholder receives for each share owned a right to purchase shares of the surviving corporation upon the occurrence of a triggering event. Triggering events are typically the acquisition by a single purchaser or group of a specified amount of stock or the commencement of a tender offer for a specified percentage of the company's stock. Following the occurrence of a triggering event, the company issues certificates to stockholders that allow them to exercise and trade their rights. Because the rights issuance is in the nature of a dividend, it does not generally require shareholder approval, although company bylaws may mandate this.

The rights usually allow the certificate holder to purchase stock of the surviving entity for half price after the merger has been consummated, so the effect of the flip-over is to reduce the acquirer's equity. There is a plus and minus here. Because the rights usually may be redeemed for a nominal amount before the triggering event (and often within a short period of time thereafter), a bidder has an incentive to negotiate with management before the actual takeover attempt. But there is a catch: once the takeover bid has occurred and the rights become redeemable, they may adversely affect the company's ability to negotiate with a white knight, as they would dilute the white knight's future potential equity.

Thus a flip-over plan should also include a provision that a transaction approved by the directors will not result in the stockholders' rights becoming exercisable even though the triggering events have occurred. Such a provision allows the company to seek a white knight.

What are back-end plans?

A back-end plan is similar to a flip-over plan, although its objectives differ. Holders of the company's common stock receive a right for each share owned that entitles them, upon the occurrence of certain triggering events (for example, a 20 percent acquisition by a bidder), to exchange each share for a note that matures typically within a short period of time (such as one year). Alternatively, the right may be exchanged for cash or preferred stock, or a combination of the three. The value of the right may be fixed at the outset or may be calculated from a formula based on the highest price per share paid or offered by a bidder during the takeover attempt.

The purpose of the plan is to maximize stockholder value in the event of a merger or business combination by ensuring a minimum acceptable price and to protect stockholders from the adverse effects a significant minority interest can have on other bidders even if no merger results. A back-end plan is not designed to prevent a takeover but to ensure a proper negotiated value for the company and its stockholders.

The plan will usually provide that the rights will not be exercisable if the acquirer, upon reaching a certain level of ownership, offers to purchase the remainder of the outstanding shares at the price set by the plan. The rights are usually redeemable for a specified period of time (for example, 120 days) to allow a bidder to express its intentions to complete the transaction as specified.

Such a plan will likely be upheld by the courts if (1) it is not designed to prevent all takeovers, (2) the back-end price is reached with the advice of investment bankers and reflects the realizable value over the plan's life (for example, one year), (3) the plan is a reasonable response to the threat perceived by the directors (for example, a possible second-step merger), and (4) the plan is plausibly related to the goal of shareholder wealth maximization.

How do charter and bylaw amendments help companies deter takeovers?

Charter and bylaw amendments will generally not prevent takeover attempts, but they do provide protection from coercive and abusive acquisition tactics. These amendments may also slow down the acquisition process, giving the company's directors more time to react and negotiate. Proposed amendments must be approved by stockholders, and they almost always are. In 1992, however, shareholders of at least seven companies denied management the support required to initiate or maintain such defensive measures.

Any amendments adopted by the stockholders will apply equally to the company's management and any bidder who acquires shares. There is another important consideration in adopting amendments: if the stockholders reject the proposals, the company may seem—and indeed may be—more vulnerable to takeovers by bidders.

What kinds of defensive charter and bylaw amendments are there?

The most widely used charter and bylaw amendments include supermajority provisions, fair price provisions, contingent cumulative voting provisions, staggered board provisions, defensive consent requirements/notice of business and special meetings provisions, and special classes of stock.

What are supermajority provisions?

A company may adopt a charter amendment to require more than a simple majority (a supermajority) of its stockholders to approve certain matters, such as any merger or business combination. There are several effective variations of this defense, one of which is a requirement that a majority of the disinterested stockholders—a majority of the minority—approve the transaction. To protect the supermajority provisions, there should be a provision that would require a supermajority to modify the supermajority provisions of the charter.

What are the drawbacks of supermajority provisions?

One of the disadvantages of supermajority provisions is that they apply to friendly as well as hostile takeovers. Therefore, to the extent such provisions may deter hostile bidders, they may also make it more difficult to negotiate a friendly takeover. As a partial cure, such a provision may be coupled with one specifying that a simple majority is sufficient if the directors approve the merger.

Some companies can find themselves stuck with supermajority provisions that are unnecessarily broad. For instance, in the spring 1992 and 1993 proxy season, Baltimore Bancorp management tried to eliminate its supermajority vote requirements but failed to get the two-thirds vote that was required to do so.

What are fair price provisions?

A fair price provision is a variation of a supermajority requirement that would require a specified supermajority to approve a proposed merger unless the bidder pays the minority stockholders a fair price. Usually a fair price means a price that equals or exceeds the highest price paid by the bidder in acquiring shares of the company before the merger. The purpose of this provision is to ensure fairness to stockholders in a two-tier acquisition.

How does contingent cumulative voting work as a defense?

Cumulative voting permits a stockholder to vote the number of shares owned by him or her multiplied by the number of directors being elected; all of a stockholder's potential votes may be added together and cast for a specific director.

Contingent cumulative voting, if coupled with a staggered board of directors, may provide the minority stockholders who disfavor the merger with a tool to block or delay the election of a slate of the bidder's directors. For example, a charter amendment may provide that when and if a bidder acquires a certain specified percentage of the company's stock (for example, 35 percent or more), cumulative voting goes into effect. In this case, the minority stockholders may be able to elect or retain more directors than if the charter amendment were not in place.

What effect does a staggered board have on a target company?

The election of directors on a staggered basis—usually one-third of the directors are elected each year for a three-year term—prevents a bidder from electing a new slate of directors in a single meeting of stockholders and thereby gaining immediate control of management.

By itself, the staggered board (or "classified board") provision would not deter a takeover, but in conjunction with contingent cumulative voting, staggered elections may give a company more flexibility in dealing with unwanted bidders. About half of all public companies have staggered boards as of 2006.

How do "consent requirements" provisions work?

Many states' corporation laws provide that a majority of stockholders may, without calling a meeting, act by written consent. A company that does not

amend its charter to provide otherwise may be susceptible to a bidder acquiring a majority interest and then immediately amending its charter to remove other impediments to control.

To combat this possibility, the company may, by charter amendment, eliminate the written consent provisions entirely or require that all stockholders consent before actions can be approved without a meeting unless state law prohibits the elimination of the consent procedure. If the consent procedure cannot be eliminated, the company may consider amending its charter or bylaws to require stockholders wishing to take action by written consent to notify the board of directors and request that it establish a record date to determine which stockholders are entitled to sign a consent. The passage of such an amendment would also permit the directors a reasonable opportunity to prepare a response and oppose the proposed action, by soliciting proxies, if necessary. Such an amendment might also contain specified periods for consent revocation and consent validity.

What about special classes of stock?

Until 1988 many corporations defending against takeovers created special classes of stock that gave superior voting rights to management. In that year the SEC approved Rule 19c-4, the "one share, one vote rule" that banned such a technique. Some exchanges—the New York Stock Exchange (NYSE) and NASDAQ (but not the American Stock Exchange)—have similar rules. In 1990 in *Business Round Table v. SEC,* the U.S. Court of Appeals for the Second Circuit overturned Rule 19c-4, and companies returned to this practice. Although the NYSE does have a rule against multiple classes of stock, it has limited application. Berkshire Hathaway, Ford Motor Company, and the *New York Times* have all had such a structure in recent days.

How does confidential voting fit in all of this?

Confidential voting is one of several causes célèbres for many shareholders, especially these who want to vote against management without detection. Some 160 companies now have confidential voting policies—often because of pressure from shareholders.

Another popular type of shareholder resolution is the rescission of the antitakeover devices listed above. Note, however, that larger institutional investors are moving away from piecemeal confrontation and toward unseating entire boards—or working behind the scenes for voluntary changes.

What kinds of defensive sales are there?

A company may sell a crown jewel to avoid being taken over, may radically downsize itself, or may sell its stock to a white squire or white knight.

What is the crown jewel defense?

The crown jewel defense is the sale of particularly attractive assets by the target company to dissuade a bidder from pursuing its takeover attempt. Such sales may also give the company flexibility and resources to fend off a bidder by generating capital and/or reducing costs. On the other hand, if a bidder is interested in a specific asset, such as a subsidiary, and is willing to acquire the entire company for it, the asset may be very valuable to the company as well, and its sale may be detrimental over the long term.

As discussed earlier, courts will generally view with disfavor an asset or crown jewel lockup that has the effect of stopping or discouraging the bidding process.

What is a white squire?

To remain independent, the company may determine that its best course of action is to sell a large block of its stock to a friendly investor, a white squire, that the company does not believe is a threat. The more well-known white squires are investment vehicles such as Warren Buffet's Berkshire Partners or Goldman Sachs's newly formed GS Capital Partners L.P., but white squires can also be operating companies. The obvious danger here is that relations between the white squire and company may take a turn for the worse, and the white squire may decide to acquire control of the company at a later date.

To prevent the white squire from becoming a hostile bidder, companies typically use standstill agreements. A standstill agreement imposes certain limitations on the investor that assure the company that the stock will not find its way to a hostile bidder. Typically, the stock purchase agreement will limit the percentage of stock the white squire may acquire in addition to the shares in question for a specific period of time. It will also contain restrictions on the resale of the minority interest to third parties, which is usually coupled with a right of first refusal by the company. The voting rights relating to the block of shares sold also may be limited.

The directors' decision to enter into such an arrangement and the provisions of the standstill agreement will be evaluated under the business judgment doctrine. These arrangements are generally upheld if the court finds that entrenchment is not the directors' sole or primary purpose.

What is a white knight?

A white knight is a friendly acquirer sought by the target as a positive alternative to a hostile acquirer. Unless the friendly acquirer pays as much or more than a hostile acquirer, however, this kind of defensive sale is vulnerable to legal challenge.

What is in it for the white knight?

White knights can make money in the right deal. A. Alfred Taubman, for example, made an estimated profit of $275 million on his gallant purchase of Sotheby's Holdings, Inc., the auction house.

May a company make an acquisition or agree to a merger to avoid being acquired?

Yes. A company may combat an unwanted bidder by acquiring other companies or divisions that make it less attractive to the bidder. The company may also acquire assets that may precipitate an antitrust problem for the bidder if the transaction is completed. The effectiveness of antitrust barriers is mitigated by the fact that government agencies are generally willing to consider proposed curative measures by the bidder (that is, a promise to sell the unit[s] in question) before rejecting a merger.

This same defense can be used in merger form. When Paramount wanted Time, Time merged with Warner Corporation in a successful attempt to flee its suitor. In the landmark case of *Paramount, Inc. v. Time, Inc.* (1990), the court used the business judgment rule to uphold this merger.

What is the Pac-Man™ strategy of defense?

When a company learns it is the object of a tender offer, it may respond by tender offering for the stock of the hostile bidder. In this eat-or-be-eaten strategy, named after a video game popular in the early 1980s, the company undertaking the counter tender offer thereby concedes that the business combination is desirable but indicates that it should control the resulting entity. It also forgoes certain defenses it might otherwise bring, such as antitrust and other regulatory barriers that concern the legality of the combination.

The disadvantages of the Pac-Man defense are that the original target company's stockholders will not receive any premium (the original target company may actually give the other company's stockholders a premium), it is very

costly, and it may damage the company, even if successful. When considering the legality of this defense, courts will apply the business judgment rule.

What kinds of defensive payments may a target make?

Two ways to spend a company out of immediate danger are *greenmail* and *golden parachutes.* Both, however, entail risks.

What are the potential risks of greenmail as a takeover defense?

Bidders sometimes accumulate stock and threaten to initiate a tender offer with the ultimate purpose of reselling those shares to the company at a premium rather than obtaining control of the company. Greenmail is a payment to purchase such stock at a premium.

Paying greenmail is largely ineffective in protecting the interests of the target (other greenmailers may surface once the company has succumbed the first time), discriminatory (other holders of the same class of stock may not share in the premium), and legally questionable: there have been stockholder lawsuits with various degrees of success to recover greenmail payments as corporate assets. Furthermore, greenmail is relatively unpopular with stockholders.

Finally, greenmail payments are expensive. Not only are the premiums high, but they may be taxable. Section 5881 of the IRC imposes a 50 percent excise tax on greenmail payments, payable by the recipient.[53] The tax is imposed not only upon cash payments by the target to purchase the greenmailer's stock, but also on other, more disguised payments constituting consideration for the stock, such as reimbursement of the greenmailer's related transaction expenses or purchases of other assets of the greenmailer. It can also be imposed on payments made by related parties, such as a white knight, and thus tends to compel a defeated raider to sell out to an independent holder, such as an arbitrageur, rather than to a party controlled by or acting under agreement with the target.

The effect of all these developments has been to decrease greatly the incidence of greenmail in recent years.

What are golden, lead, and tin parachute payments?

These are the nicknames given to severance payments promised to top management, middle management, and workers, respectively, in the event of their dismissal during or immediately subsequent to a change of control.

Aren't these parachute payments also unpopular with stockholders?

Yes, and increasingly more so, because stockholders, who often oppose such payments, get advance warning of them through compensation disclosures in the proxy statement. In the spring 2006 proxy season, shareholders of at least 32 companies filed proxy resolutions asking to ban golden parachutes—a fairly typical annual tally. In recent years, majority support for such proposals has been common. However, because votes are usually treated as "precatory" measures (with no obligation to adopt them even if they pass), shareholders usually try to work behind the scenes to get companies to adopt the requested policies voluntarily. Then the shareholders withdraw their resolutions. In 2006, at least four proposed policies got adopted before the annual meetings.

RELATED STATE LAWS

What provisions of state law limit director and officer liability for defensive measures?

Charter opt-in provisions authorize corporations to pass a charter or bylaw provision eliminating or reducing the personal liability of directors for money damages. This provision is particularly significant in takeovers, since many shareholder suits against defensive target boards do request money damages.

Several states have raised the threshold of liability to require more than proof of simple negligence by board members. Gross negligence, or recklessness, generally must be proved by the plaintiff for personal liability to attach.

Other provisions protecting directors include expanded indemnification for derivative suits against the board, expanded provisions permitting corporations to provide benefits other than indemnification, and provisions that permit directors to base their decision to reject an offer on considerations other than price, for example, the effect of the transaction on the community and other corporate constituencies.

What states have passed antitakeover statutes?

As of late 2006, 43 states had passed antitakeover statutes—all states except Alaska, Alabama, Arkansas, California, Montana, New Hampshire, and West Virginia. Washington, D.C., where some public companies are incorporated (although it is not a state) has no antitakeover statutes, either. Common wisdom said that antitakeover laws could be a draw for incorporation, but recent research indicates that governance flexibility is more important.[54]

Antitakeover statutes apply generally to corporations organized within the state. However, some states (for example, Massachusetts) have statutes asserting that companies not incorporated in the state will still be subjected to the statute's provisions under certain circumstances—for example if the companies have substantial operations there (such as executive offices), if the bulk of their workforces or assets are in the state, if at least 10 percent of the shares are owned by state residents (excluding brokers or nominees), or if 10 percent of the shareholders reside in the state.

What are the most common state antitakeover statutes?

State antitakeover statutes may offer one or more of several protections. In order of popularity, these are laws: banning *freeze-outs* (33 states), protecting the right to honor *other constituencies,* also called *stakeholder* statutes or *nonstockholder* or *nonmonetary considerations* (31 states), setting a *control share* requirement (27 states), requiring *fair prices* (27 states), and allowing *poison pills* (25 states). Others include antigreenmail provisions, labor contract or severance pay requirements, cash-out requirements, recapture of profits, and classified board mandates for staggered terms of board service.

How does a freeze-out provision work?

It freezes deals at least temporarily by stating that acquirers of companies incorporated in the state must wait a certain period—from two to five years—before completing the second step of their desired merger with resistant targets, under a defined supermajority vote for the merger initially.

What about "other constituency" statutes?

These impose a different standard of care on directors in evaluating any business combination. Directors must examine and consider the long-term effects of an offer on the company, its stockholders, the affected community, and other corporate constituencies.

What is a "control share" statute?

This is a statute regulating a "control share acquisition," typically defined as the acquisition of enough shares in a target company to give the acquirer control over more than a specified percentage of the voting power of the target. The triggering level of share ownership is usually defined as an acquisition

that would bring the bidder within a certain range of voting power—variously defined as 20 to 33⅓%, 33⅓ to 50%, and more than 50%.[55] Most control share acquisition laws state that shares acquired in a control share acquisition shall not have voting rights unless the shareholders approve a resolution granting voting rights to the acquirer's shares.

What is a fair price statute?

These require any bidder who is rebuffed by a board to pay a defined fair price to all shareholders unless a supermajority approves the bid.

How do poison pill and antigreenmail provisions work?

Poison pill provisions authorize corporate boards to enact shareholders' rights plans. Without such authorization, poison pills may not be instituted or may be more vulnerable to legal attack by regulators or shareholders.

Conversely, antigreenmail provisions effectively ban, rather than protect, another popular antitakeover measure. These bar the repurchase of a specified percentage of shares at a premium from an investor who has held the shares for less than a specified amount of time, unless the same premium is offered to all shareholders, or all shareholders approve it.

Could you please describe antitakeover provisions governing labor contracts?

Some states force acquirers to honor labor contracts, providing severance pay for employees who lose their jobs as a result of a takeover. Some states have adopted cash-out provisions requiring the acquirer of a certain percentage of a company's shares to buy the shares of remaining shareholders at a statutorily defined fair price.

Furthermore, some states have statutes allowing companies to recapture the profits of bidders who put them into play by buying their shares and reselling them within 18 months. Also, one state—Massachusetts—requires all companies incorporated in that state to have staggered terms for their boards of directors.

Do any states ban specific antitakeover practices?

Yes. Some states have enacted statutes prohibiting companies from granting nonroutine increases in compensation such as golden parachutes or special bonuses while a tender offer is open.

CONCLUDING COMMENTS

Leaders of public companies engaging in merger transactions need to retain advisors who know the regulations surrounding public company mergers. They also need to build positive relations with their shareholders and other constituencies, including employees, customers, and bondholders. If they master these two Rs (regulations and relations), their companies are more likely to avoid problems such as poor economic performance. Unfortunately, however, this is a risk for every company, public or private. In the next chapter, we will consider what happens in public and private companies when a company faces insolvency.

NOTES

1. There are more than 15,000 public companies; however, only 10,000 of them sell equity securities. The others sell only debt securities.
2. *The Securities Act of 1933,* Section 2(a)1.
3. Regulation FD (Fair Disclosure) addresses selective disclosure. The regulation provides that when an issuer, or person acting on its behalf, discloses material nonpublic information to certain enumerated persons (in general, securities market professionals and holders of the issuer's securities who may well trade on the basis of the information), it must make public disclosure of that information. The timing of the required public disclosure depends on whether the selective disclosure was intentional or nonintentional; for an intentional selective disclosure, the issuer must make public disclosure simultaneously; for a nonintentional disclosure, the issuer must make public disclosure promptly. Under the regulation, the required public disclosure may be made by filing or furnishing a Form 8-K, or by another method or combination of methods that is reasonably designed to effect broad, non-exclusionary distribution of the information to the public. See for example Regulation FD, Rule 10b5-1 and Rule 10b5-2, described in www.sec.gov/rules/final/33-7881.htm.
4. Rule 10b5-1 addresses the issue of when insider trading liability arises in connection with a trader's "use" or "knowing possession" of material nonpublic information.

   Rule 10b5-2 addresses the issue of when a breach of a family or other nonbusiness relationship may give rise to liability under the misappropriation theory of insider trading. The rule sets forth three nonexclusive bases for determining that a duty of trust or confidence was owed by a person receiving information. See, for example, Regulation FD, Rule 10b5-1, and Rule 10b5-2, described in www.sec.gov/rules/final/33-7881.htm.
5. *In re Caremark Int'l Inc. Derivative Litigation,* 698 A.2d 959 (Del. Ch. 1996).
6. *In re: The Walt Disney Company Derivative Litigation,* No. 411/2005.
7. Nancy E. Barton, Dennis J. Block, Stephen A. Radin, *The Business Judgment Rule,* Fifth Edition (New York: Aspen Publishing, 2002)—a 2,000-page book.

For a brief overview of these duties from SEC Commissioner Raoul Campos, see www.sec.gov/news/speech/2006/spch081506rcc.

8. In their oft-quoted treatise *The Modern Corporation and Private Property* (New York: MacMillan, 1932), Adolf Berle and Gardiner Means pointed out that the purpose of a board of directors is to represent the interests of shareholders, thus bridging the gap between management and ownership in the widely held public company. This is called the "agency theory" of corporate governance.
9. *In re CompuCom Systems, Inc. Stockholders Litig.,* No. Civ. A. 499, 2005 (WL 2481325).
10. The plaintiffs asserted that the directors of CompuCom were not independent and therefore could not receive the protections of the business judgment rule that the defendant directors of CompuCom were "dominated and controlled" by the majority shareholder, Safeguard Scientifics, Inc. According to plaintiffs, Safeguard caused CompuCom's board to orchestrate a "fire sale" that benefited Safeguard, but not plaintiffs, http://courts.delaware.gov/opinions/(nvivy031klhizg55ad1hss55)/download.aspx?ID=80820.
11. *In re Emerging Communications, Inc. S'holders Litig.,* 2004 WL 1305745 (Del. Ch. 2004).
12. The duty of good faith is especially complex. For an excellent article discussing this duty, see Zachary S. Klughaupt, Good Faith in the World of Delaware Corporate Litigation: A Strategic Perspective on Recent Developments in Fiduciary Duty Law, *FDCC Quarterly,* the official journal of the Federation of Defense and Corporate Counsel, http://findarticles.com/p/articles/mi_qa4023/is_200604/ai_n16522834/pg_10.
13. See, for example, "Materiality," from the Task Force on Materiality, American Academy of Actuaries. Professionalism Series #8, www.actuary.org/pdf/prof/materiality_06.pdf#search=%22materiality%202006%22.
14. FASB, Statement of Financial Accounting Concepts No. 2, Qualitative Characteristics of Accounting Information ("Concepts Statement No. 2"), 132 (1980). See also Concepts Statement No. 2, Glossary of Terms—Materiality, cited as still current in SEC Staff Accounting Bulletin No. 9 on materiality, issued August 12, 1999, www.sec.gov/interps/account/sab99.htmtaf.
15. "SEC Revises Executive Compensation Disclosure." September 29, 2006. From Duane Morris, LLC. www.duanemorris.com/alerts/alert2313.html.
16. *In re PNB Holding Co. Shareholders Litigation,* C.A. No. 28-N (Del. Ch. August 18, 2006). http://courts.delaware.gov/opinions/(nvivy031klhizg55ad1hss55)/download.aspx?ID=80820.
17. *Emerald Partners v. Berlin,* 787 A.2d 85 (Del. 2001), as summarized by Gordon Smith, University of Wisconsin Law School, at conglomerateblog.com, in a comment posted January 28, 2006.
18. *Omnicare Inc. v. NCS Healthcare Inc., Del., No. 605, 2002, 4/4/03*); For detailed commentary on the decision, see the Web site of Morrison Foerster: www.mofo.com/news/updates/files/update972.html, or the Web site of Cooley Godward, www.cooley.com/news/inthenews.aspx?id=37909320.

19. The authority for this definition is usually cited as *Hanson Trust PLC v. ML SCM Corp.* (1985).

20. Also, Section 14(d), 15 U.S.C. s. 78n(d), which deals with tender offers by third parties and contains many provisions analogous to those in s. 13(e).

21. *Wellman v. Dickinson,* 475 F. Supp., 783, 823–834 (S.D.N.Y. 1979), *affd. on other grounds,* 682 F. 2d 355 (CA2 1982), *cert. denied,* 460 U.S. 1069 (1983).

22. Section 13(g)(1)(3) in the Securities Exchange Act of 1934. See *Securities Exchange Act of 1934* (New York: Wolters Kluwer Law & Business/Aspen Publishing, a Red Box Service Publication), November 15, 2006, p. 77. For an electronic version of this text that includes links to cross-references, see the Securities Lawyer's Deskbook, an electronic publication of the University of Cincinnati College of Law www.law.uc.edu/CCL/34Act/.

23. Rule 13(d)1(k)(1)(ii) under the Securities Exchange Act of 1934. See *Exchange Act Rules, Vol. II, Rules 13a-1 Through 15b11-1* (New York: Wolters Kluwer Law & Business/Aspen Publishing, a Red Box Service Publication), November 15, 2006, p. 18. Note that because of frequent changes under Section 14, this booklet covers rules under Section 13 and Section 15 but not Section 14, which are covered in separate booklets covering Regulations 14A, C, D, and E, as cited elsewhere in this chapter. (The SEC does not have a Regulation 14B, which is reserved.)

24. Katherine Burton, "Pirate Capital May Have Violated SEC Filing Rules," Bloomberg.com, September 13, 2006.

25. Securities Exchange Release No. 22 181 [1984–1985 transfer binder] CCH Fed. Sec. L. Rep. Par. 83788 at p. 87526 (June 26, 1985).

26. Rule 14d-3(a)(3)(i) in *Regulations 14D and 14E in Tender Offers Under the Securities and Exchange Act of 1934* (New York: Wolters Kluwer Law & Business/ Aspen Publishing, a Red Box Service Publication), November 15, 2006, p. 22.

27. Rule 14d-3(b)(1) and (2) in *Regulations 14D and 14E in Tender Offers Under the Securities and Exchange Act of 1934,* op. cit. (note 26), p. 9.

28. The 20-day minimum applies to all companies except for roll-up transactions, in which case a 60-day minimum applies. Rule 14e-1states (in part) as follows: "As a means reasonably designed to prevent fraudulent, deceptive or manipulative acts or practices within the meaning of Section 14(e) of the Act, no person who makes a tender offer shall: (a) Hold such tender offer open for less than 20 business days from the date such tender offer is first published or sent or given to security holders; *provided however,* that if the tender offer involves a roll-up transaction as defined in Item 901(c) of Regulation S-K and the securities being offered are registered (or authorized to be registered) on Form S-4 or Form F-4, the offer shall not be open for less than 60 calendar days from the date the tender offer is first published or sent to security holders." See Rule 14e-1 in *Regulations 14D and 14E in Tender Offers Under the Securities and Exchange Act of 1934,* op. cit. (note 26), p. 45.

29. The 10-day rule includes an exception for changed bids. Rule 14e-1 states (in part) that "no person who makes a tender offer shall . . . (b) increase or decrease the percentage of the class of securities being sought or the consideration offered or the dealer's soliciting fee to be given in a tender offer unless such tender offer premium remains open for at least 10 business days from the date that notice of such increase or decrease is first published or sent or given to security holders; *provided, however,* that, for the purposes of this paragraph, the acceptance for payment of an additional amount of securities not to exceed two percent of the class of securities that is the subject of the tender offer shall not be deemed to be an increase." See Rule 14e-1(a) and (b) in *Regulations 14D and 14E in Tender Offers Under the Securities and Exchange Act of 1934,* op. cit. (note 26), p. 45.

30. See Rule 14e-1(d) in *Regulations 14D and 14E in Tender Offers Under the Securities and Exchange Act of 1934,* op. cit. (note 26), p. 45.

31. See Rule 14d-7(a) in *Regulations 14D and 14E in Tender Offers Under the Securities and Exchange Act of 1934,* op. cit. (note 26), p. 17.

32. See Section 14(d)(5) in the *Securities Exchange Act of 1934,* op. cit. (note 22), p. 81.

33. See Rule 14e-1(c) in *Regulations 14D and 14E in Tender Offers Under the Securities and Exchange Act of 1934,* op. cit. (note 26), p. 45.

34. See Rule 14f-1 in *Regulations 14D and 14E in Tender Offers Under the Securities and Exchange Act of 1934,* op. cit. (note 26), p. 53.

35. The term *offeror* in this question refers to the company whose shares are being tendered. Rule 10b-13 in *Exchange Act Rules Vol. 1* (New York: Wolters Kluwer Law & Business/Aspen Publishing, a Red Box Service Publication), July 2006.

36. See Rule 14a-2(b) in *Regulations 14A and 14C: Solicitation of Proxies Under the Securities Exchange Act of 1934* (New York: Wolters Kluwer Law & Business/Aspen Publishing, a Red Box Service Publication), November 15, 2006, p. 4.

37. Rule 14a-3 in *Regulations 14A and 14C: Solicitation of Proxies Under the Securities Exchange Act of 1934* (ibid., p. 5).

38. Rule 14a-4(d) *Regulations 14A and 14C: Solicitation of Proxies Under the Securities Exchange Act of 1934* (ibid., p. 13).

39. Rule 14a-7, *Regulations 14A and 14C: Solicitation of Proxies Under the Securities Exchange Act of 1934* (ibid., p. 19).

40. *Amster & Co.,* 1991 WL 275760 (Dec. 19, 1991).

41. For a description of Regulation FD, see note 3 above.

42. See James B. Stewart, *Den of Thieves* (New York: Simon and Schuster, 1991). Other books about the era include Ken Auletta, *Greed and Glory on Wall Street: The Fall of the House of Lehman* (New York: Warner Books, 1986); Sarah Bartlett, *The Money Machine: How KKR Manufactured Power & Profits* (New

York: Warner Books, 1991); Connie Bruck, *The Predator's Ball: The Inside Story of Drexel Burnham and the Rise of the Junk Raiders* (New York: Penguin Books, 1989); Michael Lewis, *Liar's Poker: Rising through the Wreckage on Wall Street* (New York: Penguin Books, 1990); and Michael Lewis, *The Money Culture* (New York, London: W. W. Norton & Company, 1991).

43. Holders of promissory notes may also sue under 10b-5, as the Supreme Court held in a case involving note holders in the Farmer's Corporation, an Arkansas company.

44. *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 126 S. Ct. 1503, 1513 (2006).

45. *Gollust v. Mendell,* No. 90-659 (June 10, 1991).

46. *Dirks v. SEC,* 463 U.S. 646 (1983).

47. For the 2006 case, see www.usdoj.gov/civil/cases/tobacco2/.

48. *Mohawk Industries v. Williams,* No. 05-465, 547 U.S.S.Ct. (June 5, 2006). The Supreme Court said the circuit court needed to decide whether the case was qualified to be considered under RICO. At issue was the established RICO rule that the defendant must "conduct" or "participate" in the affairs of some larger enterprise, and not just its own affairs.

49. *Anza v. Ideal Steel Supply Corp.*, No. 04-433, 126 U.S.S.Ct. 1991 (June 5, 2006). For the American Bar Association review of the case, see www.abanet.org/publiced/preview/summary/2005-2006/r.html.

50. See Code of Federal Regulations, Title 12, Volume 3, Revised as of January 1, 2003 12CFR221.124, p.53–55. Title 12, Banks and Banking, Chapter 2, Federal Reserve System, Part 221, Sec. 221.124 Purchase of debt securities to finance corporate takeovers. See http://a257.g.akamaitech.net/7/257/2422/14mar20010800/edocket.access.gpo.gov/cfr_2003/12cfr221.124.htm.

51. *2006 Directors and Officers Liability Survey Report* (Chicago: Tillinghast-Towers Perrin 2006).

52. "Poison Pills—Issues in 2006 and Statistical Trends," tsiohttp://blog.issproxy.com/2006/03/poison_pillsissues_in_2006_and.html.

53. See "Excise Tax on Greenmail," Title 26, Chapter Part 1, Part 156, www.access.gpo.gov/nara/cfr/waisidx_06/26cfr156_06.html.

54. "The Demand for Corporate Law: Statutory Flexibility, Judicial Quality, or Takeover Protection?" Marcel Kahan *J Law Econ Organ,* 2006; 22:340–365. Lucian Bebchuk, Oren Bar-Gill, and Michala Barzuza, "The Market for Corporate Law," *Journal of Institutional and Theoretical Economics,* 2006, Vol. 162, pp. 134–17. See also Lucian Bebchuk and Allen Ferrell, "Antitakeover Law and Regulatory Competition," Discussion Paper 363, Harvard Law School.

55. Source: Professor Stephen Bainbridge, University of California at Los Angeles, in his securities law blog. "Does State Corporation Law Really Race to the Top?" www.professorbainbridge.com/2003/09/does_state_corp.html.

CHAPTER 11

Workouts, Bankruptcies, and Liquidations

INTRODUCTION

Every year, workouts, bankruptcies, and liquidations become final options for thousands of distressed businesses—small and large, new and old. This is not surprising: business is by nature risky—and certain types of risks, if not anticipated and prevented, can lead to financial problems.

But in business, as in life, destiny is determined as much by people's response to events as by the events themselves. Financial problems may not mean the end of a business; they can signal a new beginning. Indeed, no business activity shows the power of new ownership as clearly as a successful workout or bankruptcy. By structuring such arrangements properly, the owners or acquirers of a business can help a company avoid—or emerge from—bankruptcy, thus bringing it back from financial death into long-lasting financial life.

In this chapter, we show how to achieve a corporate resurrection by performing a workout or bankruptcy, especially by reorganizing a business under Chapter 11 of the U.S. Bankruptcy Code (a special legal code pertaining to insolvent companies and individuals). We also discuss very briefly some do's and don'ts of liquidation. Emphasizing the M&A angle, this chapter also provides guidance on dealing with claims stemming from leveraged buyout transactions that result in insolvency. Finally, building on these fundamentals, we address some specific financial and accounting/tax issues to consider when crafting an agreement to buy an insolvent entity in whole or in

part. The general framework of this chapter, and some of its text, is based on an earlier title in the series, *The Art of M&A Structuring,* by Lajoux and Nesvold. However, we have updated this chapter to reflect recent developments in bankruptcy law and accounting.

GENERAL CONSIDERATIONS

What is bankruptcy?

A debtor (individual or entity) is, generally speaking, one that may be unable to make timely payment of its obligations to creditors. In a narrower, more technical sense, bankruptcy is the condition of an individual or entity that has filed for protection from creditors under bankruptcy law. (Indeed, one bankruptcy attorney has claimed that "Bankruptcy is no longer a sign of true insolvency or liquidation. It's often a strategic tool by management."[1] In any given year, most bankruptcy filings are made by individuals rather than by entities. This chapter focuses on workouts and bankruptcies involving insolvent entities.

What is insolvency? How do the regulatory and accounting authorities define it?

The Bankruptcy Code defines the term *insolvent,* as it applies to a corporation, as a "financial condition such that the sum of [the] entity's debts is greater than all of such entity's property, at a fair valuation."[2] (Debts include contingent liabilities under this definition.) A *fair valuation* of an entity's property refers to the amount of cash that could be realized from a sale of the property "during a reasonable period of time."[3] A *reasonable period of time* is the time "a typical creditor would find optimal: not so short a period that the value of goods is substantially impaired via a forced sale, but not so long a time that a typical creditor would receive less satisfaction of its claim, as a result of the time value of money and typical business needs, by waiting for the possibility of a higher price."[4]

The Uniform Fraudulent Transfer Act defines *insolvency* as having more liabilities than salable assets, and in addition it deems insolvent any debtor "who is generally not paying his debts when they become due."[5] This is sometimes referred to as the *equity definition* of insolvency.[6] Most state laws have a definition that resembles the one in the Bankruptcy Code, but some states (e.g., New York) follow the equity definition for certain situations other than for fraudulent transfers.[7]

Under GAAP, a company may be considered solvent if it has sufficient assets to pay debts as they occur or if it has *book assets* that are greater than *book liabilities.* This GAAP definition is more lenient than other definitions because it does not count contingent liabilities.

Why is it important to know how regulatory and accounting authorities define insolvency?

It is important to know how relevant authorities define insolvency because the duties of officers, directors, and other parties might change as the zone of insolvency approaches. Also, certain authorities have heightened powers in the affairs of insolvent corporations—and may assume control of them in certain circumstances.

When does a pattern of late payments cross the line into a state of insolvency?

Generally, insolvency begins when creditors stop trusting the entity to pay in an acceptable time frame. One or even two or three missed debt payments may not trigger a response from creditors if there is no history of financial difficulty or misdoing. However, a recurring pattern of missed payments will usually trigger some kind of action. The action will vary depending on the type of debt involved.

- If the debt is a bank loan, a loan officer will call and point out that the borrower is in violation of a loan agreement and ask for an immediate meeting, which usually includes someone from the bank's workout department.
- If the debt is a commercial bill for merchandise, usually someone from the accounts receivable department will telephone and follow up by letter to inquire about the missed payment or payments.

What are the various alternatives available to an entity that cannot meet its current debt structure with its current cash flow?

Several alternatives are available to a defaulting entity, including but not limited to a *workout* (often combined with a managerial *turnaround*), a filing for *bankruptcy* protection, and (the least desirable alternative) a total *liquidation.* This chapter discusses workouts and bankruptcy, which involve structuring concerns,

but not liquidation, which is a fairly straightforward sale of assets that does not require any complex transactional structuring in our sense of the term.[8]

WORKOUTS

What is a workout?

A *workout,* also called a *debt restructuring,* is a process through which a defaulting entity negotiates a payment schedule or plan with its creditors outside the courts. It is a strictly voluntary process controlled by the parties involved. In a workout, one or more creditors refrain from forcing immediate payment from a defaulting entity and instead agree to an organized payment schedule. A formal workout generally involves multiple creditors—and, often, a committee to represent them.

What are the advantages of a workout?

The major advantages of a workout—compared with the other alternatives such as formal bankruptcy cases—include greater control over the business entity by the participants, faster solutions to problems as they arise, and substantially lower administrative costs. Perhaps the most important advantage of a workout is its confidentiality. Because there are no public hearings and no public records, the company can preserve its public reputation, subject to its disclosure obligations if it has publicly traded securities outstanding.

How does a workout operate?

Typically, a business burdened with heavy debt or declining revenues halts some payments to its creditors and suppliers and asks to meet with the affected creditors in private. (Secured creditors are not usually invited to meetings held by distressed entities with unsecured creditors, and may not be inclined to attend even if invited.)

At the meeting, the company presents the current status of its operations and details of its financial condition. In addition, it distributes a plan detailing how it plans to meet its current and future financial obligations. The plan may include a capital restructuring, and sometimes a drastic restructuring of operations under some new management as well.

This restructuring is generally referred to as a *turnaround.* In a typical turnaround, an outside manager steps in, often serving as an interim chief executive officer, chief financial officer, or restructuring officer, to help the

company return to financial health.[9] The turnaround manager may be hired as a consultant, a temporary employee, or a permanent employee. Some executive recruiting firms have special expertise in locating qualified turnaround executives or other interim managers.

An important part of the presentation of a workout plan is a realistic estimate of the recovery that the creditors—both secured and unsecured—could expect if the company were forced into liquidation. The number should not be unrealistically low—but at the same time, it should account for the cash drain from the administration of the bankruptcy filing itself. Usually the news is not pretty. The average secured creditor receives about 77 cents on the dollar, whereas the average unsecured creditor receives *only about 2 cents,* though generalities and averages have little bearing on any actual situation.[10]

Obviously, the lower the estimate of liquidation recovery is, within reason, the more motivated creditors will be to agree to a workout plan. They might reason that if the defaulting entity files for bankruptcy protection, they may not receive any funds whatsoever, because the costs of administration, including fees for legal and accounting services, may eat up what little equity might remain.[11] By contrast, the workout allows the defaulting entity to remain an ongoing business concern, which might continue to be a source of future business and profits for them. However, if the estimate of turnaround recovery is too low or slow, creditors might want to liquidate rather than work matters out.

What are some of the types of concessions that defaulting entities may ask their creditors to accept?

Most of the time, the debtor tries to exact the largest concessions from a bank and/or a lead lender, asking them for partial forgiveness of the debt along with a reduced interest rate and more money. The predominant concession seems to be debt restructuring, such as acceptance of stock (either common or preferred) for debt, lower coupon rates, and, most important, debt stretchouts (increases in the length of the debt payment schedule).

From an operations point of view, what must a distressed entity do in order to orchestrate a workout successfully?

A distressed entity must, above all, be honest with its creditors. It must also control its accounts receivable. The entity must devise a realistic budget in sync with the concessions the creditors must provide. Even more important, the distressed entity must control its accounts payable and prove to creditors that it has

the will and the way to reduce expenses and to bring cash expenses into line with cash receipts. Company management should communicate often with creditors in order to build the trust necessary for cooperation. No downside surprises!

What are some examples of successful workouts?

American Airlines, Castle & Cooke, Chrysler Corp., the Daewoo Group, and Revlon Inc. all successfully restructured themselves with the cooperation of their creditors short of formal bankruptcy proceedings.

What happens when the creditors do not go along with a workout proposal and either accelerate the loan or start to enforce it?

The distressed entity has three choices beyond finding the funds needed to satisfy the creditors:

1. It can file for bankruptcy protection under federal law.
2. It can file for insolvency proceedings under state law.
3. It can liquidate itself (subject to laws such as bulk sales laws if no one files against the liquidation by pleading a so-called involuntary petition).

BANKRUPTCY

What, exactly, is bankruptcy protection?

In the United States, protection for debtors is accomplished under the *automatic stay* provisions of U.S. laws governing bankruptcy. The main text of these laws is found as part of the U.S. Bankruptcy Code, which is Title 11 of the U.S. Code. An automatic stay means creditors cannot seize the filer's assets without U.S. bankruptcy court permission. The entity submits a plan to the creditors and the court and, if affirmed, can operate under the plan. If the plan is not affirmed, the entity can propose other plans or liquidation.

Who can file for bankruptcy, and where can they file?

Under the U.S. Bankruptcy Code, with certain exceptions for banks, insurance companies, and the like, any individual, corporation, partnership, or

other entity may file for bankruptcy or have a bankruptcy case filed against it. Under Section 101(12) of the Bankruptcy Code, these parties are called *debtors,* or in case of a Chapter 11, the debtor is called a *debtor in possession,* unless and until the debtor is displaced by a Chapter 11.

As for location, there are 89 federal bankruptcy courts, and each one maintains its own Web site.[12] Generally, companies must commence bankruptcy cases in the district of their headquarters, principal assets, or incorporation—or the districts of their affiliates.

How common are bankruptcies, and who files them?

Every year brings some 1.6 million new bankruptcy filings. Conventional wisdom has said that most of these are filed by consumers; less than 5 percent, or about 40,000 per year, are from business bankruptcies. This is one reason that Congress passed the most recent tough bankruptcy law in 2005, cracking down on what legislators saw as consumer greed. Subsequent research, however, suggests that as many as 15 percent of personal bankruptcies come from business ventures—so the actual number of business bankruptcies (counting the self-employed, who make personal rather than business filings) is closer to 120,000.[13]

In any event, insolvency is a constant risk for businesses in general. Bankrupt businesses represent about 1 percent of the business population in any given year,[14] with a slightly higher percentage of public (versus private) companies taking this route to resolve their problems.[15] (This higher percentage for public companies might seem surprising, considering the high degree of regulation focused on them, but it proves the old maxim, *caveat emptor,* even when buying or investing in a publicly held enterprise.)

Could you explain the chapters of the Bankruptcy Code as they pertain to businesses?

In the United States, bankruptcy filings are governed by the U.S. Bankruptcy Code. This code is part of the U.S. Code, which is nearly the full set of laws enacted by the U.S. Congress. The bankruptcy portion of the U.S. Code is Title 11, which itself contains 13 chapters, including the well-known Chapter 11, discussed subsequently. This title was enacted by Public Law 95-598, Title 1, Section 101, Nov. 6, 1978, Statute 2549.

The current Bankruptcy Code contains eight operating chapters.

- Chapter 1 contains general provisions.
- Chapter 3 describes case administration.

- Chapter 5 explains rules for handling creditors, debtors, and estates.
- Chapter 7 covers liquidation, or the orderly sale of the assets of a debtor, which may be an individual or a corporation (except for railroads or certain financial corporations).
- Chapter 9 covers the debts of municipalities.
- Chapter 11 enables corporations to organize through either corporate reorganization (creating a new entity) or administrative reorganization (moving people and property around). Because the debtor maintains control of the entity's assets, it is called a *debtor in possession* unless and until a Chapter 11 trustee is appointed.
- Chapter 12 provides for relief of family farmers.
- Chapter 13 provides a process by which an individual with regular income may repay all or a portion of his or her indebtedness.

There are no even-numbered chapters except for Chapter 12. The chapters used for business bankruptcies are Chapters 7 and 11. Debtors can change their status from one to the other during the course of their insolvency.[16] This chapter concentrates on Chapter 11 bankruptcies because they involve structuring—or, more precisely, restructuring.

What are the ground rules for implementing these different types of bankruptcies?

Federal rules of bankruptcy procedure are meant to ensure a "just, speedy, and inexpensive determination of every case and proceeding" under the bankruptcy code.

The rules comprise nine clusters, with rules numbered according to the clusters (the 1,000s are in Part I, the 2,000s are in Part II, and so forth).

Part I	Commencement of case: proceedings relating to petition and order for relief
Part II	Officers and administration; notices; meetings; examinations; elections; attorneys and accountants
Part III	Claims and distribution to creditors and equity interest holders; plans
Part IV	The debtor; duties and benefits
Part V	Bankruptcy courts and clerks
Part VI	Collection and liquidation of the estate
Part VII	Adversary proceedings

Part VIII Appeals to district court of bankruptcy appelate panel
Part IX General provisions

What is the exact status of bankruptcy law right now? Isn't it undergoing some changes?

Bankruptcy law is a fairly stable area of law, especially where businesses are concerned. Most of the bills before the current (110th) Congress focus on the reform of laws affecting consumer bankruptcy. The laws controlling business bankruptcy would be made less hospitable under currently proposed legislation, but would still allow for reorganization.

As mentioned, the current bankruptcy code was enacted in 1978. The following laws have amended (but not replaced) the 1978 law:

- The Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986[17] (which added an item for Chapter 12 of Title 11).
- The Bankruptcy Reform Act of 1994.[18] This law, called the Bankruptcy Reform Act of 1994, considered to be the most comprehensive piece of bankruptcy legislation since the 1978 act, contained provisions to expedite bankruptcy cases and to help creditors recover claims against bankrupt estates. It also created a National Bankruptcy Commission to investigate further changes in bankruptcy law (but so far the commission's work has not triggered any major changes in the law).
- The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005.[19] This get-tough bill was an outgrowth of a 1997 report of the National Bankruptcy Review Commission.

What are the implications of the 2005 bankruptcy law?

Although it focused on personal bankruptcy, experts are calling it a "new commercial bankruptcy code." Among other features of this new law are the following:

- It imposes substantial additional costs or burdens on debtors—such as the requirement for early cash settlements and higher utility security deposits—making it more difficult to emerge from bankruptcy.

- It transfers elements of control to certain nondebtor stakeholders—for example, it has lengthened the reclamation period for vendors, shifting the balance of power from financial creditors to trade creditors.
- It requires the unsecured creditors' committee to receive input from all creditors.

The improved status of vendors could help companies, since their vendors may keep shipping rather than defecting to other customers. On the other hand, it will make it more difficult to obtain debtor-in-possession (DIP) financing.

What is Chapter 11 reorganization?

Chapter 11 is an administrative process. It allows a financially distressed entity (i.e., one that is unable to meet its financial obligations or pay its debts as they become due) to reorganize its financial condition. This kind of bankruptcy is designed to facilitate the successful reorganization of an entity that is temporarily distressed but otherwise economically viable and worth more as a going concern than in liquidation. If the entity is not economically viable, then it is liquidated under Chapter 7 of the U.S. Bankruptcy Code.

What is the main purpose of Chapter 11 bankruptcy?

The main purpose of Chapter 11 is to save jobs and American enterprise. It protects a defaulting entity from its creditors while it works its way (through many kinds of reorganization) into sound financial health. This works to the ultimate benefit of creditors because it provides an orderly environment to allocate the entity's value. U.S. bankruptcy law is much more highly developed than the law of other countries, where there is far less gray area between the life and death of a business, and far fewer stories of the phoenix rising from the ashes.

What does it cost to file for Chapter 11?

The typical minimum cost for a smaller organization is $50,000 for basic filing and reorganization plan assistance. For larger organizations, the amounts can run in the millions. Bankruptcy filings reflect the complexity of the situations that precipitate them. In some Chapter 11 cases, literally thousands of separate creditors have claims against the entity.

Not surprisingly, the need for professional assistance rises with each level of complexity.

Here are some of the professionals that might be needed:

- Accountants (to provide auditing services)
- Appraisers (to give court-approved appraisals of assets)
- Attorneys (to make the filing and to help draft and present to the court a Chapter 11 reorganization plan)
- Investment bankers (to render financial advice)
- Turnaround managers, who, as mentioned previously, often serve as interim CEOs

Many of these professionals specialize in insolvency. The American Bankruptcy Institute (abiworld.org) has more than 5,000 dues-paying members, who refer to themselves as "insolvency professionals."

What happens in a company with multiple subsidiaries in various states of financial health? Must they all file for bankruptcy?

Several options are possible. Sometimes a parent company starts a Chapter 11 reorganization case while subsidiaries, carrying on day-to-day business, may, at least for a period of time, remain outside Chapter 11. In some cases, many affiliates of the Chapter 11 debtor-in-possession remain outside of Chapter 11 for long periods and, in some instances, reorganize outside of Chapter 11 in tandem with the reorganization plans of the Chapter 11 debtors-in-possession. In large part this is because creditors recognize that they can obtain greater value by proceeding in this manner. Doing so, however, requires the development of governance/financial protocols for dealing with conflicting interests.

Many real estate investment trusts (REITs) were reorganized in Chapter 11 while their operating subsidiaries remained outside bankruptcy. Similarly, Western Union operated outside bankruptcy in the 1990s while its parent corporation, New Valley Corporation, reorganized very successfully in Chapter 11.

Exactly how common are *business* bankruptcies (as opposed to personal bankruptcies), and what is the current trend here?

See Figure 11-1 for current statistics.

FIGURE 11-1

Quarterly Business Filings by Year (1994–2006)

Year	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter	Total
1996	13,388	13,992	13,198	12,887	53,465
1997	13,831	13,991	13,456	12,653	53,931
1998	12,410	11,552	10,346	9,888	44,196
1999	9,180	10,378	8,986	9,020	37,564
2000	9,456	9,243	8,211	8,413	35,472
2001	10,005	10,330	9,537	10,013	40,099
2002	9,775	9,695	9,433	9,500	38,540
2003	8,814	9,331	8,446	8,294	35,037
2004	10,566	8,249	7,574	7,778	34,317
2005	8,063	8,736	9,476	12,798	39,201
2006	4,086	4,858			

Source: American Bankruptcy Institute abi.com, October 2006, New Generation Research, Inc., Boston, MA. Reprinted with permission.

What are some bankruptcies of historical note?

Before 1970, very large company bankruptcies were rare. When Penn Central failed in 1970 and W.T. Grant failed in 1975, these events sent shock waves throughout business. (Indeed, many attribute the modern "corporate governance" movement to these pivotal events. Corporate governance advocates favor independent corporate boards and active shareholders, which can both serve as checks on management.) In 1980, Chrysler (today DaimlerChrysler) narrowly avoided bankruptcy with a government bailout.

Since the 1980s, companies have been filing for bankruptcy in record numbers. During this period (as the Web site bankruptcy.com reports), a number of household names bit the financial dust, including Allied Stores, Continental Airlines, Eastern Airlines, LTV, Federated Department Stores, Greyhound, R.H. Macy, Maxwell Communication, Olympia & York, and Pan Am. (Texaco also filed for bankruptcy, but the trigger for that event was a very large jury verdict against the company for having backed out of a verbal agreement to acquire Pennzoil.)

The most infamous bankruptcy in recent years has been Enron, which filed for protection from creditors under Chapter 11 in December 2001,

eclipsing in importance some of the other high-profile public company bankruptcies of that year, such as Bethlehem Steel, Pacific Gas and Electric, Reliance Holdings, and W.R. Grace. The Enron bankruptcy was not only large (at $63 billion) but also complex. A total of 75 entities (the parent company and 74 subsidiaries) all filed for bankruptcy, affecting numerous creditors. (The petitions specifically name 20 major unsecured creditors.)

Enron, while complex, is not the largest bankruptcy in history. That distinction belongs to the $106 billion bankruptcy of WorldCom in July 2002. Figure 11-2 shows Enron and WorldCom in historical context.

What can acquirers learn from the bankruptcies of Enron and WorldCom?

Lessons learned from these bankruptcies are captured in the reports written about them after the fact: the so-called Powers report and the Breeden report.

- *The Powers Report.* On February 1, 2002, William C. Powers, Jr., presented to the Enron board of directors the Report of the Investigation by the Special Investigative Committee of the Board

FIGURE 11-2

The 10 Largest Bankruptcies, 1980–Present

Company	Bankruptcy Date	Total Assets Pre-bankruptcy	Filing Court District
Worldcom, Inc.	07/21/2002	$103,914,000,000	NY-S
Enron Corp.*	12/2/2001	$63,392,000,000	NY-S
Conseco, Inc.	12/18/2002	$61,392,000,000	IL-N
Texaco, Inc.	4/12/1987	$35,892,000,000	NY-S
Refco Inc.	10/17/2005	$33,333,172,000	NY-S
Global Crossing Ltd.	1/28/2002	$30,185,000,000	NY-S
Pacific Gas and Electric Co.	4/6/2001	$29,770,000,000	CA-N
Calpine Corporation	12/20/2005	$27,216,088,000	NY-S
UAL Corp.	12/9/2002	$25,197,000,000	IL-N
Delta Air Lines, Inc.	9/14/2005	$21,801,000,000	NY-S

*The Enron assets are taken from the 10-Q filed on 11/19/2001. The company has announced that the financials were under review at the time of filing for Chapter 11.

Source: BankruptcyData.com.

of Directors on Enron Corp. Powers chaired the special investigative committee. The main message of the report is that the board of directors should have exercised stronger oversight of the company's special financial arrangements (largely off-balance-sheet arrangements involving insiders). These undisclosed arrangements hid the conditions that led to Enron's bankruptcy, and also contributed to it.

- *The Breeden Report.* On August 26, 2003, Richard C. Breeden, delivered "Restoring Trust: Corporate Governance For The Future of MCI, Inc." to the U.S. district court judge overseeing MCI's bankruptcy. Breeden is former chairman of the SEC and currently corporate monitor of MCI-WorldCom. The report includes a "Governance Constitution" with 78 specific corporate governance recommendations that MCI must implement before it emerges from bankruptcy. Many of the recommendations will become part of the company's articles of incorporation, where they can be changed only with the approval of MCI's board and stockholders.

What are the chances of long-term recovery from a Chapter 11 bankruptcy?

Only about one in five recover, and of those, half fail again, according to the American Bankruptcy Institute (at abiworld.com). Companies that file Chapter 11 a second time are sometimes referred to jestingly as filing "Chapter 22."

Suppose an entity has assets in many jurisdictions. Where can it file for bankruptcy?

Within the United States, according to Section 1408 of Title 28 of the U.S. Bankruptcy Code, an entity must file its bankruptcy petition in the district where the entity is domiciled, where it has its principal place of business, where its principal assets are located, or where any of its affiliates have filed.

Given the fact that there are multiple bankruptcy courts within the United States and, more broadly, many places where a company might conceivably be headquartered, there is obviously a great deal of flexibility in venues.

This multiplicity of forums for bankruptcy cases has led to a certain amount of "forum shopping"—as companies look for jurisdictions favored by debtors or their lenders based on rulings making postpetition reorganization and lending more likely. For instance, within the United States, the U.S.

Bankruptcy Court for the Southern District of New York has a reputation for fostering reorganization. A substantial percentage of the largest U.S. bankruptcies have been filed in that district.

What, exactly, happens in a Chapter 11 filing?

In a Chapter 11 filing, the debtor entity initially has the exclusive right to file a Chapter 11 plan. The steps of the plan are as follows:

1. The debtor develops a plan with its main constituencies: secured creditors and the statutory creditors' committee for unsecured claimholders.
2. The company prepares a reorganization plan and files the proposed plan with the court.
3. The company files a disclosure statement, which must be approved by the bankruptcy court as having adequate information before creditors and shareholders can work on the plan.
4. The court holds a hearing on confirmation of the plan to determine whether it satisfies all legal requirements.
5. If confirmed, the plan proponent carries out the plan by distributing any payments or securities called for by the plan.[20]

What does the reorganization plan entail?

The plan identifies the assets of the entity and explains how the assets will be allocated. If the debt involves bondholders who are governed by a bond indenture agreement, 90 percent of the bondholders must approve the plan (and the other 10 percent must go along).

The plan should devote some of the assets in the short term to the insolvent entity so that it can continue operating, thus generating revenues and, eventually, profits, to pay its debts. The plan must also factor in repayment to creditors. Debtors will have a natural tendency to allocate as little as possible to creditors, while creditors will want to allocate as much as possible to themselves.

Debtors have a period of time in which they have the exclusive right to file a reorganization plan. If the court accepts the plan within that time period, no one else may file a plan. After the time period elapses, creditors may file their competing plans. The exclusive period is normally 120 days, but judges have the right to extend it. Some judges have extended filing periods by as much as four years among secured claims, unsecured claims, and equity. Customers also have a say in matters.

What if one or more creditor classes reject the plan?

Before a plan can be confirmed, at least one impaired creditor class must accept it. If one or more classes accept it while one or more classes reject it, the plan may sometimes be confirmed if the rejecting classes receive at least as much as they would in liquidation and no classes junior to them participate.

How can shareholders get a committee to represent their interests in a reorganization plan under Chapter 11?

On request, the U.S. trustee may appoint a shareholders' committee. If one is not appointed, the court may order its appointment if shareholders may have a real interest in the case.

Also, as long as the company is not hopelessly insolvent, shareholders can ask the judge of the bankruptcy court to appoint an equity committee that would extend the focus of the court beyond creditors.[21] This is a rare practice—one attorney specializing in it said he found only six examples out of hundreds he researched—but it does happen.[22] The goal of such a committee and its advisors would be to obtain as much equity as possible.

Also, shareholders can petition the bankruptcy court to protect their rights to elect directors of the insolvent entity. For example, the official committee of equity security holders in the Chapter 11 bankruptcy proceedings of Adelphia Communications Corp. filed suit in a U.S. bankruptcy court. They wanted the court to force the company to hold a shareholders' meeting to elect directors.[23]

During a reorganization, what happens to the board of directors of the debtor company?

There are no particular requirements for changes. Sometimes, the board remains the same. At other times, there is a change in the identity of the chairperson, CEO, and/or directors, or a change in the structure of the board. For example, the board may decide to combine or split the chairperson and CEO roles, may decide to appoint a lead director, or may decide to replace the entire board. These matters are decided on a case-by-case basis, depending on the decisions of the board itself, the bankruptcy court, and the creditors' committees (and shareholders' committees, if these exist).

If the board of an insolvent company chooses a particular bidder for a company, can this choice be challenged?

It is difficult to challenge the decisions of a bankruptcy court judge once the decision has been made. The best thing is to get in on the ground floor of a reorganization during the time the committees and plan are being formed. Even then, it is possible for a board of directors to favor a particular bidder through a lockup or otherwise. (See the Samex case at the end of this chapter.)

What is a prepackaged bankruptcy?

A prepackaged bankruptcy, or *prepack,* authorized under Section 1126(b) of the Bankruptcy Code, is a type of bankruptcy filing known for its speed and simplicity. It begins with a plan already negotiated out of court and approved by the requisite number of creditors. Prepacks may enable companies to emerge from bankruptcy in weeks or months rather than the more typical two to five years. Management may retain some equity, and creditors can preserve their claims.[24]

In the prepack, unlike the ordinary Chapter 11 bankruptcy, the court can force creditors to go along with a plan proposed in an out-of-court workout. In the ordinary bankruptcy filing involving bondholders, as mentioned earlier, 90 percent must approve.

If the bondholders do not approve the plan, the defaulting company can file for a *prepackaged bankruptcy,* where it is required to have received the approval of only a minimum of 51 percent of the creditors holding at least 66 percent of the debt.

How are prepackaged bankruptcies structured?

Generally, old debt is exchanged for a package that includes new debt instruments, equity, and sometimes cash. Heavily leveraged companies persuade their bondholders and other creditors to exchange high-yield bonds for a package of lower-yielding debt and equity.

Are there any other alternatives available to a distressed entity if it does not want to go through an out-of-court workout or a bankruptcy reorganization?

Yes. It can opt for state insolvency procedures as an alternative.

STATE INSOLVENCY PROCEEDINGS

What is a state insolvency proceeding?

In this kind of proceeding, a distressed entity voluntarily begins an action in which it assigns its property to its creditors for liquidation, leading to a total discharge of its debts in that state. It is a good choice for an entity that wants to liquidate its assets—but note that it may have to be subordinated to federal bankruptcy laws.[25]

What are the main advantages and disadvantages of a state insolvency proceeding?

The main advantage of a state insolvency proceeding is that it is inexpensive and fast. The main disadvantage is that the discharge of debts is not binding on creditors located in other states. This can be a major disadvantage to a distressed entity with creditors outside its home state, as their claims will not be discharged. By contrast, in a Chapter 7 bankruptcy proceeding under federal law, all claims within the United States will be discharged.

INVESTING OPPORTUNITIES: STRUCTURING THE PURCHASE OF A TROUBLED COMPANY

What are some of the ways a buyer can structure the acquisition of a troubled company?

It can buy the company in part (by buying shares in an insolvent entity or by investing in a fund that invests in such entities) or in whole (by acquiring all the assets or shares of the entity).

In cases where the entity is merely distressed and has not yet filed for bankruptcy, the buyer can purchase shares of the company on the open market. Once the company files for bankruptcy, purchases of the company must go through bankruptcy court.

The buyout of a bankrupt entity need not be structured as a purchase of shares, though. As long as the seller has made a proper effort to market the assets and there is no otherwise feasible plan for the bankruptcy court to consider,

an asset sale may be approved. It would normally be structured as a purchase of assets under Section 363 of the Bankruptcy Code.

What is Section 363?

Section 363 is part of the Bankruptcy Code. Under Section 363(f), a bankruptcy trustee or debtor-in-possession may sell the bankruptcy estate's assets "free and clear of any interest in such property." In theory, this means that the claims on any assets used as collateral will be suspended, and buyers (i.e., the new owners) will not inherit any old liabilities.

However, there are some limitations when the sale is structured as the sale of corporation. In buying a corporation—not merely its assets—under Section 363, a buyer may still inherit the corporation's indebtedness. This was the finding in *Amphenol Corp. v. Shandler* (2006).[27] The bankruptcy court found that an Insilco subsidiary, PCM, following the stock sale to Amphenol, remained subject to the $1 million preference claim by the liquidating trustee.

Are there funds that buy insolvent entities?

Yes. Several kinds of funds have formed for the purchase of distressed entities, called variously *reorganization funds, turnaround funds, vulture funds,* or *workout funds.* By whatever name, their focus is the same: to invest at bargain rates in an entity that is undergoing financial distress or is already bankrupt and then to reap the benefits when the company emerges from this state.

Guides for purchasing distressed entities are available. For example, the American Bankruptcy Institute has published *Bankruptcy Business Acquisitions,* second edition (Alexandria, Virginia: American Bankruptcy Institute, 2006).[26]

What is the quality of information available on a troubled company?

If the company is merely in the zone of insolvency but not yet in a formal bankruptcy, the information can range from excellent to poor—even fraudulent. In a typical negative scenario, a company reports good performance, then shows signs of troubled performance, triggering an investigation (typically internal) that reveals that the trouble is far worse than previously reported.

Once the worst is over, though, and a company has filed for bankruptcy, the quality of information improves. All formal financial reporting in a bankruptcy is done under oath, and there are criminal penalties for falsification of records and statements. Furthermore, by law, the debtor must file detailed reports on its finances, which are a matter of public record. Also, debtors may be compelled to testify in more detailed examinations dictated by Bankruptcy Rule 2004.

Bankruptcy Rule 2004 states that "on motion of any party in interest, the court may order the examination of any entity." Further, it says that this examination may relate to "the acts, conduct or property or the liabilities and financial condition of the debtor, or to any matter which may affect the administration of the debtor's estate, or to the debtor's right to a discharge." In some cases, such as Chapter 11 cases, "the examination may also relate to the operation of any business and the desirability of its continuance, the source of any money or property acquired or to be acquired by the debtor for purposes of consummating a plan and the consideration given or offered [for this money or property], and any other matter relevant to the case or to the foundation of a plan."

Information on bankrupt entities is so good, in fact, that securities issued to creditors in a federal bankruptcy in some circumstances are tradable without registration (enabling some forms to go public without the expense of a registration).

Of course, in a transaction with a distressed entity, all the normal deal imperatives apply, including the necessity of having thorough financial, legal, operational, and transactional due diligence. This subject is beyond the scope of this book, but we urge buyers to hire experts in this area and to master it themselves to the extent possible.

Is there a preferred time when an investor should get involved?

Success is possible at all stages of bankruptcy—before, during, and after—but there are pros and cons to each.

Investing *before or during* the filing is generally not advisable, because pre-petition shareholders are generally very low in any plan to receive any postfiling disbursements after the filing. (It might be better to lend money, buy a loan, or purchase bonds, rather than buy stock, because lenders and bondholders rank higher than shareholders.)

However, prefiling investment might make sense in the case of a company that has a relatively high chance of emerging from bankruptcy.

- First, anyone who is a shareholder prior to the filing can ask to be represented by a committee, as discussed later in this chapter.
- Also, an investor who wants to buy a controlling position might be in a stronger position to make an offer if that investor is an insider and has influence on the bids being presented to the bankruptcy court. Once the court has accepted a bid, it is very difficult to challenge this decision.
- Third, a two-phase strategy, moving from bonds to stock, is also possible if one gets in on the ground floor of a Chapter 11 filing. Several successful fund managers have purchased the bonds of a distressed entity at the time of its bankruptcy filing in anticipation of equity ownership or a cashout down the line. The distressed entity's plan of reorganization could swap the interest-bearing bonds for a package of new equity or cash. Classic examples include Sam Zell's purchase of Carter Hawley Hale Stores bonds and MFS Fund's purchase of Maxicare's high-yield (junk) bonds.

There are also options *during* the bankruptcy process, between the time the plan of reorganization is announced and the end of the plan as the company emerges from bankruptcy. At the time of its plan of reorganization, a company usually issues new shares of stock—often at bargain prices. Once it is evident that the company has survived the bankruptcy process, the price of the shares often rises. Getting in on the ground floor enables one to buy low and sell high as a partial investor.

Also, in many situations, the court-approved plan will include a provision for the exchange of old bonds or old preferred stock for new shares of common stock. The best time to purchase these post-petition shares is before the plan of reorganization is confirmed. However, because of the headaches caused by bankruptcy, many creditors will want to sell off the shares received. Some investors buy up these shares when they are offered, contacting the company's creditors to ask if their shares are for sale. Others wait until the activity dies down to see how the company is operating and how it is being perceived in the marketplace.

Will the SEC protect investors in a bankruptcy?

Generally, the SEC's role is limited. The SEC will do the following:

- Review the disclosure document to determine if the company is telling investors and creditors the important information they need to know

- Ensure that stockholders are represented by an official committee, if appropriate

Although the SEC does not negotiate the economic terms of reorganization plans, it may take a position on important legal issues that will affect the rights of public investors in other bankruptcy cases as well. For example, the SEC might step in if it believes that the company's officers and directors are using the bankruptcy laws to shield themselves from lawsuits for securities fraud.[28]

Do you have any guidance on co-investors?

If the contemplated investment is promoted by an investment bank, the investor should consider the bank's general standing and success/failure record in this type of investment. Also, it is important to know whether bankers are putting their own funds at risk along with yours. Investors should stay away from anything that looks like a bailout by an investment banker.

STRUCTURING A LEVERAGED BUYOUT TO MINIMIZE INSOLVENCY RISK

Highly leveraged transactions, such as leveraged buyouts, can result in post-acquisition insolvency. How can creditors protect their interests in such a situation?

Leveraged buyouts may be structured in a variety of ways—as a cash merger, a stock purchase, or an asset acquisition. However an LBO is structured, it will by definition use the value of the target company (value of assets minus liabilities) to finance the acquisition of the target company. As a consequence, creditors are involved because they have claims on those assets that are both leveraged and transferred.

Depending on the way the leveraged buyout *entity* is structured, the transaction will have an impact on creditors unless it is specifically structured to lack such an effect.[29]

- The simplest LBO structure has an *impact on creditors.* In this structure, the deal architect would insert all or part of the newly created acquisition debt into the target (or its successor), which also

takes possession of the assets and pledges them as collateral for the debt. As a result, the claims of the target's pre-acquisition creditors will be on a par with any new unsecured debt of the target and/or will be subordinate to any new secured debt.

- To structure a transaction that will have *no impact on creditors,* the deal architects must take an extra step. They must leave the target's assets in a separate corporation (generally the original target corporation) that does not assume any liability for the newly created LBO debt. The LBO debt in this structure is the obligation of a separate entity, usually the company that purchased the target's stock (such as a leveraged buyout fund). The creditors that have claims against the assets are not disadvantaged, because the assets used as collateral have not been diminished and the liabilities have not increased. To illustrate this important point, we provide, at the end of this chapter, one transaction diagram showing ways to structure the entities and relationships involved in a leveraged buyout transaction. One shows a safe way (Figure 11-3) and six show risky ways (Figures 11-4 to 11-9).
- There is also the issue of how the actual *financing* is structured. Some financial structures can create such problems, while other financial structures can help prevent them.
- The practices of upstreaming and cross-streaming pose dangers to creditors. *Upstreaming* occurs when a subsidiary provides collateral to secure a borrowing by its parent. *Cross-streaming* occurs when collateral is provided by one subsidiary to secure borrowing by a sister subsidiary. Both of these can weaken the financial integrity of a corporate structure.
- By contrast, downstreaming poses no particular danger to creditors. Downstreaming occurs when a parent makes guarantees and pledges to support borrowing by a subsidiary.

Upstreaming and cross-streaming pose risks to creditors because the donor entity—the one providing the collateral or guaranty—is not getting "reasonably equivalent value," which is going instead to its affiliate. (*Reasonably equivalent value* has technical meaning in the context of fraudulent conveyance law, as discussed subsequently.)

In addition, each subsidiary is typically asked to guarantee all the senior debt of its parent, and yet the assets of the subsidiary represent only a fraction of the total acquisition. The result is that each subsidiary, taken by

itself, cannot repay the full acquisition debt and may be rendered insolvent if the guarantee is called against it alone.

Preserving creditors' claims through the proper entity and financing structures can help prevent the entity's owners from being sued for "fraudulent conveyance." If the target becomes insolvent, and pre-acquisition creditors become disadvantaged as a result of the transaction, creditors can invoke fraudulent conveyance laws to improve their creditor standing. (In fact, a forward-looking bankruptcy trustee, debtor-in-possession, or court-authorized creditor or creditor's committee can avoid the transfer in the first place by appealing to Section 548.)

What, exactly, are fraudulent conveyance laws, and what deal attributes can cause a company to run afoul of these laws?

Fraudulent conveyance laws stem originally from English common law. Originally called Statute of Elizabeth laws, after Queen Elizabeth I, they are now enshrined in the U.S. bankruptcy law (Section 548 of the Bankruptcy Code) and the Uniform Fraudulent Conveyance Act and the Uniform Fraudulent Transfer Act. All states have adopted fraudulent conveyance laws based on the uniform acts or on common law.

Under the U.S. Bankruptcy Code and comparable provisions of state law, a transfer of property (such as a lien given by the acquired company on its assets, or the note secured by that lien), may be deemed "fraudulent" under certain conditions, enabling interested parties to avoid a transfer or to sue over it.

A court may find fraud if the debtor transfers property with an actual intent to hinder, delay, or defraud creditors. Alternatively, a court may find fraud if an acquirer of the property receives "*less than reasonably equivalent value*" in exchange *and* if one of the following three conditions exists:

1. The company was *insolvent* at the time of such transfer or became insolvent as a result of the transfer.
2. The company was left with *unreasonably small capital* as a result of the transfer.
3. The company incurred or intended to incur debts beyond its *ability to pay.*

"Less than reasonably equivalent value" is a somewhat ambiguous term. It does not necessarily refer to market value.[30] Instead, it may be as simple as the price *actually paid for a property in a foreclosure,* as long as state

foreclosure laws (pertaining to notice of intent to foreclose, etc.) are otherwise respected. State foreclosure laws, by the way, are basically the law of mortgages (since any foreclosure essentially ends a mortgage agreement). In the United States, mortgage law is mainly governed by state statutory and common law. When a mortgage is a negotiable instrument, it is governed by Article 3 of the UCC, which covers negotiable instruments. Legal treatment of a mortgage depends in part on the identity of the entity holding the mortgage (the mortagee). Thus, although mortgage law is handled at the state and common law level, as noted, institutions that are chartered by the federal government may fall under federal law.[31]

Who can be sued under fraudulent conveyance laws or be forced to give up funds if a company goes bankrupt after it is acquired?

Courts may impose these penalties on any party who knew that the loan proceeds would be paid to the target's original shareholders while debt was being imposed on the target's assets.[32]

The entity that emerges from bankruptcy may be liable for the full amount of the conveyance (the purchase price of the company).

Target shareholders might have to refund the purchase price for their stock.

Lenders in the know might have to subordinate their claims to the claims of other creditors or be asked to refund any loan payments received.

Professionals advising the transaction might have to refund their fees, or be sued for negligence.

Suppose that through sophisticated structuring, a transaction gives the appearance of providing adequate consideration. Won't a court respect that at face value?

No. The courts are smarter than that. They have developed something called the *step-transaction* doctrine to see through such tricks. This doctrine developed out of common law but is now enshrined in U.S. tax law. Decisions citing this doctrine vary greatly, but according to one expert tax lawyer, the applicability of the step-transaction doctrine (i.e., the collapsibility of the structure containing the steps) depends on four factors:

1. *The degree of interdependence of the steps.* The higher the degree of interdependence, the more likely the steps may be collapsed.
2. *The extent of any binding commitments.* The fewer the binding commitments, the more collapsable the structure.
3. The elapsed time between the various steps (the shorter the time, the more collapsible the structure).
4. *The end result or intention of the parties.* The more the structure appears to be engineered for a specific outcome, the more likely it is to be collapsed.[33]

In addition to fraudulent conveyance laws, what other laws give legal exposure to parties in a transaction with a company that is or becomes insolvent?

Even if a transaction would not violate fraudulent conveyance laws, it might be considered a breach in fiduciary duties under common law—both with respect to the law of corporations and the law of trusts.

Corporation law varies slightly from state to state, but the laws of all states assert a *duty of due care* and a *duty of loyalty.*

- Exercising due care means acting on behalf of the company's stockholders in good faith and with the level of care that reasonable directors would exercise under similar circumstances, paying attention therefore to the likely effects of the transaction.
- Exercising loyalty means avoiding conflicts of interest. State courts have found that directors and officers breach the duty of loyalty when they appropriate a corporate asset or opportunity or use their corporate office to promote, advance, or effectuate a transaction (between the corporation and themselves or a party related to themselves) that is not substantively and entirely fair to the corporation.[34]

These duties of care and loyalty are owed primarily to stockholders, whom directors represent as fiduciaries and are generally protected by the so-called business judgment rule, which protects director decisions as long as they are made with care and loyalty.[35]

However, in insolvency, things change. The duties of care and loyalty are focused on multiple constituencies, not just stockholders, who in fact rank lower than creditors in the distribution of postfiling funds. Also, some legal experts say that the business judgment rule may not apply to board decisions made outside court-supervised proceedings.[36]

An added twist in any complex transaction is the law of trusts, also called the *corporate trust fund doctrine.*[37] In general, this doctrine provides that, once insolvent, a company's assets are to be managed as though held in trust for the benefit of its creditors. Under this doctrine, directors and officers of a financially distressed company should avoid intermingling of funds and other assets, among affiliated companies or within the same company, where different groups of creditors may have different claims on the assets.

According to basic trust law principles, a fiduciary may not mingle assets in a way that weakens the claims against any of those assets.

FINANCING ALTERNATIVES FOR COMPANIES WITH LOSSES

If an entity is having trouble meeting its obligations because it has a lot of debt that has claims on assets, what are its chances of borrowing more money from lenders?

Banks are reluctant to take on any term debt for companies with a weak balance sheet (i.e., a high ratio of total funded debt to earnings before interest, taxes, depreciation, and amortization, or EBITDA).[38] But a new level (or *tranche*) of junior secured debt has emerged to fill the gap left by the traditional lenders. Hedge funds, distressed-debt funds, or specialized high-yield funds are structuring this new debt with a junior lien behind the senior lender on all of the borrower's assets and, on occasion, a senior lien on some of the borrower's assets that are considered to be *boot collateral* (assets securing the loan with no advance provided by the senior lender).

This debt is known by many names, such as a *tranche B loan, junior secured loan, last-out participation,* or *second-lien loan.* Regardless of what it is called, this junior secured loan provides incremental liquidity and leverage to borrowers who are tapped out with their existing senior lenders.

A tranche B lender looks to two broad categories to secure its loans: excess liquidation value from the borrower's assets or enterprise value that exceeds the amount of the senior loan. Credit criteria relating to these two underwritings are entirely different.

- In the *liquidation value* approach, the lender secures the loan based on the liquidation value of the company's assets. This loan is based on balance sheet considerations. (For more on asset-based lending, see the section on liquidation later in this chapter.)

- In the *enterprise value* approach, the lender secures the loan based on the intangible value of a company, including brand names, customer relations, and proprietary product lines. This loan is based on the going-concern value of a business or on the value of its various product lines.

Could you give a detailed example of a tranche B loan based on asset liquidation value?

A borrowing base for a company may provide for an advance in the range of 80 to 85 percent of the net going-out-of-business (GOB) liquidation value. A tranche B loan can provide for an incremental advance of 10 to 15 percent or more of the liquidation value. For example, when West Coast retailer HomeBase, Inc., decided to close some unprofitable stores in 2001 and convert its remaining retail outlets to a new concept, it needed capital to complete the conversion. It obtained this through a $45 million tranche B term loan as part of the company's existing $250 million credit facility. The tranche B advances expanded the borrowing base through increases in the advance rates on both inventory and owned real estate.

Tranche Bs can also be major. For example, as part of its bankruptcy proceedings, United Air Lines, Inc., entered into a new senior secured revolving credit facility and term loan (or *exit facility*) provided by a syndicate of banks and other financial institutions. The exit facility provided for a total commitment of up to $3.0 billion, consisting of two separate tranches:

1. Tranche A, consisting of up to $200 million revolving commitment available for tranche A loans and for standby letters of credit to be issued in the ordinary course of business of United Air Lines or one of its subsidiary guarantors
2. Tranche B, consisting of a term loan commitment of up to $2.45 billion available at the time of closing and additional term loan commitments of up to $350 million[39]

Could you give a detailed example of an enterprise value tranche B loan to a financially troubled company?

Consider the bankruptcy and auction sale of the assets of the Schwinn Bicycle Company. In this case, Huffy Corporation took out a $20 million junior

secured term loan commitment to support its efforts to acquire Schwinn. This exposure was essentially supported by the good credit quality of Huffy and the trade name value of Schwinn.

Huffy Corporation was the stalking horse bidder for Schwinn, and Pacific Bicycle, which owned the Roadway and Mongoose brands, emerged as the competing bidder. Pacific Bicycle paid $45 million for Schwinn's brand name during an auction in September 2001.

ACCOUNTING/TAX ISSUES FOR COMPANIES WITH LOSSES

Can an acquirer structure a transaction as an asset or stock purchase, and, if so, which is the best option for the acquirer of a company with losses?

Buyers have a great deal of discretion in how they structure the acquisition of any particular company. The best treatment depends on the basis the acquirer wants.

When a purchaser directly acquires the assets of a target corporation, and the target is subject to tax on the sale or exchange of the assets, the basis of the assets to the purchaser is their cost. This is called *cost basis.*[40]

When a purchaser indirectly acquires the assets of the target through the acquisition of stock, the basis of the assets in the possession of the target corporation is generally not affected. This is called *carryover basis,* because the basis of an asset in the target corporation "carries over" on the change of stock ownership.

A cost basis transaction is, therefore, often referred to as an *asset acquisition,* and a carryover basis transaction is often referred to as a *stock acquisition.* Neither of these terms necessarily reflects the actual structure of the transaction.

How do loss carryovers and carrybacks figure into M&A transactions with troubled companies?

First, let's review some of the material on net operating losses that we covered in Chapter 4, on general tax principles. As explained earlier, if a taxpayer has an excess of tax deductions over taxable income in a given year, this excess becomes an NOL of that taxpayer. Section 172 of the IRC allows that taxpayer

to use NOLs to offset taxable income in subsequent years (a carryover or carryforward) or to offset taxable income in earlier years (a carryback).

Can an acquirer carry back a target company's post-acquisition net operating losses or net capital loss to the target's pre-acquisition years to obtain a refund of taxes paid for those prior years?

Yes. In fact, there are two alternative procedures to carry back a post-acquisition NOL or net capital loss to obtain a refund.

The taxpaying entity may file a normal refund claim by amending its tax returns for the years to which the NOL or net capital loss is carried back. In general, a corporation may carry back an NOL two years and a capital loss three years.

Alternatively, the taxpayer may use a simplified and expedited procedure called a *tentative carryback adjustment,* which is specifically designed for carrying back NOLs, net capital losses, and excess credits.[41]

Are expenses incurred in a reorganization tax deductible?

No. Instead of being expensed, these costs must be capitalized, as they pertain to the long-term value of the company. The only bankruptcy-related expenses that may be deductible will be those to settle tort claims.[42]

What is the tax treatment of the cancellation of debt?

Generally, the rule in the IRC is that a debtor has taxable income when a debt is canceled. However, one of the exceptions to this general rule occurs when a taxpayer is still insolvent after realizing a discharge of indebtedness. (As mentioned earlier, under the tax code, a business is insolvent when the taxpayer's liabilities exceed the fair market value of the taxpayer's assets.)

If the business is still insolvent after the cancellation of a debt, the entire discharged amount is excluded from gross income. This is a very important rule. If a business is insolvent and the cancellation of a creditor's debt returns the business to solvency, then it must report income. But if the company is still insolvent after the cancellation, it does not have to report any income.[43]

There is a catch, however. When a discharge of debt is excluded from gross income, the cancellation must be used to reduce (on a dollar-for-dollar basis) any NOLs. In essence, this defers tax rather than lowering it.

If a company is an S corporation, however, the situation is more favorable for the tax treatment of canceled debt. Shareholders of S corporations may increase their corporate basis by "items of income" that are identified in the tax code. These items include tax-exempt income, losses, and deductions. This prevents double taxation. A shareholder's basis in S corporation stock is decreased when losses and deductions are "passed through." However, shareholders cannot take corporate losses and deductions on their personal tax returns when those items exceed the shareholder's basis in the stock and his or her share of the debt of the S corporation. The amounts of those items that exceed the shareholders basis are "suspended" until the shareholder's basis increases enough to allow the deduction. The forgiveness of debt is income that would be excluded from gross income if the taxpayer were insolvent. Shareholders can then "pass through" this "item of income" to increase their corporate basis. The taxpayers could then deduct any losses that were previously suspended because there had not been sufficient corporate basis to deduct the losses.[44]

That was the finding of the U.S. Supreme Court in *Gitlitz, et al. v. Commissioner of Internal Revenue* (*2001*), 531 U.S. 206 (2001). The case dates from 1991, when PDW&A, Inc., of Colorado, an insolvent S corporation, of which David Gitlitz and Philip Winn were shareholders, excluded over $2 million in discharge of indebtedness from gross income, under Section 108 of the IRC. On their personal returns, shareholders Gitlitz and Winn increased the basis in their S corporation by the amount of the discharge. Gitlitz and Winn claimed additional corporate losses and deductions because of the increase in basis. The court held that the IRC permits taxpayers to increase the basis in their S corporation stock by the amount of an S corporation's discharge of indebtedness excluded from gross income.

LIQUIDATION

What is a liquidation?

A liquidation is a sale of assets that ends the existence of a going concern.

What is a partial liquidation?

A partial liquidation is a sale of the assets of one business within a larger network of businesses (such as a subsidiary). The proceeds of the liquidation are typically distributed to shareholders.

If a company buys an insolvent company, may it liquidate that company without incurring any special legal exposure?

Directors are under no special obligation to file for bankruptcy if a corporation is insolvent. In *Odyssey Partners, L.P. v. Fleming Cos.,* 735 A.2d 386 (Del. Ch. 1999), the plaintiffs, minority shareholders in Fleming Cos., claimed that directors violated their duty of loyalty to the minority stockholders by selling off assets rather than seeking reorganization. The court, relying on the business judgment rule, rejected this argument. The court pointed out that, in light of its conclusion that the corporation was insolvent, a board has an obligation "to consider and protect interests other than those of stockholders" and reasonably considered those interests in declining to pursue a Chapter 11 reorganization. This led to the board's acquiescence in a foreclosure sale of substantially all of the corporation's assets to the majority stockholder as the corporation's sole secured creditor, in connection with which the majority stockholder undertook to pay off in full all claims of all the corporation's unsecured creditors. The court found that this consideration by the directors of the interests of the unsecured creditors was legitimate, given that the minority stockholders would not necessarily have done better in a contested Chapter 11 proceeding.[45]

But although directors are free to liquidate assets, they must get a reasonable value for them. Indeed, if a corporation is insolvent but does not go through bankruptcy proceedings or otherwise place itself under the supervision of the courts, directors have an enhanced duty to "protect" the value of corporate assets and "account for waste," if any.[46] Fortunately, however, in a liquidation, directors' decisions on priority of creditor payments is protected by the business judgment rule.[47]

How are liquidations treated under the U.S. tax code?

If a company buys another company, adopts a plan of liquidation, and liquidates the company, then the liquidation will be tax-free under Sections 332 and 337 of the IRC.[48] Chapter 5 discusses Section 332 in more detail.

Also, under certain circumstances (in a partial liquidation) although gain is fully recognized at the corporate level, a shareholder (other than a C corporation[49]) receiving the proceeds avoids dividend taxation in addition to receiving certain tax benefits. To qualify, the corporation or affiliated group of corporations doing the partial liquidation must have been operating at least two separate businesses (including, of course, the one liquidated) for at least five years.

CONCLUDING COMMENTS

Workouts, bankruptcies, and liquidations exemplify the importance of careful structuring in any transaction—especially transactions with entities that are undergoing financial difficulty. Buyers who make a diligent effort to repay creditors and preserve value for shareholders can reap substantial rewards over the long term.

DIAGRAMS SHOWING VARIOUS STRUCTURES FOR REORGANIZATIONS AND WORKOUTS OF INSOLVENT COMPANIES[50]

In the transaction depicted in Figure 11-3, a venture capitalist lends $1 million in equity to Newco, the acquirer, while banks lend $9 million. The acquirer takes the resulting $10 million and buys Target from the shareholders. Target, which already has $2 million in liabilities, remains a separate subsidiary of Newco after the transaction and does not guaranty or otherwise assume liability for the $9 million loaned to Newco. This transaction structure would not point to fraudulent conveyance, *even if T becomes insolvent after the transaction, because it does not increase the debt load of the target company.*

In Figure 11-4, a venture capitalist forms Newco by investing $1 million for an equity stake in Target, which becomes a Newco subsidiary, and guarantees

FIGURE 11-3

Structure Posing No Fraudulent Conveyance Risk: Newco Purchases Target Stock

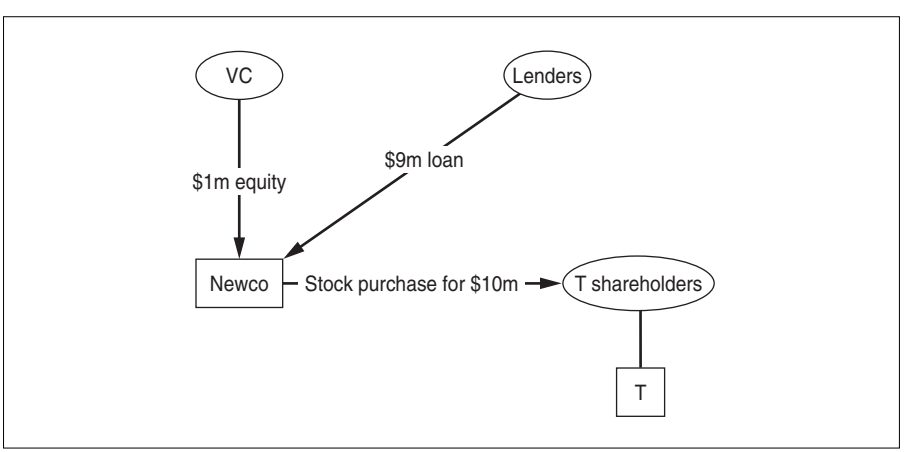
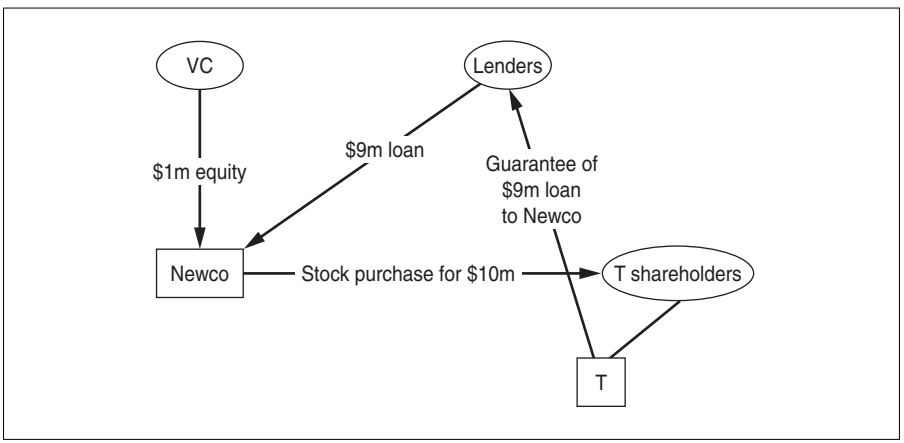


FIGURE 11-4

Structure Posing Fraudulent Conveyance Risk via Guarantee: Target Guarantees Newco Debt



Newco's $9 million debt. If Target, which already has $2 million in liabilities, becomes insolvent as a result of the transaction, this structuring technique could ***point to fraudulent conveyance.***[51]

In Figure 11-5, a venture capitalist forms Newco by investing $1 million for an equity stake. Target, which already has $2 million in liabilities, borrows $9

FIGURE 11-5

Structure Posing Fraudulent Conveyance Risk via Transfer of Loan Recipient: Target Does the Borrowing

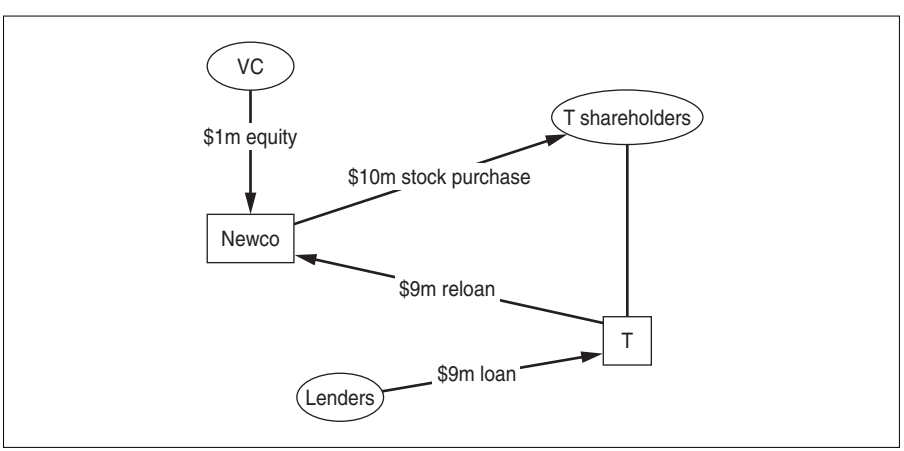
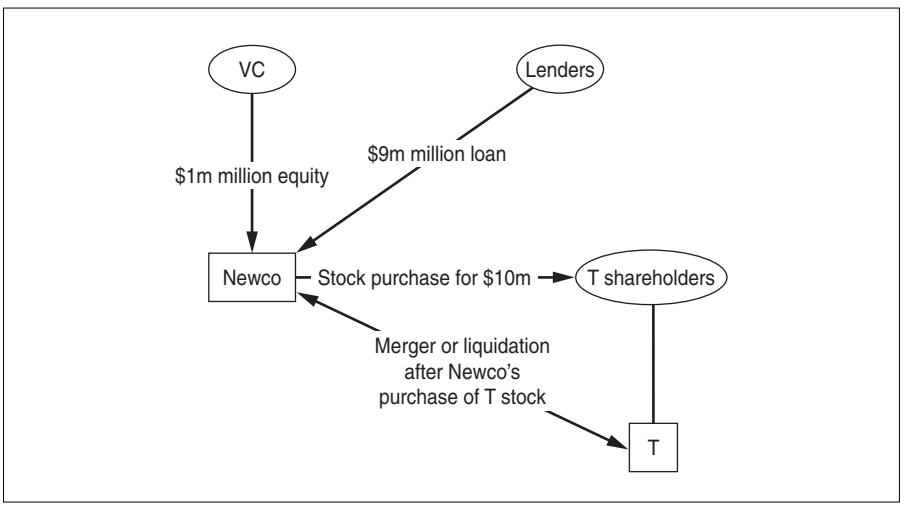


FIGURE 11-6

Structure Posing Fraudulent Conveyance Risk via Simple Merger: Newco Purchases the Target's Stock and the Two Combine



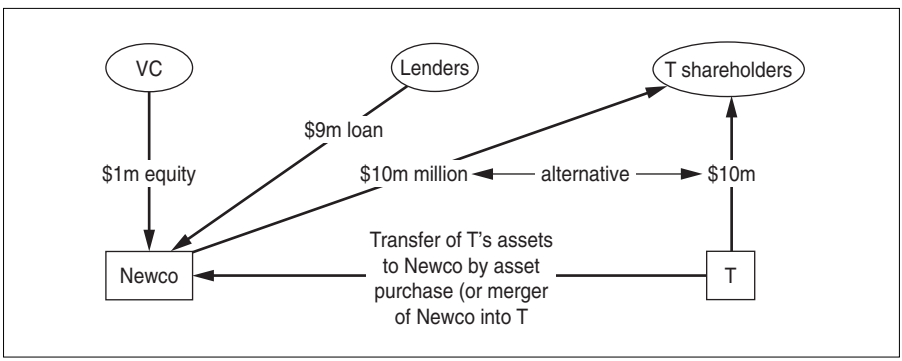
million, and reloans it to Newco. If Target becomes insolvent as a result of the transaction, this structuring technique could ***point to fraudulent conveyance.***

In Figure 11-6, a venture capitalist forms Newco by investing $1 million for an equity stake. Newco borrows $9 million and buys the Target stock, merging with Target completely (through a liquidation of Target, an upstream merger of Target into Newco, or a downstream merger of Newco into Target) and assuming Target's liabilities. If the newly combined company becomes insolvent as a result of the transaction, this structuring technique could ***point to fraudulent conveyance.***

In Figure 11-7, a venture capitalist forms Newco by investing $1 million for an equity stake, and Newco borrows another $9 million. Newco then takes the $10 milliion and does one of two things: (1) purchases Target's assets for $10 million and assumes Target's $2 million in liabilities, and then liquidates, distributing $10 million to shareholders; or (2) merges with Target (with either Newco or Target surviving the merger) and distributes $10 to Target shareholders pursuant to the merger plan. If Target's creditors fail to be paid what they are owed following this transaction, the transaction could ***point to fraudulent conveyance.***

FIGURE 11-7

Structure Posing Fraudulent Conveyance Risk via Distribution to Shareholders: Newco Buys Target Stock/Merges with Target, and Then Makes Distribution to Target Shareholders



In Figure 11-8, a venture capitalist forms Newco by investing $1 million for an equity stake. Newco uses the money to buy 10 percent of Target's stock. At the same time, Target borrows $9 million, which Target uses to redeem the rest of the stock. If the newly combined company becomes insolvent as a result of the transaction, this structuring technique could ***point to fraudulent conveyance.***

In Figure 11-9, a venture capitalist forms Newco by investing $1 million for an equity stake. Newco contributes the $1 million to its wholly owned subsidiary S. S borrows $9 million and then merges into T (in a reverse subsidiary

FIGURE 11-8

Structure Posing Risk of Fraudulent Conveyance in Multistep Transaction Involving Small Stock Purchase and Large Loan: Newco Purchases Part of the Target's Stock and Target Borrows to Redeem the Rest of the Stock

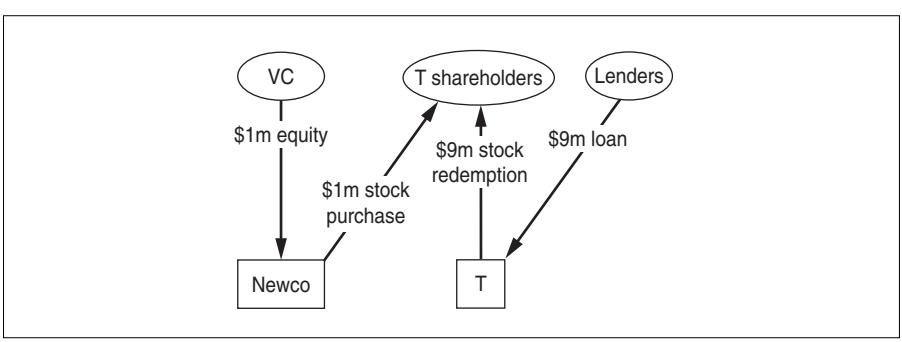
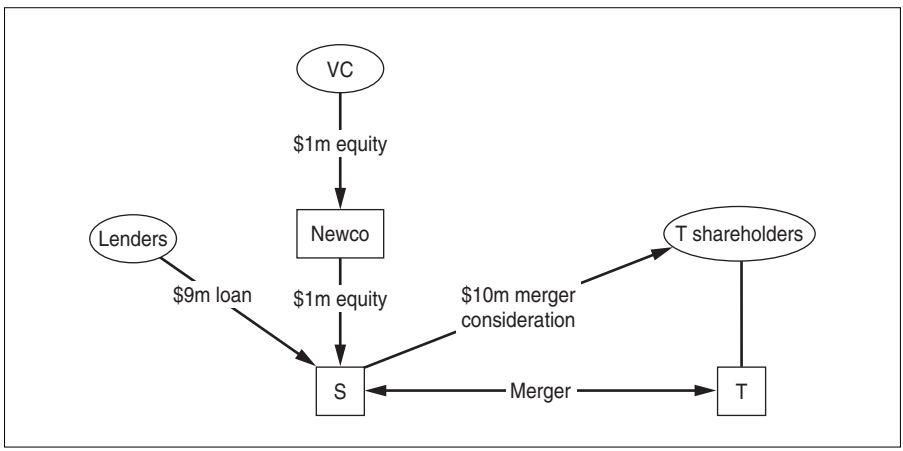


FIGURE 11-9

Structure Posing Fraudulent Conveyance Risk via Transfer of Risk to a Subsidiary: Newco Acquires Target via Forward or Reverse Subsidiary Merger



merger) or T merges into S (in a forward subsidiary merger). T's shareholders receive $10 million pursuant to the plan of merger (the $1 million of equity plus the $9 million of S acquisition debt). If the resulting company becomes insolvent as a result of the transaction, this structuring technique could ***point to fraudulent conveyance.***

The "Samex" Case: Illustrating the Vulnerability of the Bankruptcy Process to Fraud, and the Relative Finality of Acquisition Decisions Made in Bankruptcy Court

The following case is based on actual events as alleged in correspondence from a bidder to the unsecured creditors' committee of a manufacturing company located in the Midwest. The facts are true, but the names of the parties are fictitious.

Two manufacturing companies, Retool and NewThink, attempted to buy an insolvent entity, Samex, located in another state. When Samex filed for bankruptcy, its CEO announced a decision of the board to sell the company. The sale would be structured as an asset sale, and substantially all the assets of the company would be sold.

The three largest stockholders of Samex were also three of the largest creditors to the company, with both secured and unsecured debt. Less than two years before, these same stockholders had crafted a reverse merger that allowed them to take over the majority interest in Samex. These stockholder/creditors then controlled the board with three out of the five seats, allowing them to orchestrate this decision. They formed an investment group, called TET, which made a first ("stalking horse") bid, purportedly intended to be part of a court-approved process for competitive bids to be solicited. The bidders claimed that their bid price, at a minimum, would match the amount of all the secured debts of the company, which were senior to their own debt.

The TET bid was structured to be partly in cash and partly in notes. TET bidders said that the cash portion would be capped at $20 million, the estimated amount of the company's current senior secured debt. They said that the notes portion was worth $12 million, an amount representing what Samex already owed of TET. (The TET credit was junior only to Samex's bank and other lenders, principally leasing companies.) This was supposed to be a lowball bid to attract additional bids. The unsecured creditor's committee of the board, believing that other bids would be forthcoming, approved the bid.

Therefore, the CEO of Samex stated that the target price was $32 million. The deal was structured to give a cap on a purchase price rather than a purchase price. Here is the actual agreement language (disguising the name of the commercial bank holding the senior debt):

> The cash consideration to be paid by Buyer to Seller for the Assets (the "Purchase Price") shall be the sum of (a) the amount required to pay the secured debt of Senex Bank as of Closing plus (b) $750,000 plus (c) any Cure and Closing Costs (as hereinafter defined) plus (d) any other liabilities specifically assumed by Buyer as part of the Approval Order plus (e) the Stay Bonuses (as hereinafter defined) less (f) the Closing Date Cash (as defined in Section 1.2). Notwithstanding the foregoing, if the Purchase Price exceeds the Purchase Price Cap (hereinafter defined) or the Cure and Closing Costs exceed $2,500,000, then the Buyer shall be entitled to elect not to pay the Purchase Price and refrain from consummating the Closing. Buyer shall be entitled to participate in any discussions regarding the Cure and Closing Costs. For the purposes of this Agreement, "Cure and Closing Costs" shall mean the aggregate of (i) any amount(s) required to cure a default under any contract, lease or license listed in Exhibits A to C hereof or any Discretionary Agreement, (ii) any purchase option(s) on assets not owned by Seller and used in connection with the Business, (iii) any amount(s) required to pay a third-party to extinguish a lien upon any of the Assets or assets not owned by Seller and used in connection with the Business, (iv) any fees due and owing by the Seller that would be permitted under the Debtor Professional Fee Carveout (as defined in the DIP Financing Facility), (v) any fees due and owing by the Seller that would be permitted under the Committee Professional Fee Carveout (as defined in the DIP Financing Facility), (vi) quarterly fees

due and owing by the Seller to the Office of United States Trustee, (vii) any winding up fees incurred by the Seller not to exceed $50,000. For the purposes hereof, the "Stay Bonuses" shall mean the aggregate amount necessary to pay each of the employees listed on Schedule 2.1.1 hereto an amount equal to (x) one-half of the annual salary that such employee is currently receiving from Seller and as listed on Schedule 2.1.1 (such annual salary with respect to each such employee, his or her "Annual Salary") for each such employee that is not offered a full-time position with the Buyer, and (y) one-twelfth of such employee's Annual Salary, for each such employee that is offered a full-time position with the Buyer. The "Purchase Price Cap" shall mean (a) Twenty Million and No/100 Dollars ($20,000,000) subject to adjustment as set forth in Section 2.1.2 below plus (b) any cure costs for Discretionary Agreements that Buyer elects to assume plus (c) any other liabilities specifically assumed by Buyer as part of the Approval Order less (d) the Closing Date Cash.

The competing bidders had the impression that $32 million was an actual bid, and so tried to match it, even though it was actually high for an asset sale. Each of these bidders had a strategic reason for wanting to purchase the company. That is, they had new technologies that could be leveraged to increase the worth of Samex's assets into something that could justify the $32 million price. Although they lowered their bids slightly during the bidding process, they wound up bidding more than TET, the insider group.

Previously, the TET group, through the company's bankruptcy filings, had convinced the bankruptcy court to allow an investment banking company to monitor and supervise the competitive bidding process, a group that the TET group hand-selected. This investment banking company succeeded in disqualifying all other bidders through a process that they defined and controlled and that was not subject to oversight review by the courts.

In the end, following the recommendation of the investment banking firm, the court approved the bid from the insider "stalking horse" group, the only remaining bid on the table. The inside bidders wound up paying less than $20 million, because a decision by the bankruptcy court forced a lowering in the amount of senior debt owed to Senex's bank, the senior lender.

Shareholders in a Samex subsidiary called RIF attempted to challenge the transaction. After acquiring RIF for stock and holding it as a wholly owned subsidiary, Samex put RIF into bankruptcy when RIF was operating at near breakeven. The Samex shares owned by the sellers of RIF lost virtually all of their value as a result of the bankruptcy filling. The RIF sellers alleged that the acquisition of RIF and the subsequent bankruptcy filing indicated a pattern of fraud by TET for the purpose of obtaining control of RIF (via Samex) at bargain rates. Specifically, the RIF sellers alleged that the insider group from TET used the bankruptcy process to take over Samex (and via Samex, RIF), eliminating the shareholders of RIF and weakening the claims of the shareholders of Samex, giving almost nothing to all other creditors, and using the assets of Samex to finance RIF's purchase.

An attorney in a major law firm specializing in litigation against directors and officers, when presented with this same pattern of facts, declined to take on the case, stating, "My conclusion is that any claims related to the acquisition in the bankruptcy proceedings are probably barred as a result of the court's approval of the transaction. Thus, it is not a case that we would be willing to prosecute."

The competing bidders, unsecured creditors, and minority investors in Samex all believe that they could have been served better through a truly independent bidding process. At this time, however, it appears that the decision of the bankruptcy court, because of its legal status as such, is final.*

*See Kurt A. Mayr, "Unlocking the Lockup: The Renewal of Plan Support Agreements Under New Section 1125(g) of the Bankruptcy Code," the *Journal of Bankruptcy Law and Practice,* December 2006. This article explains that plan support lockup agreements "memorialize the material terms of a restructuring proposal (often simply a term sheet) that has been agreed upon between a debtor and one or more of its major stakeholders." And says lockups are "an essential tool in out-of-court workouts and so-called 'prenegotiated' or 'prearranged' Chapter 11 cases."

NOTES

1. Jonathan Rosenthal, advisor to the shareholder committees of Adelphia and Kmart, in a *Business Week Online* interview posted on the Turnaround Management Association Web site (turnaround.org). See note 9 for more information about this association.
2. 11 U.S.C. § 101(32)(A).
3. *Travellers International AG v. Trans World Airlines, Inc.* (*In re Trans World Airlines*), 134 F.3d 188, 194 (3d Cir. 1998), *cert. denied,* 523 U.S. 1138 (1998).
4. Ibid., at 195.
5. Uniform Fraudulent Transfer Act §§ 2(a) and (b). Failure to pay debts when they become due is sometimes referred to as "equitable insolvency."
6. *Brandt v. Hicks, Muse & Co.* (*In re Healthco Int'l, Inc.*), 208 B.R. 288 at 300 (Bankr. D. Mass. 1997 noted that "insolvency in the bankruptcy sense [is] an excess of liabilities over the value of assets," but in the context of fiduciary obligations of directors to creditors, "another form of insolvency is equally relevant—insolvency in the equity sense," that is, "an inability to pay debts as they mature. Even though not insolvent in a bankruptcy sense, a business is insolvent in the equity sense if its assets lack liquidity."
7. New York Business Corporation Law (§ 102(a)(8)) defines *insolvent,* in part, as "being unable to pay debts as they become due in the usual course of the debtor's business."
8. Note, however, that liquidations should never be used as a way to avoid the obligations for financial stewardship imposed in a bankruptcy proceeding. Although directors are free to liquidate assets, they must get a reasonable value for them. Indeed, if corporation is insolvent but does not go through bankruptcy proceedings or otherwise place itself under the supervision of the courts, directors have an enhanced duty to "protect" the value of corporate assets and "account for waste," if any. (See *N.Y. Credit Men's Adjustment Bureau v. Weiss,* 305 N.Y. 1 at 7. Note also that in a liquidation, directors' decisions on priority of creditor payments is protected by the business judgment rule. *Curiale v. Reissman* (Supreme Court of New York, filed March 7, 1993), *aff'd,* 202 A.D.2d 201, 609 N.Y.S.2d 777 (1st Dep't 1994), in which the appellate court, without issuing an opinion, affirmed the ruling of the New York County Supreme Court.
9. The Turnaround Management Association, headquartered in Chicago, has 34 chapters and more than 7,000 members as we go to press. The Web site is turnaround.org.
10. Source: Commerce Clearing House, Washington, D.C.
11. On the other hand, creditors should not allow the threat of a bankruptcy filing to force them into unreasonable concessions. See Dan Torrez, "Desperate Companies Cry Wolf with Faux Filings," *Austin Business Journal,* June 2003.

12. For links to the U.S. bankruptcy courts' Web sites, see abiworld.org.
13. Elizabeth Warren and Robert M. Lawless, "The Myth of Disappearing Business Bankruptcy," 93 *California Law Review* 745 (2005).
14. In the United States, some 15 million entities file taxes as going concerns every year, and the total number of bankruptcy filings, including personal filings, is only 1.5 million. (The number of business filings, as mentioned, is about 40,000, but some entity owners use personal bankruptcy to resolve the claims against their businesses.) Of the 15 million business entities in the U.S., about 1 percent are publicly held (the 15,000 that must report to the SEC because they sell stock to the public).
15. In the first half of 2003, public company filings numbered 76, the fewest bankruptcies during any six-month period since the first half of 2000. In 2002, 191 publicly held companies filed for bankruptcy, down from 2001, when there were 257 bankruptcy filings from public companies, and up from 176 in 2000. Sources: bankruptcydata.com, abiworld.org, PricewaterhouseCoopers 2003.
16. For a case involving the carryover of one bankruptcy to another, see *Young v. United States,* No. 00-1567 535 U.S. 43 (2002).
17. Public Law 99-554, Title II, Section 257(a); October 27, 1986.
18. Public Law 103-394, Title V, Section 501(d), October 22 1994 (which struck out Chapter 15 in Title 11).
19. Public Law No: 109-8. For a good analysis of this law, see "Establishing Rules of Engagement," *The Deal,* October 17–23, 2005, pp. 26–27. Comments about the impact of this new law are based in part on this article.
20. Source: U.S. Securities and Exchange Commission. (sec.gov).
21. The source for this material on shareholders committees is Jonathan Rosenthal, of Saybrook Capital, Santa Monica, advisor to both Kmart and Adelphia. He cautions, in an article posted on the Turnaround Management Association Web site (tma.org), as well as BusinessWeek Online (bwonline.com): "Having an equity panel doesn't guarantee shareholders a better shake, but at least they have a fighting chance. . . . Once you gain official status, you have a very different standing in the courtroom. The judge will listen to you, and the company is obligated to pay for your legal and financial advisers."
22. Source: Jonathan Rosenthal, ibid.
23. Source: bankruptcydata.com.
24. The LTV case from 1991 is a case in point. Judge Burton R. Lifland of the U.S. Bankruptcy Court for the Southern District of New York held in the LTV case that bondholders who participated in an out-of-court workhout could not value the bonds at their face value, but only at their discounted purchase price. This is why LTV opted for a prepack—to be able to value the bonds at their face value See Craig Nemiroff, "Original Issue Discount and the 'LTV Risk'

Reconsidered," *Yale Law Journal,* Vol. 105, No. 8 (June 1996), pp. 2209–2234.

25. The supremacy clause of the U.S. Constitution states that where the U.S. Constitution has preempted an area, the states cannot act in conflict with the federal jurisdiction. Since Congress is empowered to enact bankruptcy laws, the states must abide by these laws.

26. The 1,542-page manual is available for purchase at ABI's Online Bookstore at this link: www.abiworld.org/eseries/source/orders/index.cfm?task=3&SKU=06_002.

27. *Amphenol Corp. v. Shandler* (*In re Insilco Technologies, Inc.*), Adv. Proc. No. 05-52403 (Bankr. D. Del. Sept. 18, 2006).

28. Source: U.S. Securities and Exchange Commission, www.sec.gov/investor/pubs/bankrupt.htm.

29. For this observation, and the structuring points in this section, we acknowledge Martin D. Ginsberg and Jack S. Levin, Mergers, *Acquisitions, and Buyouts: A Transactional Analysis of the Governing Tax, Legal, and Accounting Considerations* (New York: Panel Publishers/Aspen Law and Business: December 2006).

30. See U.S. Supreme Court, *BFP v. Resolution Trust Corporation,* as receiver of Imperial Federal Savings Association, et al. Certiorari to the United states Court of Appeals for the Ninth Circuit. "*Held:* A 'reasonably equivalent value' for foreclosed real property is the price in fact received at the foreclosure sale, so long as all the requirements of the State's foreclosure law have been complied with." No. 92-1370. Argued December 7, 1993; decided May 23, 1994.

31. The Office of Thrift Supervision, an office in the Department of the Treasury, regulates federally chartered savings associations. The comptroller of the currency charters and regulates national banks. Federal credit unions are chartered and regulated by the National Credit Union Administration.

32. This list is a paraphrase of one found in Ginsberg and Levin, op. cit., note 35, Section 1506.2.

33. See Robert W. Wood, "Sale vs. Reorganization: Eye of the Beholder," *M&A Tax Report,* vol. 10, no. 12, July 2002, p. 5.

34. See, for example, *Solash v. Telex Corp.* [1987–88 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,608 (Del. Ch., Jan. 19, 1988). Source: Messineo et al. white paper.

35. This fiduciary principle normally applies to stockholders, not holders of convertible debentures and stock purchase warrants unless they have converted or exercised them. (*Benjamin v. Kim* [1999 Transfer Binder] Fed. Sec. L. Rep (CCH) 90, 478 (S.D.N.Y. 1999) held that a convertible debenture does not impose the trust relationship and concomitant fiduciary duties implied in an equity position. Rather, it represents the repayment of debt.)

36. See Martin J. Bienstock and Robert L. Messineo, "When Financial Trouble Comes: A Guide for Directors," *Director's Monthly,* September 2001, pp. 1–8.

37. Ibid.

38. This substance of this answer came from the writings of Colin Cross, managing director, Back Bay Capital Funding, president of the Chicago chapter of the Turnaround Management Association.

39. Form 8K for UAL Corp. February 2006. http://biz.yahoo.com/e/060201/uaua8-k.html.

40. With the exception of a stock acquisition governed by the provisions of Section 338 of the IRC, the acquisition of all or part of the stock of a target corporation does not alter the bases of the assets owned by the corporation. And with the exception of an asset acquisition governed by the IRC's tax-free reorganization provisions, the acquisition of the assets of the target will produce a cost basis to the purchaser.

41. See Reg. Section 1.1502-78(e), published June 1, 2001, cited in Ginsberg and Levin (op. cit, note 29), Section 1206.8.1, p. 12.113.

42. The Internal Revenue Service ruled in TAM 9204001 that a company may deduct the usual cots of settling tort claims as long as they do not relate to the institution and administration of a bankruptcy proceeding. Source: Source: Martin D. Ginsberg and Jack S. Lewis, *Mergers, Acquisitions, and Buyouts: A Transactional Analysis of the Governing Tax, Legal, and Accounting Considerations,* op. cit. (note 29).

43. Note: These rules do not apply to business indebtedness related to real estate.

44. Source: Dr. Bart A. Basi, The Center for Financial, Legal & Tax Planning, Inc. (taxplanning.com).

45. Similarly, in *Quadrangle Offshore* (*Cayman*) *LLC v. Kenetech Corp.,* 1999 Del Ch. LEXIS 213 (Del. 1999), the court held that the board's decision to convince noteholders from filing a bankruptcy petition were reasonable in light of the corporation's situation and "comported with the board's fiduciary duties towards its common shareholders."

46. See *N.Y. Credit Men's Adjustment Bureau v. Weiss,* 305 N.Y. 1 at 7.

47. In *Curiale v. Reissman* (Supreme Court of New York, filed March 7, 1993), *aff'd,* 202 A.D.2d 201, 609 N.Y.S.2d 777 (1st Dep't 1994), the appellate court, without issuing an opinion, affirmed the ruling of the New York County Supreme Court.

48. Note: "In most situations, a corporate taxpayer that is selling a consolidated subsidiary's stock will want the purchaser to agree to elect under Code Section 338(h)(10) to treat the stock sale as an asset sale for federal income tax purposes." Source: Sonnenschein.com.

49. A C corporation is the most common kind of corporation under the U.S. tax code. In the tax code, it is contrasted to the S corporation, which is for certain kinds of small businesses.

50. Source: Martin D. Ginsberg and Jack S. Lewis, *Mergers, Acquisitions, and Buyouts: A Transactional Analysis of the Governing Tax, Legal, and Accounting Considerations,* op. cit. (note 29).

51. This "badge of fraud" would be even more evident if the target company granted a lien on its assets to secure the $9 million loan. The same point applies to Figures 11-5 through 11-9.

CHAPTER 12

Structuring Transactions with International Aspects

INTRODUCTION

Today, more than ever before in their history, business buyers and sellers operate in a global economy. The growth of offshore currency markets, the availability of international debt financing, and the liberalization of national securities exchanges around the world have made it virtually impossible for any business to ignore the existence of an economically and technologically unified world. Today, U.S. firms' annual overseas exports exceed $1.3 trillion, suggesting confidence in global markets.[1] Moreover, companies are engaging in an increasing variety of international mergers, acquisitions, and other investment activities—much of it contributing to the boom in global trade.

Of the more than $2 trillion spent on M&A annually, nearly half is spent to buy firms in the United States.[2] Yet the United States has no monopoly on deal making. Many of the largest transactions in recent times have been transborder deals that do not involve U.S. companies. As we go to press, headlines discuss Softbank Corp.'s agreement to acquire a 97.7 percent majority stake of Vodafone KK from Vodafone Group PLC for ¥1.8 trillion (US$15.5 billion).[3] BP PLC's agreement to acquire a 25 percent minority stake in China Petroleum & Chemical Corp. for 113 billion Chinese renminbi (US$14 billion), MTN Group Ltd.'s agreement to acquire Investcom LLC for £8.3 trillion (US$5.5 billion), and Kookmin Bank's offer to acquire approximately 50.5 percent controlling stake in Korea Exchange Bank from Lone Star Management Co. Ltd. for 4.3 trillion Korean wons (US$4.4 billion).

These buyers and sellers are doing their deals in an increasingly fluid financial environment. Around the world, stock exchanges are opening up their listings to foreign issuers, providing 24-hour trading to accommodate global buying and selling. There are even "pre-emerging" stock markets to choose from. In another sign of the global times, investment banks are beginning to publish worldwide stock indexes. Meanwhile, language barriers are falling as more companies print annual reports in multiple languages.

A quick note on terminology. By *foreign,* we mean located outside the corporation's country. Thus to a French-incorporated company, a British acquirer would be foreign, even if in the same region. We are not using this term to indicate transactions across state lines within a multistate country.[4] Also, it is important to note who pays the taxes due from a foreign entity.[5]

This chapter is divided into two parts—nontax and tax. It makes a distinction in each of those areas between issues relating to foreign investment in the United States (inbound transactions) and those relating to U.S. investment overseas (outbound transactions). It includes information useful to companies acquiring other U.S. companies with international components and to U.S. companies wishing to finance their domestic or foreign activities through international techniques and sources.

NONTAX ISSUES REGARDING FOREIGN INVESTMENT IN THE UNITED STATES

U.S. Limitations on Foreign Ownership

Are there any limitations under U.S. law regarding the form of business association in which a foreign person can participate?

Generally, U.S. laws impose no limitations on the form of business association a foreign person can use to create or conduct a business or own business interests. The type of business association a foreign person decides to use is often dictated by the particular needs of the enterprise and the impact upon that enterprise of federal and state laws—particularly tax laws, which may be an incentive to use one particular structure and a disincentive to use another. Any foreign person would be well advised to check with local counsel on the impact of all relevant tax, business, securities, and related laws prior to deciding on the most favorable form of business association to achieve his or her specific goals.

Must the parties forming a new corporation be citizens of the United States and residents of the state of incorporation?

Not necessarily. The ease and simplicity of corporate formation in the United States may come as a surprise to those accustomed to the formality of incorporating under certain foreign systems. In the absence of express requirements in state corporation statutes, these parties, called *incorporators* (not synonymous with stockholders), are merely legal instruments used to organize a corporation. They need not be citizens or residents of the state under whose laws the formation of the corporation will be formed. For example, Delaware Corporation Law Section 101(a) states the following:

> Any person, partnership, association, or corporation, singly or jointly with others, and without regard to his or their residence, domicile, or state of incorporation, may incorporate or organize a corporation under this chapter by filing with the Secretary of State a certificate of incorporation which shall be executed, acknowledged, filed, and recorded in accordance with Section 103 of this title.

If everyone owning and operating a corporation that is incorporated under the laws of a state of the United States is a non-U.S. citizen, isn't the corporation considered foreign?

No. A corporation formed under the laws of any state is simply a corporation of that state. However, the business activities of that corporation may be restricted because its owners are not U.S. citizens, and its owners may have to pay additional taxes because of their foreign citizenship (see "International Tax and Disclosure Considerations" later in this chapter).

What type of federal restrictions apply to foreign ownership of U.S. businesses?

There are no blanket restrictions on the ownership of U.S. businesses by foreign persons. There are, however, certain federal regulations restricting or limiting foreign ownership in particular industries or in certain circumstances. The following laws control foreign investment and activity in specific industries or circumstances:

- The *Federal Communications Act* bars aliens, foreign governments, certain U.S. corporations controlled by foreign interests, and

corporations organized outside the United States from possessing a broadcast or common carrier license.

- The *Federal Aviation Act* prohibits any foreign air carrier, or person controlling such an entity, from acquiring "control in any manner whatsoever" of any U.S. entity or enterprise substantially engaged in the aeronautics business.
- The *Mineral Lands Leasing Act* requires that any corporation applying to the secretary of the interior for a federal lease to develop certain natural resources of the United States disclose the identity and citizenship of shareholders owning more than 10 percent of its stock, in which case the lease will be granted only if U.S. persons can obtain reciprocal licenses or leases from the home governments of such foreign shareholders.
- The *Shelflands Act* stipulates that offshore leases for the development of energy resources be held only by citizens, nationals, and permanent resident aliens of the United States or by business associations thereof. However, because the Department of the Interior considers any corporation organized in the United States an entity suitable for an award of a lease, foreign possession of leases is possible through incorporation of a U.S. subsidiary.
- The *Merchant Marine Act* restricts the registration and licensing of vessels to those vessels owned, chartered, or leased from the secretary of commerce by a U.S. citizen, or a corporation, partnership, or association organized in the United States and controlled by U.S. citizens.
- The *Edge Act* limits foreign ownership of corporations chartered by the Federal Reserve Board to engage in international banking and finance.

In addition to the aforementioned U.S. statutes, additional, recent legislation has been developed to monitor or control foreign investment in and trade with the United States.

In 1975, the Committee on Foreign Investment in the United States (CFIUS) was formed by executive order. The mandate of this committee is to review investments by foreign governments in the United States that, in the judgment of CFIUS, may have an effect on the national interests of the United States. The committee, however, has no power to block or modify investments by foreign governments. In 1988, the Omnibus Trade and Competitiveness Act, also called the Exon-Florio Amendment, authorized the president to suspend or

prohibit mergers, acquisitions, and takeovers of U.S. entities by "foreign persons" if it is determined that "the foreign interest exercising control might take action that threatens to impair the national security." The president's determination is not subject to judicial review.

In making the determination, the president may take into account domestic capacity to meet national defense requirements, among other factors. The president must commence any investigation within 30 days after notice of the merger, acquisition, or takeover and complete the investigation not later than 45 days from determining to undertake it. Any decision to take action must be announced no later than 15 days after the investigation is completed.

Are there any special federal requirements that apply to U.S. businesses owned or controlled by foreign persons?

Yes, primarily disclosure requirements. First, disclosure requirements generally applicable to acquisitions, such as requirements under the Hart-Scott-Rodino Act and the Williams Act (see Chapters 2 and 12), apply to foreign as well as U.S. investors. Second, the following federal laws establish specific disclosure requirements for foreign investors or have other requirements pertaining to foreign investments:

- The *International Investment and Trade in Services Survey Act* requires U.S. business enterprises to report to the Department of Commerce, within 45 days, the acquisition of a voting interest of 10 percent or more in such enterprise by one or more foreign persons if the interest was acquired for a price exceeding US$1 million. Under this law, passed in 1976, if the enterprise has annual sales, assets, or net income greater than $10 million, annual and quarterly financial reporting are also required. In addition to the reporting requirements of foreign investors, the act also requires reporting by any citizen of the United States who assists or intervenes in the acquisition of a voting interest of at least 10 percent by a foreign person or by one who enters into a joint venture with a foreign person to create a U.S. business enterprise.
- The *Foreign Investment in Real Property Tax Act,* passed in 1986, granted the secretary of the Treasury the authority to require reporting by foreign persons holding direct investments in U.S. real property interests having an aggregate fair market value of $450,000 or more.

- The *Agricultural Foreign Investment Disclosure Act* requires a foreign person or entity to file a report within 90 days following the acquisition or transfer of any interest, other than a lien or security interest, in U.S. farming, ranching, or timberland.
- The *Tax Equity and Fiscal Responsibility Act,* passed in 1982, requires domestic and foreign corporations that (1) are controlled by a foreign person and (2) engage in a trade or business in the United States to file annual information returns.
- The *Tax Reform Act of 1986,* the *Revenue Reconciliation Act of 1990,* the *Omnibus Budget Reconciliation Acts of 1990* and *1993,* and the *Taxpayer Relief Act of 1997* have preserved or expanded foreign reporting requirements. The 1997 tax law contained several technical provisions relating to the taxation of controlled foreign corporations. These are still subject to interpretation, but readers should note Section 1131 regarding transfers to foreign entities, Section 1144 regarding earnings invested in excess passive assets, and Section 13232, which modifies taxation of investment in U.S. property.
- *American Jobs Creation Act of 2004.* Provisions related to repeal of exclusion for extraterritorial income (ETI). Provides transitional relief for taxpayers subject to the ETI repeal by allowing a tax exclusion of 80 percent in 2005 and 60 percent in 2006 of extraterritorial income; creates deduction relating to income attributable to U.S. production activities. Provides incentives to reinvest foreign earnings in the United States; installs new interest expense allocation rules; recharacterizes overall domestic loss; bases differences and reduction to two foreign tax credit baskets; implements 10-year foreign tax credit carryforward and 1-year carryback; and repeals the 90 percent limitation on the use of foreign tax credits against the AMT among other items.
- *Tax Increase Prevention and Reconciliation Act of 2005.* Accelerates the inflation adjustment to the exclusion amount for foreign earned income to 2006 from 2008; also extends through 2008 certain exemptions for income of controlled foreign companies.
- The *Tax Reconciliation Act of 2006,* signed into law on May 17, 2006, increases the U.S. federal income tax liability of U.S. employees located outside the United States. These changes are of interest to employers that provide tax-equalization benefits or housing allowances to U.S. employees relocated abroad. This could

include foreign acquirers of U.S. companies.[6] The provisions are retroactive to January 1, 2006.

In addition to these laws, there are the regulations for implementing them. Consider recent proposed changes to rules for carrying over tax attributes. The IRS has proposed "Stock Transfer Rules: Carryover of Earnings and Taxes." These final regulations provide guidance with respect to the carryover of certain tax attributes, such as earnings and profits and foreign income tax accounts, when two corporations combine in certain foreign-to-foreign or inbound corporate reorganizations or liquidations.[7]

Must foreign investors be concerned about specific state regulations as well as U.S. federal law when acquiring a U.S. business interest?

In general, states do not restrict foreign investment, except with respect to specific industries, such as banking and insurance. Most states have passed antitakeover laws (see Chapter 10), but these apply equally to U.S. and foreign acquirers. Some states restrict land ownership with respect to certain types of property, and the exploitation or development of natural resources by foreign investors. A foreign person desiring to acquire a business interest in the United States should seek legal counsel to ensure that there are no special restrictions imposed by the state in which the target business is domiciled, as well as under the federal law.

Do any of the foregoing restrictions apply to U.S. businesses in which foreign persons hold debt rather than equity?

No. In the United States, the percentage of equity owned is the exclusive means of measuring the extent of a foreign investor's control of a U.S. corporation. Debt holdings are not considered.

Does federal or state law limit the ability of a U.S. company to guarantee the indebtedness of a foreign affiliate?

There are no federal limitations on the ability of a U.S. company to guarantee foreign indebtedness. Any state limitations on a corporation's ability to

guarantee indebtedness would be set forth in the state's corporation statutes, but such limitations are relatively rare. Where limitations do exist under state law, these limitations apply regardless of the nationality of the person on whose behalf the guarantee is given.

Are there legal limitations under U.S. law on the ability of a U.S. company to pledge its assets to a foreign lender?

The power of a corporation to acquire, utilize, and dispose of assets arises from state corporation statutes and is not dependent on the identity of other parties to the transaction. For example, Section 122 of the Delaware General Corporation law empowers any Delaware corporation to "sell, convey, lease, exchange, transfer, or otherwise dispose of, or mortgage or pledge, all or any of its property and assets, or any interest therein, wherever situated." Federal law in the United States imposes no restriction on the pledge of assets by U.S. individuals or entities.

Does the United States impose any restrictions on the amount of dollars that can be paid by a U.S. business to a foreign investor?

There is no limit, under current U.S. law, on the amount of money that can be taken out of the United States by either U.S. or foreign investors. In fact, it is the lack of such restrictions that has led to the rapid development of large off-shore currency markets, such as the Eurodollar market.

Restrictions Imposed by the Acquirer's Home Country

Do most countries have laws that affect their citizens' acquisitions in other countries?

Many industrialized nations impose certain domestic laws and/or additional external investment laws on foreign companies acquired by their citizens. The acquirer must be aware of how these domestic and external investment laws might affect its investment.

An example of one area of concern is trade policy. Whereas the target company's country may want to increase exports, the parent company's

country may wish to restrict imports. In addition to general national trade policy concerns, there may be licensing requirements for imports and exports, and other trade barriers such as quotas and tariffs.

ACQUISITIONS OF ENTITIES INVOLVING ASSETS LOCATED OUTSIDE THE UNITED STATES

What are the main differences between acquisitions that are confined geographically to the United States and those that are international in whole or in part?

One of the advantages that the United States offers dealmakers is that it is a large, homogeneous area that runs on the same basic accounting, legal, and cultural principles. A buyer from Washington state making an acquisition in Florida, or a company in Arizona selling to a firm in Vermont, negotiates from a great deal of shared knowledge, shared perceptions, and shared business practices.

This is not true when a buyer goes abroad, even if only part of a transaction is international. It may seek to find the foreign equivalent of a particular transactional structure in a particular jurisdiction only to find that there is no such equivalent. For example, a buyer of a corporation in a particular country may assume it can offer its lenders warrants as part of its financing package. However, warrants may not be contractual obligations enforceable against corporations in that country. Therefore, the buyer would have to find other devices to give its lender the same or similar economic and legal rights as those embodied in a warrant.

In the United States, a management team and board of directors might decide on a transaction for strategic reasons and then call in the accountants and lawyers. However, they are basing the planned transaction on a great deal of law, tax, and accounting they already know and take for granted. When dealing in the international arena, managers will need a background on the meaning and reliability of information about the target and country in which it is located.

International dealmaking often forces buyers or sellers to learn an entirely different conceptual vocabulary or framework. At a very basic level, they will find that the same words have different meanings in different countries. For example, the titles for British *director* and French *directeur* do not mean the same thing as the U.S. title of *director* (i.e., member of the board), but instead refer more generally to an executive.

Similarly, the American concept of antitrust takes on a different meaning in Europe. Whereas the primary aim of U.S. antitrust law has been to maintain market efficiency and to protect consumers by preventing undue market concentration, antitrust law in the European Union aims at fostering market integration by pulling down barriers. In both Europe and Japan, strong cross-shareholdings render the term *shareholders' rights* and *investor activism* virtually untranslatable.

On the tax and regulatory front, in some countries an acquirer may find that the seller has the government as a silent partner. Many foreign countries reserve the right to review and amend the contracts between a domestic seller and a foreign buyer, in some cases to protect their citizens against overreaching by more sophisticated foreign businesspeople and in others to ensure that the transaction promotes economic development or other governmental policies.

Furthermore, U.S. accounting standards are not universal. In fact, due to generally higher corporate taxes, among other things, Europeans have been accused of playing with reserves in ways to reduce profits (and taxes) in good years. As a result, an income statement of a European company might be substantially misleading to analysts in the United States and must be reinterpreted (and usually recast) by local counsel. Despite the issuance of "accounting directives" for the EU and despite the work of the International Accounting Standards Board (IASB), European accounting still varies from country to country.

Finally, an American firm acquiring abroad will encounter a new cultural and ethical framework. Differences in forms of government, legal systems, language, and economic approaches must be considered and generally understood by potential cross-border investors. Furthermore, a country's identity is a product of its historical, religious, and social underpinnings, all of which have played a role in the development of that nation's business culture.

What are some of the principal issues a U.S. company should know about in connection with the acquisition of a non-U.S. business or a U.S. business with significant foreign assets?

Some of the key areas to focus on are as follows:

- Differences in rights accorded to employees
- Laws and beliefs pertaining to financing—for example, the Islamic principle under sharia (Islamic law) that it is wrong to charge or pay interest.

- The ability to use foreign assets to support financing from lenders
- Regulatory requirements and limitations with respect to the acquisition itself and with post-acquisition operations

In Italy, for example, limitations on foreign purchasers include the following:

- A prohibition preventing foreign entities from purchasing, directly or indirectly, a controlling interest in newspaper publishing companies and television broadcasting companies
- A ban on foreign ownership of ships and aircraft registered in the Italian naval or aircraft registry
- Various restrictions and prohibitions contained in articles and bylaws of Italian corporations (especially banks) regarding the ownership of securities by foreigners
- Disclosure rules pertaining to filing obligations applicable to anyone purchasing interests above certain financial thresholds

What types of regulatory requirements affect the pre-acquisition stage of a transaction?

The actual purchase of stock or assets and/or any other contractual arrangements between the parties, such as licensing of intellectual property, may require prior foreign government approval or, at minimum, pre-closing, or immediate post-closing, notification. Under the Australian Foreign Takeovers Act, for example, foreign investors acquiring over 15 percent of an Australian company must notify the Australian Treasury Department for approval, and the Treasury can prohibit any such acquisition it deems not in Australia's national interest.

Do many countries have local (state or private) ownership requirements for businesses operating within their borders?

Yes, it is common for a government to restrict the percentage of ownership that a foreign investor may hold in a local business. For example, in nations belonging to the Andean Pact (a regional organization in Latin America), no more than 20 percent of the capital stock of a company engaged in domestic distribution may be acquired by foreigners. Mexico and Canada have similar restrictions in specific industry sectors.

Won't the restrictions of this nature be lifted under the North American Free Trade Agreement?

The North American Free Trade Agreement (NAFTA) has reduced restrictions but has not eliminated them. Canada has retained its investment screening provisions for investments of more than $150 million and will continue to restrict investments in cultural enterprises (broadcasting, cable, television, film, music, publishing, and recording). Mexico is allowed to screen acquisitions involving more than $25 million—a threshold that will rise to $150 million over 10 years, with exceptions in certain sectors (cultural enterprises, financial services, transportation, oil and gas, and uranium production). In these sectors, the Mexican government reserves the right to review smaller transactions.

U.S. and Foreign Laws Affecting U.S. Acquisitions of Foreign Companies/Assets

Are there many restrictions on the form in which one can do business outside the United States?

Generally speaking, one has the same options as those available in the United States, that is, through a branch or division located in a foreign country, a subsidiary corporation, or a partnership, although it may be necessary to form the corporation or partnership within the foreign country in accordance with local laws. The joint venture is another common form of business association. In fact, in some countries, such as most nonmarket economies, it is the only investment vehicle available to foreigners.[8]

What is the current stance of U.S. antitrust law with regard to U.S outbound acquisitions?

Unless the product manufactured or distributed by the foreign entity enters into the stream of commerce in, or causes a direct anticompetitive effect inside, the United States, U.S. antitrust laws will not apply to the acquisition or to the operations of the entity thereafter. This is true whether the manufacturing or distributing entity is a wholly owned foreign concern or a foreign subsidiary of a U.S. corporation. If, however, the product does enter the stream of commerce or cause an anticompetitive effect in the United States, then U.S. antitrust laws

will apply in the same manner as if the foreign entity were located in the United States, although enforcement is difficult. Even where U.S. courts might find that an act overseas is causing an anticompetitive effect within the United States, the jurisdiction of U.S. courts will usually not reach within the boundaries of another sovereign nation. The Department of Justice has issued guidelines that deal with these kinds of international antitrust concerns.

What do the Department of Justice guidelines concerning international antitrust say about U.S. acquisitions of foreign entities?

In June 1988, the Department of Justice issued Antitrust Enforcement Guidelines for International Operations to replace an earlier guide issued by the department 11 years before.

The guidelines generally follow the department's domestic Merger Guidelines issued in April 1984, which were revised in April 1992. The guidelines say that the department's Antitrust Division will seek to prohibit mergers that would create, enhance, or facilitate the exercise of market power. The guidelines also explain the analysis of the treatment of foreign competition, describing four examples of the competitive analysis that the department would use in mergers involving foreign competitors.

The first case describes an acquisition of a foreign competitor by a U.S. firm. The guidelines discuss the difficulty in measuring the market power of foreign competitors. Allocating all of a foreign firm's capacity to the U.S. market may be inappropriate if the firm would have difficulty establishing a reputation for quality or a service and/or distribution network, or if exchange rates are unfavorable. If market share data alone give a distorted view of the market, the Department of Justice will consider qualitative evidence regarding the competitive significance of foreign competitors (e.g., the existence of significant worldwide excess capacity).

The second case discusses how trade restraints such as voluntary export restraints (VERs), import quotas, and tariffs affect competitive analysis in a merger. Foreign competitors will not be excluded from the relevant market solely because their sales into the United States are subject to quotas or VERs; it is difficult to assess the effectiveness and longevity of such restraints and to measure the likely supply responses of competitors not subject to the restraints. However, the competitive significance of a foreign competitor will be discounted in the case of an "effective binding" percentage quota, because a reduction in domestic production would lead to a reduction in imports by foreign firms subject to the quota, making collusion among domestic firms more likely.

The guidelines define an *effective* trade restraint as one that cannot be substantially avoided through diversion and arbitrage. A trade restraint is *binding* if firms would sell more than the restraint ceiling if the restraint did not exist. A tariff will be given little significance unless its price level is so prohibitive that imports into the United States would be unprofitable. An example of a significant tariff would be the 25 percent tariff now levied against imported trucks, and the proposed extension of this tariff to minivans and sport-utility vehicles.

The third case involves the acquisition of a foreign potential competitor. The guidelines note that the merger of a potential competitor will have a significant anticompetitive effect only if (1) the competitor would enter the market independently in the near future; (2) the market is very highly concentrated; and (3) the foreign competitor is one of only a few firms capable of entering into the U.S. market. Even if the U.S. market is very highly concentrated, eliminating only one of several potential entrants would not have any significant anticompetitive effect. If there are few potential competitors, the Department of Justice says it will consider whether the foreign competitor actually intended to enter the market, past attempts by the competitor to enter the market, and whether independent entry would be profitable.

Finally, the fourth case involves the merger of two foreign firms. The guidelines note that in evaluating the merger of two foreign firms, the department would consider the legitimate interest of other nations in determining whether to challenge the transaction. The department will be more likely to challenge a transaction if the production facilities of the foreign firms are in the United States. If U.S. production facilities constitute a viable business standing alone, the merger might be permitted to go through conditioned on the divestiture of all or a portion of those assets. In addition, the department may seek the views of the foreign government concerning the impact of various remedies on its national interests.

What are some other examples of U.S. laws that can affect foreign acquisitions?

Of particular concern to an American owner are laws such as the Sarbanes-Oxley Act of 2002, the U.S. Foreign Corrupt Practices Act of 1977 (FCPA), the Anti-Boycott Regulations of the Export Administration Act administered by the U.S. Commerce Department, the Trading with the Enemy Act, and the International Investment and Trade in Services Survey Act of 1976 (IITSSA).

The Sarbanes-Oxley Act of 2002, which applies to foreign as well as domestic issuers (as of July 15, 2006) has 80 sections, mostly focused on independent auditing. They are considered so daunting that some foreign firms have decided not to maintain their U.S. listings. The law has probably also

caused some potential acquirers of U.S. companies to reconsider. Of particular concern is Section 404, which requires companies to assess the strength of their internal controls and requires auditors to do the same, following a detailed standard. Section 404 is considered to be a revival of aspects of the FCPA—but with a greater cost of implementation.

The FCPA requires all U.S. companies to "devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances" that its bookkeeping will adhere to GAAP. It also makes it unlawful for any company "to make use of the mails or any means or instrumentality of interstate commerce corruptly in furtherance of [a payment] . . . while knowing or having reason to know" that the payment will be used to influence a foreign official to assist the company in obtaining or retaining business. The U.S. parent will be responsible for a failure of a foreign subsidiary to comply with these requirements.

The Anti-Boycott provisions empower the president to issue regulations to prevent U.S. companies engaged in interstate or foreign commerce and their subsidiaries from taking any action intending to comply with a boycott by a foreign country against another country with which the U.S. maintains friendly relations, as long as the company engages in activities in interstate or foreign commerce.

The Trading with the Enemy Act prohibits unlicensed trade between U.S. persons and any individual, partnership, or other body of individuals that is (1) resident within the territory of any nation with which the U.S. is at war or (2) engaged in business within such territory. Unlicensed trade with corporations incorporated under the laws of an enemy nation is also prohibited, as is unlicensed trade with any party determined to be an ally of a nation with which the United States is at war.

The IITSSA requires U.S. companies investing overseas to file certain reports with the Department of Commerce. The filing of reports is mandatory if a U.S. person, including a U.S. corporation, has more than a 10 percent ownership interest in a foreign business enterprise and such enterprise has significant assets, sales, or after-tax income. Moreover, there is a proposal that, if adopted, would require a U.S. company that sells service to or purchases services from an unaffiliated foreign person, including legal and accounting services, to file reports.

What regulations beyond national securities commissions govern international equity investment?

The central organization for equity involvement regulation is the International Organization of Securities Commissions (IOSCO). Headquartered

in Montreal, Canada, it is composed of 80 regulatory agencies from around the world. Although stock market rules vary considerably from country to country, the very existence of IOSCO points to a core of values. Moreover, the group and its individual members could gain more importance as the definition of what constitutes a "security" is brought into focus. And securities commissions are working together more often through IOSCO.

What about the merger regulations of the EU?

Each member has its own comprehensive merger laws, but these are superseded by any directives intended for the EU. For example, the EU's European Commission (which we will refer to here as the "EU commission") issued a proposed regulation on merger control in 1973 and subsequently amended it in 1982 and 1984; this was approved by member states in 1989. On May 1, 2004, the European Commission, the chief regulatory body for the EU, put a new regulation into effect.[9]

Has the EU been tough on mergers?

Yes. The EU's antitrust staff has been rigorous in enforcing the new merger laws, and the European Court of Justice has been tough in its rulings, despite concerns expressed by the American Bar Association and others.

Globally, how common are laws against insider trading based on nonpublic information?

Most jurisdictions outlaw the practice, at least in principle. More than 85 percent of the world's securities and commodities market regulators have rules against insider trading. This is in part because they are members of IOSCO and have signed on to the core principles listed in IOSCO's "Objectives and Principles of Securities Regulation," published in 1998 and updated in 2003. It states that one of the primary objectives of good securities market regulation is investor protection. The principles say: "Investors should be protected from misleading, manipulative or fraudulent practices, including insider trading, front running ahead of customers and the misuse of client assets." Note also that the World Bank and the International Monetary Fund use the IOSCO core principles in assessing the financial risk of countries.

FOREIGN EXCHANGE

What are foreign exchange control laws, and how can they affect post-acquisition operations?

Foreign exchange control laws restrict the amount of a country's local currency that can be converted into foreign currencies. These laws can operate either to completely restrict or to partially limit the ability of a foreign investor to remove any funds from the target's country to the foreign investor's home country (*repatriation*) or, if it may withdraw funds, to take its profits in its own currency.

Do foreign exchange control laws include restrictions on repayments of loans to nonlocal parent companies?

Yes, in some cases. For example, Japan's foreign exchange control law imposes such restrictions for loans above a certain amount. Above this threshold, the loan transaction will require prior Japanese government approval.

In Taiwan, if a subsidiary needs to obtain foreign currency to repay a loan from its foreign parent, the loan agreement itself must be submitted for approval to the Central Bank of China, and only then may the foreign currency be bought.

French regulations require approval from the French exchange control authorities prior to each advance by a foreign company to its French subsidiary or, conversely, for any setoff or voluntary prepayment of such loan by the French subsidiary.

What is the role of groups such as the European Community's Exchange Rate Mechanism (ERM)?

The ERM functions somewhat like the Organization of Petroleum Exporting Countries (OPEC). It is a group of integrated parties (in the case of ERM, European national governments and central banks) that agree to buy and sell a commodity within a certain price range. The ERM is structured more loosely, however, and allows for market forces including speculators, to play a role in price setting. (Prior to that, the margin was 2.25 percent.)

Are there any risks involved in doing business in a foreign country because of currency differences between the U.S. parent and a foreign subsidiary or affiliate?

Yes, fluctuating exchange rates pose two types of risk to the investor. First, there is the purely economic risk (1) that a deteriorating exchange rate will require U.S. parent companies to pay more for foreign currency–denominated obligations than was originally anticipated when the obligation was approved or (2) that a relative increase in the value of a foreign currency will cause U.S. creditors to be repaid a lesser amount in satisfaction of U.S. currency–denominated obligations to them. Second, there is an accounting risk that the balance sheet, which must express the value of assets and liabilities denominated in a U.S. currency at the exchange rate in place on the balance sheet date, will lose value in the translation from the local currency to U.S. dollars.

How can U.S. owners mitigate the risk inherent in fluctuating exchange rates?

To a large extent, the accounting risk was reduced in 1981 by Statement No. 52 issued by the FASB. This statement, which is still current as of late 2006, altered the rule that foreign currency translation gains and losses had to be immediately reported as income. Under Statement No. 52, such gains or losses resulting from the translation of foreign-denominated income statements are now reflected only as an adjustment to stockholders' equity. This change allows a company's lenders or investors to analyze its income statements much more consistently, without worrying as much about the impact of a volatile currency exchange.

To alleviate the risk of economic losses due to exchange rate volatility, two forms of hedging contracts have developed: the forward purchase contract and the forward sales contract—in essence a *put* and a *call.* Both are derivative instruments that can be risky. Forward purchase contracts are used to protect a U.S. debtor who is obligated to repay a certain amount in a foreign currency at a future date. When the value of the foreign currency rises relative to the U.S. dollar, the debtor will have to spend more dollars to obtain the necessary amount of foreign currency to repay its debt. The forward purchase contract locks up the price at which the debtor may acquire the needed amount of currency at the necessary time for a fixed price determined at the time the forward purchase contract is entered into. It is, in effect, a *call* on foreign currency.

Similarly, a U.S. creditor who is afraid that rising exchange rates may cause it to lose the value of its foreign-denominated receivables may hedge against

such loss through a forward sales contract. In this case, the creditor contracts to sell the foreign currency to be received at a future date for U.S. dollars at a fixed rate determined at the time the forward contract is entered into. This is a *put* equivalent. Both kinds of swap are discussed in more detail later in this chapter.

In addition to currency swaps, owners can use currency options. Options to purchase various currencies at a fixed price are available on many foreign and domestic securities exchanges. Currency options are listed on the exchanges at a particular fixed price (the *strike price*) in accordance with the length of the option period, which is generally 30, 60, or 90 days. The hedging party pays a premium for the ability to purchase the optioned currency at the relevant strike price at any time up to the termination date of the option. If the actual price for one unit of foreign currency exceeds the strike price, the hedging party can exercise its option and receive the currency at a cheaper price per unit. If the actual price never exceeds the strike price for the currency during the option period, the hedging party loses its premium paid for the option but is not required to take delivery of (or pay for) the actual currency.

This feature is the distinguishing factor between forward contracts and options, because forward contracts obligate one to take physical delivery of the currency at an agreed-upon date in the future. The degree of certainty of a hedger's need for a specific amount of foreign currency, plus the difference in the fixed price per unit of foreign currency between forward contracts and options at any given time, will dictate which form of hedging technique will be used.

In addition to currency hedging through swaps or options, U.S. companies can consider shifting production and/or fulfillment to countries where currencies are weakening. The foregoing arrangements add to the cost of the overseas investment, and both legal and accounting experts should be consulted with respect to the tax and financial reporting consequences of such hedging methods.

Repatriation

After a foreign acquisition, can the investor repatriate profits or investment capital from its business interests located in a foreign country without limitations or restrictions?

As a general proposition, most developing and newly industrialized countries have some form of repatriation restrictions, and some other nations that impose exchange controls also regulate repatriation.

Repatriation restrictions or requirements are usually imposed for the same purposes as exchange controls, that is, to acquire or retain foreign

currency in a country, to monitor foreign investment, and to police potential tax evasion. Many countries regulating repatriations also provide tax incentives for investors to reinvest profits.

Repatriation restrictions are generally accompanied by some form of additional restriction or reporting requirements, such as (1) registration of foreign capital with corresponding restrictions on withdrawal of such capital from the host country and (2) notification of amounts of foreign capital invested in the host country.

Other Regulatory Concerns

What are some other regulatory concerns involved in a foreign acquisition?

Most other regulations concerning overseas investments can be classified into the following categories: performance requirements, local content regulations, labor requirements, and technology transfer restrictions.

Performance requirements include setting minimum export levels on the one hand and maximum import levels (such as quotas) on the other. Export-level requirements are designed to promote the flow of foreign currency into a country by permitting a foreign person to invest in a particular local enterprise provided that a minimum percentage of its finished product will be exported rather than distributed locally. Countries may also impose import restrictions, usually expressed as a maximum percentage of the cost of goods produced locally that can be imported, to encourage use of local products and industries.

Local content regulations specify minimum levels of domestic raw materials or component parts to be used in manufacturing, limitations on the type of products that can be manufactured, and restrictions on product distribution within the country and in the world market. Such limitations are often tied to economic incentives such as government subsidies or tax breaks and, if not imposed by statute, can be negotiated with the host country. Various countries relate local content requirements to specific industries to ensure that local companies do not suffer from the foreign presence.

Countries concerned with unemployment will usually require foreign companies to employ a certain percentage of local labor in both unskilled and managerial jobs. Failure by the investor to accede to such demands can cause the host country government to withhold required approval of the acquisition itself.

Restrictions on technology transfers usually take the form of limitations on royalty or profit remittances, technical assistance, and payments for transfers of technology, especially between related entities. These regulations are

encountered most frequently in the developing and newly industrialized nations, although they also exist in any country that desires to promote a particular high-technology domestic industry. Technical assistance and royalty payments are frequently subjected to restrictions because they could potentially be used to circumvent dividend remittance regulations, especially to foreign parent companies.

Employee Rights

What issues concerning employees should the acquirer be on the lookout for?

First of all, the acquirer should ascertain whether the employees have any rights to approve the proposed acquisition. For example, most workers in Europe have the right to information and consultation when management contemplates major changes or plans. This right emanates from national industry sector collective bargaining agreements that set minimum standards and specific company agreements with employee representatives or trade unions.

Second, the acquirer should familiarize itself with rights of employees with respect to the governance of the enterprise. For example, Europeans have had decades of experience with various forms of so-called co-determination, imposed by law or won through collective bargaining. Worker participation in management may include the right to information, to obligatory consultations, or even to a veto in decision making. The most well-known example of co-determination is found in Germany, where, by law, each company must have two boards, one concerned with operations and the other with more strategic issues. Both boards have employee representatives. In the Netherlands, any company of medium size or larger must consult with its Works Council before implementing any decision affecting investments, dismissals, and pensions. The Works Council also has the power to challenge corporate decisions in court if its advice is not followed.

Third, the acquirer should understand the nature of employee benefits afforded in a particular country and take the cost of such benefits into account in evaluating the merits of a potential acquisition. For example, the majority of European workers have, under certain conditions, the right to not be unfairly dismissed. In most European countries, an employee is entitled to redundancy compensation—that is, continued payment even though there may no longer be work for him or her. Moreover, unemployment compensation rights in the European Union (EU) generally are more substantial than in the United States. Aside from these legislated rights, an employee can also avail him- or herself

of the usual breach-of-contract remedies, which may include damages and specific performance—forcing the employer to honor the written contract that is required between the two parties outlining employment terms covering pay scales, work hours, pensions, holidays, and so on. Finally, in several European countries unfair or "abusive" dismissal is actionable, giving affected employees a claim for damages against the companies that dismissed them.

FINANCING

Once a suitable acquisition of a foreign concern has been identified, how can an acquirer obtain financing for it?

For the most part, the methods of financing an international acquisition will not be very different from those used in a purely domestic deal. Various types of debt, ranging from standard commercial bank debt to subordinated debt (junior/senior/mezzanine) to debt secured by a variety of assets, can be used in the international context. This debt financing can be obtained from both public and private sources. Equity financing through the sale and issuance of new securities is also possible in the global deal. Whatever sources of financing an acquirer uses will have a global dimension.

In considering an international transaction, the potential acquirer may find it necessary to call on a variety of different currencies and to operate within several international jurisdictions. The acquirer must learn how such financial transactions can be affected by regulations imposed by its own government, as well as the governments of the target country, the countries in which investors and lenders reside, and the countries in which banks and securities exchanges may be located. Areas of concern will include tax consequences, the ability of investors to repatriate profits, perfecting lenders' security interests, and the like. Similarly, the rules of certain supranational or regional institutions, such as the United Nations, the EU, or the Organization of American States, or agreements such as GATT and NAFTA, may apply.

What special public sources of financing are available to the transnational acquirer?

Many countries have loan programs for businesses that wish to expand into overseas markets. Although most of these programs focus on export, they are not limited to this realm. In the United States, the Overseas Private Investment Corp.

(OPIC) provides hundreds of millions of dollars in yearly loans and loan guarantees to companies—including small companies—that do business abroad. In some cases, the borrowers have used their funds to invest in foreign concerns.

Suppose a seller demands to be paid in a currency that is different from the operating currency of the entity making the payments. How can the acquirer accomplish this?

The incompatibility of differing currencies has always ranked high among the classic dilemmas buyers and sellers face when structuring an international transaction.

At the end of World War II, many American corporations decided to apply some of their newfound wealth to direct investment in foreign companies, particularly in Europe. To finance these investments, the acquiring corporations found it necessary to come up with large amounts of the functional currency used by the target. To do this, the U.S. entity had to either borrow from unfamiliar banking institutions in the target's home country, which did not always have sufficient funds to meet the purchase price, or go through the cumbersome process of obtaining the necessary funds in U.S. dollars and converting them into the needed currency, incurring the added expense of an intermediary broker. Since the downfall of the Bretton Woods system in 1971, when the U.S. dollar was taken off the gold standard, potential acquirers have inherited the further difficulty of predicting the rise and fall of fluctuating exchange rates of individual currencies.

It is within this framework that the concept of large offshore international banking markets has developed as an alternative to currency conversion. An example of such a system is the Eurodollar market, that is, the deposit or redeposit of U.S. dollars into a large pool on foreign territory without the conversion of the funds into the local currency. The transaction is recorded by book entry, and there is no physical importation of the dollars into the foreign country. The pooling entity into which dollars are deposited may be either a foreign branch of a U.S. banking institution or an independent foreign bank, both of which have become known as *Eurobanks.* The Eurobanks can make short-, medium-, or long-term loans for acquisitions or working capital and participate in a wide variety of interbank lending activities. Eurobank deposits also exist for offshore deposits of Japanese yen, British pound, and a multitude of other currencies in demand.

Because offshore banking in different currencies has not been heavily regulated by any jurisdiction (e.g., Eurobanks are not subject to the same

reserve requirements as domestic banks), offshore banks are able to have a much higher percentage of bank funds committed to corporate and other loans.

The Eurodollar market has been successful in fostering investment in Europe, but how can the potential acquirer of targets in other parts of the world use offshore markets to finance its acquisitions?

First of all, the Eurocurrency market is not the only site of offshore currency deposits. Another big example of U.S. dollar deposits used for foreign corporate investments is the Asian international currency market, principally located in Singapore and Hong Kong. In Singapore, the government and banking authorities have invented special units of money called Asian Currency Units (ACUs). Banks authorized by the government of Singapore to handle ACUs accept deposits in all foreign currencies to accommodate corporate financing throughout the Pacific Rim.

How are interest rates on funds borrowed in the offshore market calculated?

Generally, interest in the Eurocurrency market is tied to the London Interbank Offered Rate (LIBOR), and ACUs are tied to the Singapore Interbank Offered Rate (SIBOR). The interbank offered rate is the interest rate charged by an offshore depository of a particular currency for funds lent in that currency to another offshore banking facility. This rate is used in international finance in the same way the prime rate is used in the United States, that is, as a reference rate from which the individual interest rate of a particular loan is created. LIBOR, SIBOR, and other interbank rates are listed in many of the world's financial newspapers.

What happens when one bank, whether an onshore or an offshore facility, does not have adequate funds to meet an acquirer's lending needs?

This is the function of the international syndicated loan market, which is particularly useful for onshore banks that must maintain a high ratio of capital reserves to borrowed funds, or for banks that do not want to bear the entire risk of a large international loan by themselves.

How do international syndicated loans work?

The principles behind international syndication are generally the same as in a purely domestic syndicated loan, with the added considerations of differing currencies, interest and exchange rates, tax and other government regulatory schemes, supranational currency controls, and the like.

In an international syndication, a group of lenders will pool its funds via a network of selling participations and other agreements until the required borrowing amount is obtained. There is only one loan agreement between the borrower and the syndication, which is negotiated among the parties to fit the particular needs of the transaction. Funds can flow from either onshore or offshore currency markets.

Typically, the funds borrowed under an international syndicated loan agreement will be subject to five charges to the borrower: (1) interest (which can be tied to an international reference rate such as LIBOR or SIBOR, plus a spread); (2) a management fee, which is paid to the lead bank for arranging and managing the syndication; (3) a commitment fee; (4) an agent's fee, which is usually paid to the lead bank for negotiating the loan and acting as agent on behalf of the other members of the syndicate; and (5) any expenses associated with putting together the loan, which can include legal and accounting fees, travel costs, and the like.

There are generally two forms of international syndication. In one, the lenders who are party to the loan agreement commit to lend a stated amount directly to the borrower. The lenders are severally, but not jointly, liable on their lending obligations. Every member of the syndication receives a pro rata portion of the overall receipts from the loan based on its individual commitment of funds.

In the other form of syndication, the lead bank is the only bank bound by a loan agreement to the borrower, and it is solely responsible for the commitment to fund the loan. The lead bank then signs participation or subscription agreements with other lenders who want to participate in the loan as it was negotiated by the lead bank (although, in some cases, it may be necessary for the lead bank to come back to the borrower and ask for amendments that will facilitate the lead bank's finding willing participants). Again, the lead bank will pay the participants their pro rata share of the loan receipts after deducting whatever management, agent, or subscription fees it may have negotiated.

A very typical situation is one in which a U.S. company wants to finance the acquisition of another U.S. company that has significant overseas operations. In this case, the lead bank will usually be the primary domestic lender, which may use syndication as a means of bringing in foreign lenders

familiar with the business and economic climates of the countries where the target's overseas operations are concentrated. Such syndication will reduce the risk of a U.S. lender that otherwise may be reluctant to lend overseas, but lenders will need to work out a variety of intercreditor issues, including the priority of assets securing the acquisition funding.

Are banks the only institutions that can participate in an international loan syndication?

No. Recently, international syndications have included large-scale investors willing to take the risk of lending for corporate acquisitions or refinancings. Such entities could include insurance companies, pension funds, government-sponsored investment pools, mutual funds, or large corporations. Whether a particular entity can participate in a syndicated loan may be governed by national regulations in force in the country where the potential participant is domiciled.

What types of requirements will the syndicating lenders generally request from the borrower?

The covenants and representations required by the lenders in an international syndication today are generally not much different from a domestic U.S. syndicator's requirements, although historically, international loans have tended to be unsecured. Today, more and more foreign lenders are looking to corporate fixed assets, inventories, and accounts receivable as security for international syndicated loans. Most syndication agreements include, at minimum, a negative pledge clause (whereby the borrower promises not to encumber any future assets) and a pari passu clause, stating that the priority of the lending banks' rights will be pari passu, or equivalent, compared to any other creditor of the same class. The loan agreement may also contain financial covenants and other restrictions on the borrower that are typically found in domestic loans.

Are traditional loans the only kind of financing that can be syndicated?

No; lenders may also wish to use syndication to spread the risk of large letters of credit or guarantees backed by offshore currency deposits or international commercial paper programs.

Can an acquirer's international merger and acquisition activities be funded by issuing private or public debt securities?

Yes. Private or public placements of debt can be effectively utilized by issuers who feel they can attract investors at lower rates than the interbank offered rates or who desire long-term, fixed-interest debt.

The offshore currency markets have funded individual corporate debt issues in a multitude of currencies, facilitating investment in corporations located all over the world. The most overwhelming example of this has been the Eurobond market, which has been expanding at an astounding rate. The volume of new Eurobond issues has risen dramatically in the past 15 years.

Eurobonds can be denominated in any currency, but are issued offshore and are usually structured to be sold outside the jurisdiction of the nation whose currency is used or where the issuer resides. For example, in the United States the present policy seems to be that unregistered debt securities may be issued overseas by U.S. issuers, but must not be sold or offered for sale to any U.S. person or anywhere within the United States until a 90-day "rest abroad" period passes. The SEC imposes certain requirements on U.S. issuers designed to ensure that no such sales are made during the rest abroad period, including the placement of a restrictive legend on the bond itself.

Offshore bonds are generally issued in bearer form, and many can have provisions that exclude the interest paid thereon from withholding taxes imposed by countries where the bonds are distributed. They may be privately or publicly traded and often appear on the stock exchanges of the major financial centers from London to Tokyo. Again, the use of international syndicates of underwriters and lending institutions will be instrumental in issuing offshore corporate bonds.

What other types of debt financing are available?

The list is long, thanks to two factors: borrowers' and lenders' needs for greater liquidity. These twin needs have led to the development of a whole spectrum of international negotiable instruments, the utility of which depends on the needs and repayment abilities of borrowers.

Negotiable medium-term or long-term fixed-rate notes (FRNs) are bearer notes evidencing the obligation of the maker of the notes to pay a stated principal amount upon maturity of the note, with periodic payments of

interest at a fixed rate. This type of note may be more convenient than conventional bank notes, which usually require the principal to be amortized over the life of the note rather than deferring payment until maturity. Sale of the FRNs is accomplished through subscription agreements, which provide for investors to buy a note or notes worth a certain stated amount on fulfillment of various conditions or the making of certain representations and warranties by the issuer. Terms and conditions appear on the reverse of the notes.

Another innovation in the Eurocurrency market is the Euronote, a short-term bearer note evidencing the obligation of the maker to pay the stated principal amount at maturity (generally three to six months). Because of the short term of the notes, Euronote makers can take advantage of lower interest rates in the Eurocurrency markets. The terms and conditions of short-term notes will generally be much less rigorous than those found on FRNs or in bond underwriting agreements.

Suppose an acquirer encounters a group of multinational investors, all of whom want to lend, and be repaid, in their own currencies rather than in offshore funds?

One fairly recent innovation in promissory notes is the medium-term note (MTN), in which the maker offers a program of notes through one or more agents that place the notes for a commission on a best-effort basis. Initial holders can negotiate the terms of their individual notes to suit such holder's specific repayment requirements with respect to currencies, payment structures, or rates of interest. Therefore, using an MTN program, a maker may have a series of notes outstanding, each one with a different currency, interest rate calculation, or term. This kind of note program allows an issuer to attract a larger pool of investors by catering to their specific needs at a cost that is often less than a comparable underwriter's fee would be for an underwritten offering.

How can an acquirer obtain the different currencies it needs to meet its obligations to its investors?

It could simply convert the currency generated by the target through a foreign exchange broker for a fee or through the use of a swap.

Swaps, a forward contract type of derivative instrument, may be used to exchange currencies or to exchange interest rates, or they may combine the two. A currency swap agreement is a contract calling for the parties to supply

each other with a stated amount of currency at specific intervals. For example, one party might agree to pay the other in Eurodollars in exchange for an equivalent amount of yen.

In such a case, an interest rate swap agreement is negotiated in which the borrower corporation and another party with access to various currencies, perhaps through its own subsidiaries, agree to pay each other a sum equal to the interest that would have accrued on a specific amount over a specific period of time at the desired rate. The exchanging party may be a bank or a large corporation with access to various currencies, perhaps through its own subsidiaries. This corporation may have a Eurobond issue outstanding on which it is obligated to pay a fixed rate of interest. In this case, an interest rate swap agreement may be in order, whereby the corporation and another party agree to pay to each other a sum equal to the interest that would have accrued on a specific amount over a specific period of time at a negotiated rate.

Swap agreements should generally be for shorter terms to protect against significant fluctuations in interest rates or currency exchange rates, which can throw off the economics of a swap transaction, with periodic rollover provisions allowing for the continuation of the agreement on the same or renegotiated terms of exchange. From a legal point of view, swap agreements are nothing more than international contracts that will be governed under the contract law of whichever country the parties choose to govern interpretation of contract terms. Swaps are complicated and, some might argue, risky, but as international currency markets have grown, swaps have become more and more important in structuring transnational deals.

Another financing technique is the conversion of debt for equity, or a debt/equity swap. How does it work, and when is its use appropriate?

Debt-for-equity conversions evolved as one solution to the paucity of hard currency foreign exchange available to a debtor country for external debt payments. The conversion allows the debtor country to discharge foreign hard currency–denominated debt through payments in soft local currency. Some countries that have such formal debt-for-equity conversion programs are Argentina, Brazil, Chile, Costa Rica, Ecuador, Mexico, and the Philippines. There are commercial firms that specialize in arranging such swap programs, which tend to get rather complicated. Further, more and more negotiated and even some limited auction markets are opening up for the purchase and sale of debt instruments payable in many different currencies but taking advantage of the growth and sophistication of the currency swap markets.

The basic steps in a debt/equity swap are as follows: (1) The foreign commercial bank creditor will decide either to invest in a local business located in the debtor country or to sell its loan asset to a third-party investor at a discount. (2) The bank or the investor then redeems the credit for its designated value in the debtor's local currency. (3) The bank or the investor subsequently invests the proceeds in a local enterprise.

The investor generally has one of two reasons for engaging in a swap transaction: the desire to make a new investment in the debtor country or the desire to recapitalize an existing subsidiary or affiliate in the debtor country. In both cases, the highly favorable discount rate will substantially reduce the cost of equity to the investor. On the converse side, the debtor country wishes to reduce its external debt and to encourage or maintain investment interest in its economy. Moreover, the debtor country can create value for itself if it can retire its debt at a price below its face value.

Resources derived from such transactions are intended to enhance the debtor country's economy. As a result, certain types of investments, such as those that increase exports of the debtor country, bring new technology into the country, or finance industry expansion or new product development, are given preferential consideration.

Security Interests in Foreign Assets

Can acquirers obtain security interests on the assets of foreign companies to finance acquisitions?

Yes. Today, most foreign countries have the same or analogous concepts to those of the United States regarding security interests in assets to serve as collateral for borrowing.

There are many differences, however, in the types of assets that can be secured, the methods of accomplishing such a transaction, the type of notice required, if any, and to whom notice must be given. Thus, it is imperative that local counsel be enlisted to complete these transactions.

What happens if a country does not permit a floating security interest on after-acquired property?

As previously discussed, in contrast to the customary U.S. practice of obtaining floating liens on assets not as yet acquired, many countries do not permit

this type of security interest. To include new assets as collateral, the parties must enter into additional security agreements and comply with all formalities imposed by the governing law of the country every time a newly acquired asset is to be included in the lender's security.

International LBOs

Can the concept of an LBO be applied in the international context?

Yes. The LBO has become an accepted acquisition structure in several European nations, particularly in the United Kingdom, France, and Germany. It is a useful tool for large family-owned enterprises established after World War II by owners now reaching retirement age and for large state-owned conglomerates now in the process of privatizing. In the latter case, new owners are selling off unrelated businesses, a practice not permitted under state ownership.

What would the structure of a leveraged buyout look like, for example, in a management LBO in France?

The structure employed in France would not be vastly different from the structure one would use in the United States, with certain exceptions resulting from the corporate and business laws of France. The financing will usually entail a tripartite structure comprising (1) senior debt from a traditional lending institution, which may or may not be collateralized; (2) middle-tier financing, including subordinated or convertible debt at a higher fixed rate of interest; and (3) straight equity investment by the managers and other investors. Applicable laws in France and other EU countries are, for the most part, sufficiently nonrestrictive to allow creativity in structuring an LBO.

Other than the perfection of security interests, which has already been discussed, are there any other problems a senior lender seeking security might face?

If shares of the foreign parent company's stock are pledged to a French lender, the lender may not be able to foreclose on such shares in the event of a default without the prior approval of the French government. In practice, this risk has not been an impediment to accepting such pledges of foreign stock.

Can the target company in France guarantee the debt of the foreign parent for acquisition funding?

This sort of upstream guarantee is a problem, because the 1981 French company law prohibits a French corporation from advancing moneys, making loans, or facilitating security interests with the intent of aiding a third party to purchase a French corporation's own stock. There is an exemption, however, for loans to employees of the French company. This problem goes away if the LBO is structured as an asset deal, but there are significant tax consequences in the event of an asset transaction, so the potential investor should be very careful in his or her analysis of which structure to use. In the case of an international LBO, as with all international transactions, consulting with local counsel in the country where the target is located is very important.

INTERNATIONAL TAX AND DISCLOSURE CONSIDERATIONS

This section covers basic tax and disclosure issues that affect the various kinds of acquisition and disposition activities carried on in the United States by foreign nationals and companies (inbound acquisitions), and foreign acquisition and disposition activities carried on by U.S. nationals and companies (outbound acquisitions). Although we will speak generally about the tax laws of many countries, the principal focus of discussion here will be the tax laws of the United States as they apply to transnational relationships. This section is divided into three parts:

1. A discussion of the general tax and disclosure rules that apply to inbound and outbound acquisitions
2. A general discussion of the U.S. tax rules that ought to be considered by a foreign person planning to acquire a U.S. business
3. A general discussion of the U.S. tax rules that ought to be considered by an acquirer planning to acquire a foreign business from a U.S. seller

This section will not discuss U.S. tax consequences to foreign investors of owning U.S. portfolio investments or U.S. properties unless such holdings are directly related to acquisition of operating businesses. It is assumed that the reader is generally familiar with the basic U.S. federal income tax principles that apply to acquisitions in the domestic context. (See Chapter 5.)

Note: The purpose of this segment is not to advise readers of specific, current tax rules; readers are urged to consult specialized tax guides such as those published by Matthew Bender or other legal publishers. Rather, our goal is to give a broad overview of the tax issues buyers and sellers should consider when structuring an international transaction.

What are the fundamental tax considerations for an acquirer that apply specifically to international acquisitions?

Generally, whether the transaction involves an inbound or an outbound acquisition, the basic rules governing the tax treatment of the parties involved extend above and beyond those that would apply in the domestic context. In other words, it is rare that an international transaction is excepted from domestic rules. As a result of these rules, the tax planning in the international context will inevitably become more complex.

The most important thing that a buyer or a seller of a business with international components must bear in mind is that at every stage of planning, consideration must be given to the tax rules of each of the countries involved, as well as to the manner in which their tax systems overlap and interact. It is not uncommon to have three or four different tax systems governing parts or all of a single transaction, and this may present both opportunities and traps. Because of the disparities in the tax laws, and because of the existence in many cases of income tax treaties between the countries, it may be possible to structure a transaction so that it results in less overall tax cost than would be the case if the transaction were undertaken in a single country. On the other hand, because there is often overlapping taxing jurisdiction, it is possible, in the absence of careful planning, that the overall tax cost may be greater than if only a single country were involved.

In focusing on the U.S. tax aspects of a transaction, several principles must be borne in mind. First, the United States imposes different tax rules on individuals and corporations depending on whether they are classified as "U.S. persons" or "foreign persons" for U.S. tax purposes. For this reason, a determination should be made early in the planning process regarding the classification of each of the parties and entities involved in a transaction.

Second, generally speaking, the United States imposes an overall income tax on the worldwide income of individuals who are citizens or residents of the United States and on corporations that are formed in the United States. In contrast, nonresident alien individuals and foreign corporations are not subject to U.S. taxation except on income that is sourced in the United

States. Therefore, once it is determined whether a party is a U.S. person or a foreign person, each item of income must be analyzed to determine whether it has its source in the United States or outside the United States, that is, whether it is domestic source income or foreign source income.

Third, foreign persons generally are subject to a gross percentage withholding tax on certain kinds of domestic source passive income.[10] The chief exception to this is the tax on income that is effectively connected with a U.S. trade or business or permanent establishment in the case of foreign persons who are engaged in a U.S. trade or business (or maintain a U.S. permanent establishment). In such a case, the foreign person will pay a net income tax on this trade or business income in much the same way that a U.S. person would on its overall income. Additionally, for U.S. nontrade or business income, the taxation will depend on the precise class or category of such income (e.g., dividends, interests, or royalties). Therefore, determinations will have to be made regarding the characterization of any U.S. source income on a fairly specific basis.

As we will see, there are numerous other significant issues of U.S. international taxation that will have to be understood and taken into account in undertaking any inbound or outbound acquisition.

What are some of the primary reporting obligations of U.S. companies investing abroad and of foreign companies investing in the United States?

Detailed disclosures are required of U.S. investors in foreign companies and of foreign investors in U.S. companies.

> *IRS: Disclosure of ownership.* U.S. investors owning 5 percent or more of a foreign company stock must file a Form 5471. Conversely, every domestic or foreign company that is "engaged in a trade or business in the U.S." and "controlled" by a "foreign person" must file an information return to the IRS on Form 5472. "Control" for the purposes of this reporting requirement is deemed to occur in a tax year if at any time in the year a foreign person owns at least 25 percent of the value or voting power of a corporation's stock.[11]
>
> *IRS: Transfer pricing.* In particular, a new rule requires that both outbound and inbound owners provide more information about pricing. Companies must demonstrate that they used the "best method" of pricing to ensure that the prices they charge their foreign subsidiaries are not artificially low or high. The rules were intended

primarily to obtain more tax revenues from foreign multinationals with subsidiaries in the United States, but they also apply to U.S. firms that might shift profits to subsidiaries in low-tax countries.[12]

IRS: General record keeping. Also, IRC Section 6038C requires foreign corporations doing business in the United States to maintain certain records (e.g., allocations of U.S. versus foreign income). Expenses related to income are allocable and deductible against the pertinent income to determine the foreign corporation's net U.S. taxable income.[13]

SEC: Foreign forms. Foreign corporations registering securities in the United States may have to fill out one or more of a series of forms called *foreign forms,* including Form F-4 pertaining to mergers. In general, these forms require U.S. standards of disclosure, with some leeway for other systems.

Income Tax Treaties

What is the role of income tax treaties in the acquisition process?

Income tax treaties play a major role in structuring international transactions, generally by minimizing the overall tax costs that may be imposed. The United States has treaties with 35 countries at this time.[14] When a tax treaty is applicable to a particular transaction, it is often useful to review the transaction in light of the treaty before focusing on the laws of the particular countries. In many cases, the treaty becomes the "tax law of the transaction." Treaty-related tax planning consists of analyzing the alternative structures for the chain of entities, selecting the tax jurisdictions, and defining the sources and classes of income. At each stage, tax treaties may be utilized to avoid double taxation or, in certain circumstances, triple taxation.

Most tax treaties provide for the reduction or elimination of withholding taxes on portfolio income, such as interest, dividends, and royalties, by the country from which such income is derived (the so-called country of source) and prohibit the country of source from taxing business income of an enterprise resident in the other country, unless the enterprise has a "permanent establishment" in the source country. For example, if a foreign entity is likely to be engaged in business activities in the United States, consideration should be given to placing those activities in an entity that is a resident of a country that has a tax treaty with the United States in order to avoid the U.S.

taxation of the activity. Furthermore, because most tax treaties provide that capital gains derived by a resident of one country from sources in another contracting country will be exempt from tax by such other country, such a strategy makes even more sense.

What are income tax treaties?

Income tax treaties, or income tax conventions, are international agreements entered into between two or more sovereign nations (and sometimes extended to dependent territories) for the purpose of reducing double taxation on income generated by residents of one of these countries from sources located in the other contracting country. In the United States, an income tax treaty is signed by the executive branch (usually by the secretary of state) and becomes effective, unless modified, after the U.S. Senate ratifies the treaty.

Under the U.S. Constitution, treaties are the supreme law of the land and rank equally with any federal statute. If the terms of a treaty conflict with a federal statute, whichever was most recently adopted will generally control. Case law holds, however, that Congress must clearly specify an intent to override a tax treaty for a later-enacted statute to prevail over the treaty.

In addition to their role in reducing double taxation, income tax treaties provide, through the "competent authority" mechanism, a means to resolve disputes between two tax jurisdictions that claim the right to tax income that arises in one or both of these countries. Treaties may assist in the prevention of fiscal evasion, for instance, by allowing tax information exchanges between the tax authorities of the contracting countries. Sometimes, income tax treaties are used to advance foreign or economic policies of one or both of the countries, for instance, when one of the countries is committed to allow tax breaks for capital investments in preferred industries in the other country.

Can a taxpaying entity avail itself of a particular tax treaty by incorporating a subsidiary in the treaty country?

Tax treaties ordinarily apply to, and can be invoked by, persons who are residents of the respective treaty countries. Although the definition of a *person* may vary from treaty to treaty, it usually includes individuals, corporations, partnerships, estates, and trusts.

A corporation incorporated in a treaty jurisdiction will in most circumstances be considered a resident of such jurisdiction. Generally speaking, by

establishing a corporation resident in a treaty country, investors from another country can subject their investments to the benefits available under that country's tax treaties. However, such so-called treaty shopping has in recent years been the subject of increasing scrutiny, and restrictions have been imposed by the U.S. Department of the Treasury and Congress. Specific actions taken have included (1) the termination of existing treaties with tax haven jurisdictions; (2) the renegotiation of existing treaties; (3) the ratification of new treaties that contain "limitation of benefits" provisions; and (4) the amendment of the U.S. tax code to allow treaty benefits only to bona fide residents of a treaty country.

Entity Classification

How important is the issue of entity classification in the international context?

The question of whether a particular entity should be classified as a corporation or a pass-through entity (i.e., a partnership or trust) for U.S. income tax purposes is of crucial importance in the international context. For inbound transactions, if a pass-through entity is operating a U.S. business, the foreign owner will be subject to regular U.S. income tax at graduated rates. In contrast, if the entity is classified as a corporation, the foreign owner will be subject to a withholding tax on dividend income at a flat rate (30 percent or reduced treaty rate). Depending upon the application of the branch profits tax, to be discussed later, the overall treatment in these two cases may be quite different. In outbound transactions, if a foreign entity is characterized as a corporation, its U.S. owners may be able to avoid being taxed currently on the income being earned abroad. If, instead, the entity is a pass-through entity, the U.S. owners will be taxed currently under any circumstances. In addition, there are numerous other consequences of the classification of domestic and foreign entities as corporations, trusts, or partnerships.

How does the United States classify an entity that is formed under foreign law?

The IRS has published a list of certain foreign entities and their classification for U.S. tax purposes. With respect to entities not named on this list, the proper classification of a foreign enterprise under U.S. law may occasionally

be a difficult task because foreign countries have forms of business entities that do not have U.S. equivalents.

The U.S. classification principles applicable to foreign entities provide that, as a starting point, local law (i.e., foreign law) will determine the legal relationships among the entity and its members and among the entity, its members, and the public at large. When these legal relationships are ascertained, U.S. tax principles will classify an entity as a corporation, a partnership, or a trust. It is generally perceived that the IRS does not apply classification principles to foreign entities in the same manner it does to U.S. entities. Therefore, caution must be used before assuming that the foreign entity would be treated for U.S. tax purposes in a similar manner to its foreign treatment. In addition, one should consider whether a tax treaty prohibits the United States from reclassifying the entity for federal tax purposes because of a specific definition in the treaty.

For classification purposes, when is a person considered foreign?

A *U.S. person* is either an individual who is a citizen or resident of the United States, a domestic corporation, a domestic partnership, or a domestic trust or estate. A *foreign person* is a person who is not a U.S. person. Under this definition, a *resident alien* individual can be a U.S. person. Tax treaties may provide different rules.

When does an alien individual become a U.S. resident?

An alien individual is treated as a resident of the United States for a calendar year if such individual satisfies either of the following two tests: (1) The alien is a lawful permanent resident of the United States; or (2) subject to certain exceptions, the alien is physically present in the United States for a specified period of time (as of early 2007, under U.S. immigration law, 183 days or more during the calendar year).

An individual who is a U.S. resident is taxed on his or her worldwide income, regardless of its source, and is entitled to claim deductions and credits against his or her worldwide income. If a resident alien is subject to foreign taxes on his or her foreign source income, that person will be able to claim a foreign tax credit or deduction against his or her U.S. tax liability. Tax treaties may provide tie-breaker rules in situations in which an individual is treated as a resident by more than one country.

What is a U.S., or domestic, corporation?

Under U.S. principles, all organizations incorporated under the laws of the United States or of any state (including the District of Columbia) are treated as domestic corporations for federal tax purposes. For certain purposes, corporations organized in or under the laws of Guam, American Samoa, Northern Mariana Islands, or the Virgin Islands will not be treated as foreign corporations.

What is a dual resident company?

As far as the United States is concerned, a corporation incorporated in the United States is a U.S. corporation. This corporation, however, could at the same time be treated by country X as a country X corporation if country X employed different criteria to determine whether corporations are resident for its tax purposes. In particular, some countries, including the United Kingdom and Australia, treat corporations as domestic corporations if they are managed and controlled therein. Thus, a U.S. corporation that is managed and controlled in one of these jurisdictions can also be a resident of the United Kingdom or Australia under their respective rules. Such companies are referred to as *dual resident companies.* Although at one time there could be certain tax advantages in using such dual resident companies in lieu of corporations subject to "domestic" tax in only one country (such as the deduction of financing costs on the same loan in two jurisdictions), these advantages were substantially eliminated in 1986.

Can a foreign corporation be treated as a domestic corporation for U.S. tax purposes?

Yes. IRC Section 269B provides that if a domestic corporation and a foreign corporation are "stapled entities," the foreign corporation will be treated as a domestic corporation. The term *stapled entities* means any group of two or more entities if more than 50 percent in value of the beneficial ownership in each such entity consists of stapled interests (i.e., if by reason of form of ownership, restrictions on transfer, or other terms or conditions in connection with the transfer of one of such interests, the other such interests are also transferred or required to be transferred).

More important, there are two situations in which an election may be made to treat a foreign corporation as if it were a domestic corporation. One involves an election under Section 1504(d) of the IRC to treat certain Canadian

or Mexican subsidiaries of a U.S. parent as domestic corporations eligible to be included in the parent's consolidated return. The other involves an election under FIRPTA. FIRPTA provides that a foreign corporation holding a U.S. real property interest may elect to be treated as a domestic corporation.

Are U.S. persons and foreign persons treated alike under U.S. tax rules?

U.S. taxation of U.S. persons and foreign persons differs in a number of significant ways. The most noticeable difference concerns the scope of taxation: Whereas a U.S. person is subject to U.S. taxation on its worldwide income regardless of where it was derived (or sourced) and the class of income, a foreign person is subject to tax only on the income that has a substantial nexus to the United States. The nexus is generally defined with reference to a U.S. source or business. Often, the United States will not exercise its taxing jurisdiction over certain kinds of U.S.-related income that are generated by foreign persons, because of administrative difficulties concerning collection of the tax from foreign investors.

Would U.S. acquirers of foreign targets be indifferent about whether they receive foreign or domestic source income?

Source of income (and loss), whether U.S. or foreign, can be a critical factor in determining the U.S. income tax liability of both U.S. and foreign persons. In the case of U.S. taxpayers, foreign source income is often desirable because it increases their ability to offset foreign taxes against U.S. taxes under the foreign tax credit mechanism. On the other hand, if a loss can be sourced in the United States, the U.S. tax liability on domestic source income can be reduced and more foreign tax credits can be claimed against U.S. tax liability on foreign sources. In the case of a foreign taxpayer over whom the United States asserts only a limited taxing authority, foreign source income would likely escape U.S. taxation altogether. Accordingly, in general, there is a strong incentive to convert U.S. source income into foreign source income.

How is the source of most investment income determined?

Generally, interest or dividends paid by a U.S. person will be U.S. source income and therefore subject to the current rate (or any lower treaty rate) of

withholding tax. Exceptions are provided where the U.S. payer meets certain foreign income tests. Rentals or royalties are generally sourced in the United States if they are paid for the use of tangible or intangible property that is located in the United States.

Note that U.S. source interest income of a foreign person is not subject to a U.S. withholding tax if it qualifies as "portfolio interest." Generally, among the other requirements for interest to qualify as portfolio interest, the foreign lender must be neither a bank extending an ordinary loan nor a party that is related to the U.S. borrower.

How do you determine the source of gain derived from the sale of stock of a foreign or a U.S. entity?

Income derived by a U.S. resident from the sale of personal property, whether tangible or intangible, is generally sourced in the United States. Similarly, income derived by a nonresident from the sale of personal property, tangible or intangible, is generally treated as foreign source income. This is called the *residence-of-the-seller rule.*

Under the residence-of-the-seller rule, when an individual nonresident who does not have a U.S. office to which the sale is attributed disposes of stock of a domestic corporation, the sale will generate foreign source income, gain, or loss. Similarly, when a U.S. resident individual sells stock in a foreign corporation and the sale is not attributable to a foreign office of the seller, the income, gain, or loss generated by the sale will be U.S. sourced.

Note that for individuals, the definition of the term *U.S. resident* for sourcing purposes does not equal the definition of a U.S. resident for other tax purposes. The IRC contains an antiabuse rule that is intended to prevent a U.S. person from claiming to be a nonresident of the United States for income that is sourced in a tax haven country. A tax haven is a sovereign tax jurisdiction that generally imposes only minimal or no tax on income, capital, or estates of nonresidents of such jurisdiction (e.g., the Cayman Islands, the Bahamas, and the Channel Islands). Note also that investment of $1 million or more in a business employing 10 people or more qualifies foreigners for permanent residency ("green card") status in the United States and eventual citizenship.

TAX CONSIDERATIONS IN INBOUND ACQUISITIONS

An inbound acquisition is an acquisition of a U.S. enterprise by a non-U.S. person. This acquisition may involve financing through loans made by financial

institutions that are either resident in the acquirer's own country or third-country residents or by U.S. financial institutions, or a possible joint venture with U.S. or foreign equity partners. In debt-financed acquisitions, revenues received from the U.S. enterprise will likely be used to pay off acquisition indebtedness. The acquirers may wish at some point in the future to dispose of the entity or parts thereof in a transaction that will generate a profit over the acquisition price. For these and other reasons, U.S. tax considerations may be important in every stage of the acquisition and disposition process.

This section discusses the basic U.S. tax consequences applicable to a foreign corporation or a nonresident alien engaged in M&A activities in the United States; particular attention is given to financing the acquisition and planning for eventual disposition.

Basic U.S. Income Tax Principles

What are the basic U.S. income tax principles that determine the overall tax burden on U.S. income and repatriated funds of a foreign investor?

A foreign corporation not engaged in a U.S. trade or business is taxable at a flat rate of 30 percent (or reduced treaty rate), collected by withholding at source, on its U.S. source passive income (e.g., interest, rents, royalties, dividends, and premiums). A foreign corporation engaged in a U.S. trade or business, even if it does not maintain an office within the United States, is subject to a U.S. net income tax at graduated rates on its U.S. source income that is effectively connected with its conduct of the trade or business in the United States. The latter tax may be referred to as the regular income tax. In addition, a foreign corporation is subject to the branch profits tax (BPT) rules on its "effectively connected earnings and profits," subject to certain adjustments. (The BPT is discussed later in this chapter.) If a foreign corporation owns an interest in a partnership (domestic or foreign) engaged in a trade or business in the United States, withholding under the IRC may be required on distributions to the corporation. Capital gains, whether short-term or long-term, are not subject to U.S. tax if the foreign corporation is not engaged in a U.S. trade or business, or if the interest disposed of is not a real estate asset subject to FIRPTA.

A nonresident alien individual who is not engaged in a U.S. trade or business will be subject to U.S. tax at the rate of 30 percent (or reduced treaty rate)

on his or her U.S. source passive income and will pay the going rate on net capital gains derived from U.S. sources provided that the individual spent 183 days or more in the United States within the taxable year of sale. In addition, if a nonresident alien is engaged in a U.S. trade or business within a taxable year but does not maintain an office in the United States, then any U.S. source income effectively connected with that trade or business will be subject to U.S. tax at graduated rates. Withholding rules may apply to distributions with respect to partnership interests held by such an individual. Like a foreign corporation, if the nonresident alien is careful enough not to fall within the preceding restrictions, no U.S. tax will be imposed on his or her U.S. source capital gains.

If a nonresident alien or a foreign corporation engaged in a U.S. trade or business maintains an office in the United States, specified categories of such person's foreign source income are also treated as income effectively connected with a U.S. trade or business.

Tax treaties generally modify the rules described here as they apply to treaty country residents. In particular, tax treaties reduce withholding tax rates and limit taxation of business income to income attributable to a permanent establishment.

Thus, in summary, income from operations of the acquired U.S. target will ordinarily be subject to U.S. taxation, even if carried on directly by the foreign acquirer. On the other hand, with proper planning of their U.S. activities, foreign investors may find it relatively easy to avoid U.S. tax on capital gains (other than from the disposition of U.S. real property interests) derived from the sale of their interest in the U.S. activity.

When is a foreign person treated as engaged in a U.S. trade or business?

Neither the IRC nor the regulations thereunder define when a foreign person is engaged in a U.S. trade or business. The determination is generally based on the facts and circumstances of each case and, in particular, on the level of the taxpayer's activities in the United States. If the U.S. activities of the foreign person are not considerable, continuous, and regular, the person will probably be considered as not engaged in a U.S. trade or business. Business activities of an agent in the United States will be attributed to its principal. U.S. real estate gains received by a foreign person will be deemed to be income effectively connected with a U.S. trade or business. Gains from U.S. securities trading activities for the taxpayer's own account are generally not trade or business income.

What issues should an investor consider when undertaking foreign debt financing to acquire a U.S. business?

Foreign financing to acquire U.S. business operations can take many forms. It may take the form of an investment of equity or debt, and it may involve only one foreign lender in a single-lender transaction or many lenders in an offshore public debt offering. Single-lender loans can be made from foreign banks acting in the ordinary course of their business or from foreign non-banking institutions. In addition, loans can be made by foreign shareholders of the corporation. Publicly offered debt obligations may be in bearer form to protect investor anonymity, but can also take place in registered form. Among these alternatives, one may find various forms of syndicated loans and private debt placements to various investors. In addition, foreign financing may be in the form of short-term obligations, such as a Eurocommercial paper, and long-term debt. Finally, the debt issued may be in the form of straight debt or in the form of convertible debt or debt with equity features.

An entire chapter could be written on the tax treatment of transnational financing. Very broadly, when a foreign acquirer wishes to raise debt capital outside the United States, it should consider the following issues:

- Whether the acquisition indebtedness should be incurred by the U.S. target corporation or by the foreign acquirer. In this regard, the acquirer should weigh the relative values of the interest deductions in the United States and in the foreign jurisdiction. This is an area subject to change, however, so be sure to consult a tax specialist to consider the latest laws.[11]
- Whether the interest paid to the foreign lender will be free of U.S. withholding tax by virtue of a treaty exemption or a statutory provision (e.g., the portfolio interest exemption) or whether it will be subject to a reduced withholding rate. Note that investors in the Eurobond market generally require that interest payments be free of U.S. withholding tax. Furthermore, consideration should be given to the risk of change of law or treaty termination with respect to U.S. withholding tax liability.
- Whether a back-to-back loan structure to a U.S. corporation to take advantage of a tax treaty or statutory tax exemption will be respected by the IRS.
- Whether debt with equity features will be respected as debt for U.S. tax purposes.

Branch Profits Tax

If an acquirer can choose to hold the acquired U.S. business through either a U.S. or a foreign corporation, what factors should be considered?

The acquirer needs to consider many issues beyond the scope of this chapter. Note, however, that if a U.S. business is held through a foreign corporation, the foreign corporation may be subject to a second layer of tax in the form of the branch profits tax. If the U.S. business is held through a U.S. corporation, the tax cost may in certain circumstances be substantially reduced.

What is the branch profits tax (BPT)?

The BPT imposes a second layer of tax on profits of U.S. branches or other U.S. operations of a foreign corporation. The BPT was introduced in 1986 principally to duplicate, in the case of U.S. branches of foreign corporations, the second level of tax on dividends and interest paid by U.S. subsidiaries of foreign corporations.

If one is concerned about whether the BPT applies to certain U.S. operations, one should focus on these two rules: First, the BPT does not apply to foreign individuals engaged directly or indirectly through foreign partnerships in a trade or business in the United States. Second, foreign corporations whose U.S. investments or contacts do not amount to a trade or business (or, in the case of a treaty-protected corporation, to a U.S. permanent establishment) are not subject to the BPT. Nonetheless, the BPT provisions contain certain anti–treaty shopping rules that will affect even foreign corporations that are not engaged in a trade or business in the United States to the extent that they receive dividends or interest from a foreign corporation that is engaged in a trade or business in the United States. Thus, if an entity is neither a foreign corporation nor engaged (or deemed to be engaged) in a U.S. trade or business, and it does not receive dividends or interest from the U.S. operations of such a corporation, the following discussion does not pertain to its operations.

On the other hand, if one's U.S. operations might be subject to the BPT, the next two questions provide a short road map on the effects of the BPT on the regular operations of a U.S. branch of a foreign corporation and on the financing of a branch of a foreign corporation.

What are the BPT rules concerning the U.S. operations of a foreign corporation?

Whenever a foreign corporation operates or acquires an unincorporated business (including a partnership interest) in the United States, consideration should be given to the BPT consequences of such operation. Remember that under the regular rules, the foreign corporation pays one income tax on its "effectively connected" U.S. trade or business income. The BPT is an additional tax equal to 30 percent (or a reduced treaty rate) of any foreign corporation's "dividend equivalent amount" for any taxable year in which such corporation is engaged, or deemed to be engaged, in a trade or business in the United States. A foreign corporation that is subject to the full regular tax rate and the BPT may pay an effective U.S. tax rate in excess of 50 percent.

The dividend equivalent amount includes the "effectively connected earnings and profits" (E&P) of such corporation for the taxable year, as adjusted downward or upward to reflect certain increases or decreases in the "U.S. net equity" for the year. In effect, the statute treats a decrease in U.S. net equity as a withdrawal of earnings by the foreign parent, and it treats an increase in U.S. net equity as a contribution of capital to the U.S. branch. The use of the E&P account as the tax base was designed to approximate dividend treatment.

"U.S. net equity" is any money and the aggregate adjusted bases of the foreign corporation's property treated as connected with the conduct of a trade or business in the United States, less the foreign corporation's liabilities connected with such operation. Investments in business assets will increase the net equity amount and repatriations will decrease such amount, but only to include previous increases of net equity that reduced earnings and profits.

For the BPT to apply to a particular branch of a foreign corporation, such branch must generate "effectively connected" income. Generally, income will be treated as effectively connected if the corporation is engaged in an active business, if the corporation is a partner in a partnership engaged in a U.S. trade or business, or if the corporation invests in U.S. real property with respect to which the foreign corporation has elected under Section 897(d) to be taxed on a net basis or with respect to a gain from a disposition of a U.S. real property interest (other than interest in a U.S. real property holding corporation). E&P includes certain items not subject to the regular corporate tax, such as tax-exempt income. Distributions by the foreign corporation within the taxable year will not reduce E&P for the purposes of the BPT.

If a treaty country corporation earns effectively connected income that is exempt from U.S. tax because such foreign corporation does not maintain a

permanent establishment in the United States, such earnings will not be subject to the BPT, provided that the foreign corporation is a "qualified resident" of the treaty country, as defined previously. In addition, BPT rules may be modified in other ways by an applicable tax treaty (see preceding discussion).

How do the BPT rules affect the financing for a U.S. branch of a foreign corporation?

Generally, if a U.S. branch of a foreign corporation borrows money from a foreign lender, the branch (but in practice, the foreign corporation) will be required to withhold 30 percent (or reduced treaty rate) of the gross interest paid to the foreign lender. Certain IRC provisions, such as the portfolio interest exemption and the bank deposit exemption, may apply to eliminate the withholding requirement. The tax treaties that will determine the lower rate of withholding on interest paid by the U.S. branch will be the treaty between the United States and the country of the foreign lender and the treaty between the United States and the country of the foreign corporation that maintains the U.S. branch. Section 884, however, curtails treaty benefits to discourage treaty shopping. The effect of the withholding requirement can be to increase the cost of borrowing from foreign lenders that do not qualify for an exemption from U.S. taxation and cannot obtain complete foreign tax credit benefits in their own country.

Interest expense incurred by the foreign corporation on its worldwide borrowings may be allocated, under a formula, to the U.S. branch beyond the amount of interest actually paid or accrued directly by the branch ("excess interest"). Such excess interest will be deductible by the foreign corporation in computing its U.S. net taxable income for the U.S. branch, but will be treated as paid by the U.S. branch to the foreign owner as if it were a separate lender. As such, unless a specific IRC exemption applies, the excess interest will be subject to a withholding tax at the going 30 percent rate or any lower treaty rate imposed on the foreign corporation.

In determining the applicability of a treaty, the excess interest is deemed paid by the branch to the foreign corporation as lender. If the foreign corporation is a qualified resident of the treaty country, the excess amount may be subject to lower treaty rates. It is noteworthy that the tax imposed on excess interest allocable to the U.S. branch is levied regardless of whether the excess interest actually resulted in a tax benefit to the U.S. branch. Thus, it is possible that the tax on excess interest will exceed the foreign corporation's U.S. tax benefit from the deduction of excess interest, for instance, in situations where the U.S. branch has net operating losses.

Does the BPT override tax treaties?

Congress intended that the BPT not apply where its application would be inconsistent with an existing U.S. income tax treaty obligation; however, this principle is modified in cases of treaty shopping. When treaty shopping is not involved, (1) a foreign corporation and its shareholders may continue to rely on any benefits provided by an income tax treaty with respect to BPT on earnings, and (2) a foreign corporation and a third-party foreign lender may continue to rely on benefits provided by applicable income tax treaties. When treaty shopping is involved, treaty benefits are generally overridden. For instance, unless the actual or deemed creditor or dividend recipient, as the case may be, is a qualified resident of a treaty country, the creditor or the dividend recipient cannot claim treaty benefits to reduce the 30 percent withholding obligation.

It is noteworthy that U.S. shareholders of a treaty shopping corporation or of a nontreaty country corporation may be subject to triple taxation. There are several proposals currently under consideration to eliminate this additional layer of tax on U.S. shareholders.

How can a taxpayer determine whether the foreign corporation in which it holds stock will be treated as engaging in treaty shopping?

A foreign corporation will not be considered to be treaty shopping if it is a "qualified resident" of the treaty country at issue. A foreign corporation that is resident in a foreign country will be a qualified resident, unless either (1) more than 50 percent in value of the foreign corporation's stock is owned by individuals who are neither residents of such country (regardless of whether they are bona fide residents of another treaty country) nor U.S. citizens or resident aliens, or (2) 50 percent or more of the foreign corporation's gross income is used (directly or indirectly) to meet liabilities to persons who are neither residents of that country nor residents of the United States. Note that these rules still allow treaty benefits to inure to non–treaty country shareholders, as long as they hold less than 50 percent of the corporation's stock.

If the foreign corporation fails to qualify under these tests, it will nevertheless be treated as a qualified resident if either (1) the foreign corporation's stock is primarily and regularly traded on an established securities exchange in the country in question, or (2) the foreign corporation is wholly owned (either directly or indirectly) by another corporation organized in the country in which such stock is traded. This may provide an advantage to foreign shareholders of

publicly traded treaty country corporations over shareholders of non–treaty or U.S. publicly traded corporations.

What would be the best way to avoid the BPT?

Nontreaty investors and often residents in certain treaty countries will find that operating in the United States through a U.S. corporation is the most attractive way to avoid the BPT. In other words, in an asset acquisition, a foreign corporation will avoid the BPT if it incorporates the branch into a U.S. corporation. The rate of tax on dividends and interest required to be withheld at source by a U.S. subsidiary may be reduced if a treaty country parent corporation is used. If dividends are to be distributed, at least a 5 percent treaty rate withholding tax will apply. In addition, if the investor is a treaty country resident, he or she can capitalize the U.S. corporation with indebtedness and receive interest income, sometimes free of U.S. tax, contemporaneously with interest deductions at the corporate level.

FIRPTA

What is FIRPTA?

The Foreign Investment in Real Property Tax Act of 1980, as amended, also known as FIRPTA, was enacted in 1980 to close a number of perceived loopholes that enabled foreign investors to own and dispose of U.S. real properties without incurring U.S. tax on the appreciation of the property or on the cash flow from the property. Since 1985 FIRPTA has overridden all income tax treaties. Note, however, that there have been modifications to the IRS approach to enforcing FIRPTA in recent years.

FIRPTA applies to dispositions of U.S. real property interests (USRPIs). A USRPI generally includes (1) an interest in real estate located in the United States or the U.S. Virgin Islands, or (2) any interest (other than an interest solely as a creditor) in a domestic corporation unless it can be established that such corporation was at no time a U.S. real property holding corporation (USRPHC).

A domestic corporation is a USRPHC if the fair market value of its USRPIs equals or exceeds 50 percent of its worldwide real estate plus any other trade or business assets. Thus, if the assets disposed of are clearly not USRPIs or interests in certain pass-through entities that own USRPIs, neither the seller nor the buyer of the assets ought to be concerned about FIRPTA.

FIRPTA regulations provide elaborate rules concerning the definition of a USRPI. Because many U.S. corporations own significant amounts of real estate, it will often be difficult to conclude at an early planning stage that a given target is not a USRPHC.

What are the general rules regarding FIRPTA, and how are they enforced?

FIRPTA provides that gain or loss of a nonresident alien individual or a foreign corporation from the disposition of a USRPI will be treated as if the gain or loss is effectively connected with a U.S. trade or business of such person. As such, the gain will be taxed at the regular rates applicable to U.S. citizens and residents, or to domestic corporations, as the case may be. Unlike other passive investments, gain recognized in a transaction subject to FIRPTA ought to be reported on a U.S. income tax return. Nonresident alien individuals are also subject to FIRPTA's minimum tax.

FIRPTA compliance is enforced through a withholding system. The IRC generally provides that a transferee of a USRPI is required to withhold and pay over to the IRS 10 percent of the amount realized (i.e., the consideration) on the disposition by the foreign transferor. Partnerships and trusts disposing of real estate are required to withhold 34 percent of the amount allocable to their foreign partners or foreign beneficiaries. There are several exceptions to the withholding rules, but these are beyond the scope of this discussion.

FIRPTA applies to dispositions of interests in partnerships holding real estate and to dispositions of USRPIs by partnerships held by foreigners. Moreover, FIRPTA applies to distributions of USRPIs by foreign corporations to their shareholders and to capital contributions to foreign corporations. In addition, FIRPTA provisions can override the nonrecognition treatment provided by various other sections of the IRC, where necessary to ensure that the gain subject to taxation under FIRPTA is not diminished through transactions such as reorganizations and tax-free liquidations.

Who should be concerned about FIRPTA?

Although the FIRPTA provisions may seem to be of little importance in a merger or acquisition that does not involve real estate holding corporations or direct acquisitions of real estate assets, its application is far-reaching. First, as mentioned earlier, the definition of a USRPHC is broad enough to include even a manufacturing company that owns a large plant. A foreign acquirer should take future FIRPTA taxes into account in evaluating a potential acquisition. A domestic as well as a foreign acquirer from a foreign holder is liable

as transferee-payor to withhold tax on the consideration paid for the stock if the corporation is a USRPHC and the payee is subject to FIRPTA. Failure to withhold may result in civil and criminal penalties. On the other hand, the foreign transferor (seller) is required to file a U.S. tax return to report his or her gain from the sale. Finally, if a public offering to refinance a portion of the acquisition indebtedness is contemplated, certain foreign holders (5 percent or more) will be subject to U.S. tax on the disposition of their holdings if the corporation is a USRPHC; under certain circumstances, the buyer of publicly traded stock from a 5 percent or more shareholder will be required to withhold FIRPTA tax.

Consequently, in any stock acquisition, consideration should be given to the value of the U.S. realty owned by the acquired entity, vis-à-vis its other assets, and to the tax status of the seller. If the seller provides a certificate that it is not a foreign person, no withholding will be required. In addition, no withholding is required if a domestic corporation furnishes to the transferee an affidavit stating that it is not and has not been a USRPHC during a certain test period.

TAX CONSIDERATIONS IN OUTBOUND ACQUISITIONS

In this section we will outline the most prominent features of U.S. taxation of the foreign activities of U.S. persons. As explained earlier in this chapter, the United States asserts taxing jurisdiction over the worldwide income of its citizens, residents, and corporations. As a general rule, the United States taxes only income received or accrued by U.S. taxpayers. In the domestic context, with the exception of a group filing a consolidated return or an S corporation, income earned by a U.S. taxpayer from a controlled corporation is not taxed to the U.S. owner except and to the extent that such earnings are actually distributed to the owner. As we will soon see, the exceptions to the preceding rules in the international context are so voluminous and complex in U.S. tax law as to suggest that the general rules do not apply at all. As a result of longstanding concerns about the avoidance of U.S. taxes through the expatriation of assets and earnings, there is now an extensive patchwork of rules under which the United States seeks to tax, or at least take into account, income generated in foreign subsidiaries of U.S. persons.

Needless to say, in any transaction involving an acquisition of a foreign business, the primary focus of the tax planner's attention must be the tax laws of the country or countries in which the target does business and holds assets and the country or countries in which its shareholders are located. This is all the more true at a time when income tax rates of most industrialized countries significantly exceed those in the United States. There may in fact be significant opportunities to reduce the impact of foreign taxes through the use of tax

treaties and the United States foreign tax credit system. These mechanisms are inherently imperfect, however, and a great deal of attention must be paid to U.S. tax rules for the international activities of its taxpayers in order to minimize the overall tax costs of U.S. persons engaging in a variety of multinational operations.

Planning the Outbound Acquisition

When planning an outbound acquisition, what information should the purchaser solicit from the seller in order to minimize foreign and domestic tax liabilities?

Today, where an auction process is commonly used to obtain the highest bid for a group of corporations that is for sale, the buyer cannot ignore the tax consequences to the seller resulting from the sale. To obtain a competitive edge over other bidders, the buyer should strive to maximize its own tax benefits without raising the seller's tax costs above its expectations. Alternatively, without sacrificing the purchaser's own goals, it may be possible to structure the offer in a way that reduces the seller's tax costs. With these goals in mind, the purchaser should solicit from the seller the following information:

- A precise organization chart. The chart should describe the holding company (assuming that the target is a parent of a group of corporations) and the stock ownership in all the various tiers of the domestic corporations, if any, and of the foreign corporations or entities (the "group").
- The estimated U.S. and foreign tax bases as of the projected acquisition date that the holding company is expected to have in the various domestic and foreign corporations.
- To the extent feasible, a description of the overall income tax position of the target group and the seller.
- For each of the foreign companies:

  The taxable year for both foreign and U.S. income tax purposes

  The actual and projected earnings and profits by taxable period of such corporation as of the acquisition date computed by the rules set forth in Sections 902 and 964 of the IRC

  The creditable foreign income taxes paid or accrued during each taxable period ending on or before the acquisition date

The earnings and profits and creditable foreign taxes set forth in subparagraphs B and C accumulated prior to the seller's ownership of the company

All other information (foreign currency gains and losses, tax accounting elections, distributions, utilization of foreign tax credits, etc.) necessary to determine the tax consequences of a later sale of each corporation

The estimated net book value, or pro forma balance sheet, of each foreign company as of the acquisition date

A listing of the intercompany receivables and payables, if any

Why would one need an organization chart of the structure of the target?

An organization chart will describe the precise ownership of the group and will inform one of the different tax jurisdictions (and income tax treaties) that may affect the acquisition process and the subsequent disposition of the group or several of its members. One may be aiming to buy a Greek company but may find out that the Greek company is owned by a Spanish holding company, which is in turn owned by a U.S. subsidiary of the holding company. Therefore, in this scenario, the prospective buyer will be required to evaluate the possible tax consequences of the acquisition in Greece, Spain, and the United States.

The organization chart will also provide information about whether any of the foreign subsidiaries is, or would be in the purchaser's hands, a "controlled foreign corporation" (CFC). As explained next, CFC status may have significant U.S. tax consequences to a U.S. shareholder.

CFCs and Subpart F

What is a CFC?

A *controlled foreign corporation,* or CFC, is any foreign corporation of which more than 50 percent of the total combined voting power, or the total value of its stock, is owned directly or indirectly by "United States shareholders" on any day during the taxable year of the foreign corporation. A *United States shareholder,* in turn, is a U.S. person who owns, or is considered to own under attribution rules, 10 percent or more of the foreign corporation's voting power. Note that in the definition of U.S. shareholder, voting power and not stock value is the sole criterion.

In considering the application of Subpart F, it is important to keep in mind the separate status and consequences of the CFC and the U.S. shareholder. For example, because of the 10 percent voting power test, it is possible to have U.S. persons owning stock in a CFC who are not U.S. shareholders and thus not subject to Subpart F. Additionally, there is much room for structuring flexibility to allow substantial U.S. ownership of a foreign corporation without causing it to be characterized as a CFC. One thing to bear in mind in this area is that there may be circumstances in which it will be beneficial for a foreign subsidiary of a U.S. parent to be characterized as a CFC.

What is Subpart F of the Code?

Subpart F (Sections 951–964 of the IRC) requires U.S. shareholders of a CFC to include in their U.S. gross income as constructive dividends certain amounts earned by the CFC, regardless of whether such earnings were actually repatriated to the U.S. shareholder. In addition to the CFC and U.S. shareholder requirements, Subpart F treatment will generally apply only to certain types of income earned by the CFC, which may be broadly termed Subpart F income. Note that a U.S. tax is not imposed on the CFC itself; in fact, if the foreign corporation were itself subject to U.S. taxation, an entirely different set of rules would apply.

How does Subpart F operate?

Subpart F provides that a U.S. shareholder must include in gross income certain classes of the CFC's income as a constructive dividend. Following such an imputation, the basis of the U.S. shareholder's stock in the CFC is increased in order to avoid double taxation when the U.S. shareholder later disposes of the stock of the CFC. An actual distribution of the CFC's earnings subsequent to Subpart F treatment will not be taxable to the U.S. shareholder if it pertains to the previously taxed earnings and profits, and a corresponding reduction in the basis of the stock will take place. Under certain circumstances, the U.S. shareholder may be eligible for the foreign tax credit with respect to foreign taxes paid by the CFC.

As explained subsequently in greater detail, a U.S. shareholder of a CFC is also required to include in gross income its pro rata share of the foreign corporation's increase in earnings invested in certain U.S. properties.

What classes of CFC income are subject to Subpart F?

Subpart F income includes "insurance income," "foreign base company income," and certain other classes of income subject to specific limited rules (such as international boycott-related income and illegal bribes). If more than 70 percent of the CFC's gross income is Subpart F income, the full amount of the CFC's gross income will be treated as Subpart F income.

"Insurance income" means income attributable to the issuance of any insurance, reinsurance, or annuity contract in connection with property in, liability arising out of activity in, or in connection with the lives or health of residents in a country other than the country under the laws of which the CFC is created or organized. "Foreign base company income" includes "foreign personal holding company income," "foreign base company sales income," "foreign base company services income," "foreign base company shipping income," and "foreign base company oil-related income" for the taxable year.

- Foreign personal holding company income consists of interest, dividends, rents, royalties, and other kinds of passive income.
- Foreign base company sales income generally includes various forms of income derived by the CFC in connection with the sale or purchase of property involving a related party, where the property originated in a country other than that of the CFC and is sold or purchased for use or disposition outside of the country of the CFC.
- Foreign base company services income generally includes income derived in connection with the performance of various services on behalf of a related person where the services are performed outside the country of the CFC.
- Foreign base company shipping income includes income from a variety of activities involving the use of aircraft or vessels in foreign commerce.
- Foreign base company oil-related income generally includes income from oil and gas products, except where the income is derived in the country from which the oil or gas product was extracted.

What are the rules concerning a CFC's increase in earnings invested in U.S. property?

As a general rule, each U.S. shareholder is required to take into gross income his or her pro rata share of the CFC's increase in earnings invested in U.S.

property for the taxable year. This rule is applicable to all CFCs whether or not they have earned Subpart F income, but to avoid double counting this rule applies only after Subpart F income, if any, has been imputed to the shareholder.

To prevent certain abuses, indirect investments in U.S. property will also be subject to these rules. Under Treasury regulations, any obligation of a U.S. person for which a CFC is a pledgor or guarantor will be considered U.S. property held by such CFC. If the assets of a CFC serve at any time, even though indirectly, as a security for the performance of an obligation of a U.S. person, then the CFC will be considered a pledgor or guarantor of that obligation. Consequently, if an acquirer plans to use the stock or assets of foreign subsidiaries as collateral for acquisition indebtedness, it may risk receiving a deemed distribution from the CFCs to the extent of the earnings and profits of the foreign subsidiaries that are used as collateral.

Foreign Tax Credits

What is the foreign tax credit?

A common theme throughout the tax system is that a person should be relieved of the burden resulting from the imposition of tax by more than one jurisdiction on the same income. One example of this principle is the deduction for income taxes paid to states, localities, and foreign governments contained in Section 164 of the IRC. In the case of income taxes paid to foreign governments, the IRC provides an alternative to the deduction of the foreign tax from gross income by way of a unilateral tax credit against U.S. tax for the foreign taxes. When the credit works properly, it generally provides a more complete relief from double taxation of income than the deduction. The goal of the foreign tax credit system is to limit the overall rate of tax on foreign source income to the greater of the foreign rate or the U.S. rate. The foreign tax credit is elected by a taxpayer on an annual basis and is not binding for future years. Because of the various limitations under the foreign tax credit rules, in certain circumstances it may, in fact, be more advantageous for a taxpayer to claim the deduction instead of the credit.

How is the amount of allowable foreign tax credit determined?

The amount of foreign tax credit that may be claimed as a direct credit against U.S. income tax liability is generally determined by applying a fraction to the

tentative U.S. tax liability for the year. The numerator of the fraction is the taxable income from foreign sources, and the denominator is worldwide taxable income. Foreign income and related foreign taxes are divided into several new categories, or *baskets,* described in Section 904(d) of the IRC.

Can a U.S. person obtain a foreign tax credit for foreign taxes paid by a foreign subsidiary?

Under Section 902 of the IRC, a U.S. corporation owning 10 percent or more of the voting stock of a foreign corporation may be entitled to a "deemed paid credit," or indirect credit, for foreign taxes paid by the subsidiary. The deemed paid credit is available only against dividend income received (or deemed received under Subpart F or other provisions) from the foreign subsidiary. The principle underlying this indirect credit is that a U.S. corporation receiving a dividend from a foreign corporation is deemed to have paid the foreign taxes paid or accrued by the foreign corporation on the earnings from which the dividend is distributed.

The deemed paid credit generally works as follows. First, under Section 78 of the IRC, a domestic corporation must include in income not only the amount of dividends actually or constructively received, but also an amount equal to the foreign taxes attributable to such dividend income. This is the so-called gross-up provision. Under Section 902, the U.S. corporation is deemed to have paid the same proportion of the income taxes paid by the subsidiary as the dividends received bear to the foreign subsidiary's total earnings. Additionally, if the foreign corporation owns 10 percent or more of the voting stock of a second foreign corporation, it is deemed to have paid foreign taxes of the subsidiary on the same basis. The same rule goes on for a third-tier subsidiary as well.

Under Section 960 of the IRC, similar rules are provided for an indirect foreign tax credit with respect to deemed dividend income from the foreign corporation to the domestic corporate shareholder as a result of Subpart F. Under Section 962, an individual may take advantage of this indirect foreign tax credit by electing to be taxed on Subpart F income as if he or she were a domestic corporation.

Section 1248

How is a U.S. person treated upon the sale of stock in a foreign corporation?

For the application of Section 1248 of the IRC, a U.S. person will generally recognize capital gain or loss on the sale of stock in a foreign corporation just

as it would on the sale of stock in a domestic corporation. The main purpose and effect of Section 1248 is to recharacterize the gain realized on the sale of stock in the foreign corporation from capital gain to ordinary dividend income to the extent of the selling stockholder's ratable share of the earnings of the foreign corporation accumulated during the period that the stock was owned by the U.S. person. If the selling shareholder is a domestic corporation, then it may claim the benefit of the indirect foreign tax credit with respect to the deemed dividends under Section 902. Where the selling shareholder is an individual, Section 1248 includes a mechanism that indirectly reduces his or her U.S. tax liability on account of foreign taxes paid by the foreign corporation.

CONCLUDING COMMENTS

This chapter has highlighted some issues one might encounter when embarking on an inbound or outbound transaction. We hope that our overview has been useful. Of course, as in all transactional matters, buyers and sellers should consult legal counsel familiar with applicable laws—including special counsel located in the foreign country or countries involved. Many major law and accounting firms publish useful booklets and client letters they are eager to share with current and potential clients. We encourage you to study them—as well as this book and others like it—to deepen your knowledge of the art of M&A.

NOTES

1. U.S. Census Bureau, Foreign Trade Statistics, www.census.gov/foreign-trade/statistics/highlights/index.html.
2. For example, of the $1.3 trillion spent on M&A in the six months of 2006, only about half ($561.6 billion) was for U.S. firms. "FactSet Mergerstat Release: Global M&A Wrap Up for the First Half of 2006," June 30, 2006, http://news.moneycentral.msn.com.
3. See, for example, Ian Rowley and Kenji Hall, "Softbank-Vodafone Deal rings True," *BusinessWeek,* March 17, 2006.
4. Ownership of a U.S. corporation by a foreign citizen, that is, a "controlled foreign corporation," should not be confused with the term *foreign corporation,* which has a narrower meaning. Unlike many countries, the United States has allocated to its 50 states the act of incorporation. For instance, a Delaware corporation—that is, a company incorporated in the State of Delaware—doing business in Virginia is known in Virginia as a *foreign corporation.*

5. Definition of *taxpayer* for purposes of Section 901 and related matters: "Subject to applicable limitations, a taxpayer who pays a foreign tax is allowed to claim a credit for the tax against its U.S. tax liability. The proposed regulations provide rules for determining who has paid a foreign tax. In general, the proposed regulations clarify that a person is considered to pay a foreign income tax if the person is required to take the income into account for foreign tax purposes. The proposed regulation contains special rules for foreign consolidated groups and certain types of entities." REG-124152-06. Published August 4, 2006.
6. "Recent Changes to U.S. Federal Income Tax Rules for U.S. Employees Relocated Abroad," from Cleary Gottlieb law firm. www.cgsh.com/english/news/alertdetail.aspx?id=382.
7. TD 9273. Published August 8, 2006.
8. For a guide to joint ventures, see Alexandra R. Lajoux and H. Peter Nesvold, the *Art of M&A Structuring: Techniques for Mitigating Financial, Tax, and Legal Risk* (New York: McGraw-Hill. 2004).
9. See "A Simple Guide to the EC Merger Regulation of 2004, by John J. Parisi of the Federal Trade Commission (FTC). www.ftc.gov/bc/international/docs/ECMergerRegSimpleGuide.pdf.
10. See Publication 515 (1/2006), *Withholding of Tax on Nonresident Aliens and Foreign Entities for Withholding in 2006.* Revised: 1/2006.
11. On June 21, 2006, the IRS issued final and temporary Treasury regulations (TD 9268 REG-109512-5) clarifying information required to be reported, by foreign corporations and foreign-owned domestic corporations. For a guide to these regulations, see Madeline M. Chiampou, "Forco and Foreign-Owned USco Reporting," at www.hodgsonruss.com/article_975.html.
12. For a guide to the new rules, see Helen Shaw, "New Transfer Pricing Regs, New Headaches," August 2, 2006, www.cfo.com/article.cfm/7245815.
13. See Determination of Interest Expense Deduction of Foreign Corporations: "Foreign corporations that are engaged in a trade or business within the United States are subject to tax on their income that is treated as effectively connected with the trade or business. Expenses related to that income are allocable and deductible against the effectively connected income to determine the foreign corporation's net U.S. taxable income. A three-step formula under section 1.882-5 applies to the allocable amount of interest expenses allowed in determining the net U.S. taxable income. These temporary regulations provide amendments to the three-step formula and provide special elections that may be implemented on timely filed returns and amended returns for the first year these rules are effective. These temporary regulations also provide amendments to the branch profits tax rules under section 1.884-1(e)(3) to permit foreign corporations greater latitude in electing to treat their net equity as increased and in determining the timing for when earnings are deemed remitted." TD 9281. Published August 17, 2006.

See also Exclusion from Gross Income of Previously Taxed Earnings and Profits: "These proposed regulations provide guidance relating to the exclusion from gross income of previously taxed earnings and profits under section 959 of the Internal Revenue Code and related basis adjustments under section 961 of the Code. These regulations reflect relevant statutory changes made in years subsequent to 1983. These regulations also address a number of issues that the current section 959 and section 961 regulations do not clearly answer. These regulations, in general, will affect United States shareholders of controlled foreign corporations and their successors in interest." REG-121509-00. Published August 29, 2006.

The source for both of these explanations is the Internal Revenue Services, August 2006 Plain Language Regulations, www.irs.gov/taxpros/article/0,,id=160640,00.html.

14. For a list of current tax treaties involving the United States, see August 2006 Plain English Regulations, www.irs.gov/publications/p515/15019904.html.

CASE

A WOFC Case Study: J. T. Smith Consultants

This case study is designed to demonstrate the wheel of opportunity and fit chart (WOFC) method of growth planning. The WOFC system has been used in hundreds of different companies in a wide range of industries and countries. The author has applied the WOFC method productively to companies as diverse as a major insurance company with 12 "product lines" and a pecan packager with only one. A multibillion-dollar publisher with eight profit centers used it to target and make a $300 million acquisition. An electrical transmission manufacturer used it to aid negotiations in selling itself off at a premium, as did a major U.S. manufacturer of automobile window lifts and door, hood, and trunk latches.

Successful WOFCers include two major cosmetics companies, three auto parts manufacturers in Brazil and Japan, a major U.S. aerospace manufacturer, a chain of supermarkets, a multilocation structural steel fabricator, and farm machinery manufacturers in the United States and Brazil. WOFC can be used anywhere there is business—in Italy, for instance, the WOFC method was used to plan the consolidation of some 30 knitting mills that had been taken over by the government because it was thought to be cheaper than paying unemployment; WOFC was also used after the consolidation. In Brazil it was used to outline an economic development program to discover how to best utilize an entire region's resources—human, educational, agricultural, geophysical, infrastructural, and financial.

A caveat: Do not make the mistake of applying to your own case the particular set of variables that survived the Instant Delphi in the following J.T. Smith case. Every company, like every person, is different. Each has its own persona. Every business entity has its own special strengths/weaknesses/opportunities universe. Never borrow plans from another; develop your own.

The authors believe that the relative importance of any of the hundreds of things that can be said about a company—its management, its workers, its markets, or its operations—can be quantified using the Instant Delphi process as described in this case and in the main text. Those numbers can and should be used to rate internal or external entry opportunities against each other so that those that fit can be differentiated from those that don't before resources are committed to any acquisition or de novo entry.

THE CASE

J.T. Smith Consultants is a firm of consulting mechanical engineers (ME) in corporate form based in Detroit, Michigan. It was founded in 1979 and specializes in the layout and design of automobile parts manufacturing and automobile assembly facilities. J.T. Smith is a so-called close corporation with only a few stockholders. Stock is issued only to department heads and changes hands infrequently.

During the good years, rather than reinvesting earnings in growing the company, the founding principals had habitually drawn out the company's earnings in salaries and bonuses and reinvested them in Detroit real estate. After seven fat years (1989–1995) and seven *very* lean years (1996–2002), the automobile boom of 2003–2007 had made J.T. Smith's operations extremely profitable.

By 2007, J.T. Smith's billings were in the low nine figures and the backlog was substantial. Sales had been helped by the automobile industry's long years of downsizing, which had forced the Big Three (GM, Ford, and Chrysler) and many of their parts suppliers to contract out, or "outsource," engineering work normally performed in-house. Smith had exploited this phenomenon to the full, and in 2007 billings were running some 35 percent ahead of 2002. In addition, J.T. Smith had used its computer expertise to develop quick-response capabilities (QRC) by establishing in-plant "virtual engineering" centers hooked up to its Detroit headquarters' computers, library, and staff by broadband communications.

The centers were ideal for situations such as Ford's $95 million rush-rush reengineering of its Sharonville, Ohio, truck transmission plant. Many at J.T. Smith believed that outsourcing of normally in-house engineering was a sea-change in the industry, effective only in the United States but in all of North America and perhaps the world.

Cofounder Jackson Tecumseh Smith was such a believer. At age 59 he was very much involved in the day-to-day affairs of his company. He had been through good times and bad, and he did not want to repeat those last seven difficult years ever again. "This time, we're going to reinvest in ourselves rather than in real estate," he vowed at a crucial board meeting. "We simply must get bigger: The big firms survive in good times and bad. However, we've finally learned that automobile manufacturing is a cyclical industry, so while we're growing, we're also going to diversify."

Smith decided that he needed a 10-year strategic plan and began by creating a planning committee. Committee members included Smith; cofounder

Tom Jones, chief operating officer; Hal Miller, executive vice president; Harry Teets, vice president for marketing; Wilber Clarke, vice president for finance; Jasper Walsh, vice president for engineering; and Carole Henry, comptroller. Each of them was a stockholder and had been with the firm for many years. All except Carole Henry, a CPA, were registered professional engineers.

Alfred Klinger, vice president of planning (a recent hire), was made secretary of the committee. He was a registered professional engineer (mechanical) and had his MBA as well.

The first meeting of the committee was held in early March of 2006. Very little happened—everyone had been too busy with the crush of new business to think about planning. Besides, they expected Klinger to come up with a plan. Smith pointed out that the job of a planner was not to plan, but to see that those responsible for the operations of the firm made a plan to which they could commit. Klinger was therefore directed to come up with a "plan to plan."

In early April of 2007, Klinger recommended the wheel of opportunity and fit chart (WOFC) method of strategic planning and took the following steps:

1. He scheduled an off-site, three-day WOFC session for June 2, 3, and 4—a Sunday-afternoon-through-Tuesday-afternoon series of sessions (see Exhibit Case-1) to be held at a local country club.
2. He devised Strength (Supplement) and Weakness (Complement) sheets and filled them in with sample supplements and complements (see Exhibit Case-2 and Case-3).
3. He prepared a description of potential variables (see Exhibit Case-4).
4. He devised an Opportunity Description sheet and filled it in with a sample opportunity (Exhibit Case-5).
5. He held a series of six one-hour WOFC "orientation" sessions to ensure that everyone understood his or her responsibilities to the plan and to discuss sample Strength and Weakness sheets.
6. During the orientation sessions each of the participants pledged to consult with his or her subordinates to discover their ideas of strengths and weaknesses, to abstract them, to add their own, and to enter them each on separate Strength and Weakness sheets.

7. All attendees promised to look through their own files for opportunities and to hold meetings with their subordinates to develop more ideas and write them up on the opportunity sheets.
8. Klinger appointed himself facilitator and in turn appointed the assistant comptroller as monitor. The monitor in turn selected an assistant monitor.
9. He set up on a projecting computer the Instant Delphi Tally Input sheet to be used in the Delphi sessions (see Exhibit Case-6) and to follow the scoring in the Fit Chart itself (Exhibit Case-7).
10. He devised a wheel of opportunity for J.T. Smith to be filled in with the most logical opportunities as determined at the scheduled planning meeting (see Exhibit Case-8).

THE WOFC SESSIONS

Session 1—Orientation

The first session was held as planned on-site at the country club. Attendees were the seven participants, the facilitator, the monitor, and the assistant monitor. The reception, strictly a social affair, was followed by a dinner. Promptly at 8:00 P.M. the orientation session began.

Using a projector, the facilitator outlined the rules for running the sessions and led the ensuing discussion:

1. The fit chart was developed first so as not to be unduly influenced by the opportunities universe.
2. Only the seven participants were to vote in the Delphi. The facilitator and monitor were cautioned that they were to be careful not to influence the votes or distort the tallies.
3. Although observers were permitted to attend, they were not to interrupt the meetings (though they were encouraged to discuss the variables during the breaks). They were there to serve as support personnel only—to supply factual information when it was called for. (There were no observers present during the first session.)
4. Only those scoring high or low in the Delphi were allowed to

express an opinion without the special permission of the facilitator.

5. There were to be no phone calls made by or to any of the participants, the facilitator, or the monitor during the sessions. However, the assistant monitor was assigned the responsibility of screening any emergency calls for any of the participants, who were allowed to respond during the breaks. The sessions were to be suspended if any of the participants left the meeting for any reason. Any significant time lost was to be made up by extending the session into extra days.
6. The monitor was to ensure that the site and the sessions and records were secure and that nondisclosure agreements had been signed with all participants, as well as the facilitator, the monitor, and the assistant monitor. (If any observers attended later, they were also to sign nondisclosure agreements.)
7. The assistant monitor was to arrange for the taping and transcription of the session and to ensure that the taping process, the tapes, and the transcriptions were secure.

Immediately after dinner, each participant received sample Strength and Weakness sheets and a flow chart with a sample fit chart and a wheel of opportunity left blank.

Using transparencies and a projector, Klinger, the facilitator, took the group through the WOFC process beginning with the sample Strength and Weakness sheets (Exhibits Case-2 and Case-3) and answering questions as they arose. The rationale of the Delphi process was explained in detail.

At the end of the first session, participants received the actual Strength and Weaknesses sheets that were to be considered in the morning sessions along with summary descriptions contained in the Descriptions of Potential Variables (Exhibit Case-4). The participants were urged to discuss the strengths and weaknesses with the preparers and each other, and to make notes where clarification might be needed so that each of the participants would be voting on the same thing.

Session 2

Session 2 began with requests for clarification of several key strengths and weaknesses followed by general discussion led by the facilitator. Agreed-upon corrections were made by the assistant monitor, and new Strength and

Weakness sheets were created, copied, and distributed to the participants in time for the beginning of Session 3.

Session 3

By discussion and voice vote, eight weaknesses were isolated and entered as complements and seven strengths were isolated and entered as supplements. The assistant monitor entered these selected variables on the master transparency of the Instant Delphi Tally Sheet, which was projected for all to see, with blank copies distributed to each of the participants to be filled in by hand as the Delphi proceeded in Sessions 4 and 5 and the relative ratings of the strength and weaknesses were developed. (See Exhibit Case-7 for the *completed* Tally Sheet. The blank tally sheet is not shown in any exhibit.) During the lunch break the monitor revised the early draft of the Description of Potential Variables prepared by the facilitator (Exhibit Case-4), edited it in accordance with the discussion, duplicated it, and passed it out to the participants.

Session 4

Following the lunch break, Rounds 1 and 2 of the Delphi were completed.

Session 5

Rounds 3 and 4 of the Delphi were completed by the end of the day.

DISCUSSION AND OBSERVATIONS

Complements (Weaknesses)

Cyclical Complements, Client Dependency, and Entry/Exit Threats. The seasonal and product life-cycle variables were dismissed with very little discussion. They also felt they were not affected by random forces such as weather, fads, and fashions. They knew very well that they were super-dependent on the Big Three, and only geographic dispersion could help them there. As for entry threats, there had not been a major ME engineering startup in 15 years and no sign—in spite of the current good times—that there would be one.

The group felt that, in general, they were not sensitive to entry threat and, except for Ford, there was little exit threat. Only Long-Term Cyclical Resistance survived the discussion and became the first Complement.

Long-Term Cyclical Resistance. During Round 1, the CEO and the COO were at odds on this variable. The CEO gave it zero points and the COO a high score of 200. In view of Mr. Smith's pre-sessions statements as to the cyclicality of the automobile business and the desirability of "diversifying," his entry of zero was hard for the group to understand. But, backed by Clarke and Walsh, who also entered zeroes for the variable, he explained that by "diversification" he meant to get away from dependence on mechanical engineering alone and envisioned the building of a full-time professional engineering services company.

In opposition, the COO argued that even if they added electrical and civil engineering, their principal client would still be the highly cyclical automobile industry. Furthermore, mechanical engineering work both led and lagged the automobile cycle, whereas electrical and civil seemed to be tied more tightly to it. He suggested that the firm's sensitivity to cyclicality might be exacerbated if they diversified into those areas. Further, he said that his research had shown that many firms in cyclical industries were very profitable because there was very little threat of competitive entry, pricing was generally inelastic, and margins were high. Further, once numbers were developed to define the cycle—exactly how their sales were affected by the cycle and whether they led it or lagged it or both—they then anticipated its effects and compensated for the cycle.

This variable commanded increased attention during subsequent rounds and wound up with solid support from six of the seven participants, eventually becoming the third-ranking complementary variable with 100 points.

GROWTH VARIABLES

Billings Growth. In the first round, Sith gave Billings Growth zero points, saying that he was "saving his points for the full-lining Complement." Jones responded by saying that while they were very busy today, the Big Three supplied 70 percent of the firm's total billings and the firm had become increasingly dependent on one of the Big Three, Chrysler. He felt that they should develop more clients—perhaps 50 rather than their present 25 (they

considered profit centers at the Big Three, especially geographically dispersed operations, as separate clients). He was supported by Teets, who said it took a year's effort to develop one new client and they had to get going now if they were to keep their present increased billing rate through the year 2000 and beyond.

Teets also observed that they had only a 12 percent penetration in the mechanical engineering market anyway, although their penetration in the ME subspecialty of automation was considerably higher. Teets believed that investing in more sales help could bump their share of the Detroit-sourced ME market to 18 percent. "We keep our clients, once we've got 'em," said Teets. "Let's invest where we know we're good."

In spite of two stubborn holdouts, Walsh and Henry, the cyclical resistance variable was awarded increasing points in subsequent rounds and finished up as the second-ranking complement at 120 points.

Profit Improvement. Surprisingly, each participant had allocated 100 points to this variable in the first round. Why? Because none of them could believe that anyone would want *not* to make more money—that is, increase their margins.

Clarke pointed out that profits in most businesses are either margin-driven or capital-turns driven, and profits at J.T. Smith, as at most service companies, were margin-driven. "Pricing in the engineering field is important but is seldom cutthroat in competitive situations except in hard times, and much of our work is awarded in noncompetitive, negotiated contracts. Further, many jobs are split between competing firms. Hourly billing rates tend to be the same for comparable skills. Improving profits by bumping margins is risky. If we want to make more money, we should increase volume and turn our capital faster. Right now we have substantial amounts of cash available to finance it."

Following Clarke's lead, the discussion centered on the relationship between sales (billings) and profits as impounded in the classic equation, $S/C \times P/S = ROC$, where S is sales, C is capital and P is profit.

As the discussion progressed, however, the big question remained unanswered: Could they charge more for the same old service? Teets suggested that perhaps they were all leaving something on the table—especially during the current boomlet. He noted that the legal and accounting professions had accelerated billing rates far faster than the consumer price index (CPI), which engineers had generally tracked. Smith agreed. Henry thought they should at least try to raise prices. But Clarke asked, "When was the last time we lost a

job on price alone?" The answer was, "In 1999." Clarke also noted that some 50 percent of the firm's billings were on task orders on master contracts that had been negotiated years before with annual reviews and adjustments on hourly rates tied to the CPI.

By Round 3, the variable had been dropped. Why? They made goof profits on their work, they seldom took a loss on a job, and the participants needed the points to support other Complements and Supplements.

MARKETING-RELATED VARIABLES

The group reviewed the variables outlined in the Review of Potential Variables. Of particular concern was the effect on QRC (which kept margins up) if they got bigger. Teets said he was just as concerned with survival as he was with growth. The last seven years had been tough. He wanted to make sure that they knew the dollar volume of billings to be reached in any one field of endeavor (such as CAD services) to ensure its survival *and* growth.

The group did not believe that the PIMS data, developed for industry in general, applied to them. If J.T. Smith became a market leader with a 35 percent share of market, their annual billings would be over a billion dollars, which would give them impossible administrative problems; thus the Attain Maximum Market Penetration variable was not included. The Attain Pricing Independence variable was also passed over for consideration as they did not have much proprietary software and had little hope of developing more.

They did want to broaden their client base but were not sure how they could do it while being based in Detroit. Their "virtual engineering centers" concept might lend itself to that broadening, but it was too new for them to know. As the automobile market was the largest market in the world, the Enter Larger Markets variable was passed over. So was the Increase Clients by Number variable, since the automobile industry itself, with decentralization, was now effectively a highly fractionated industry and not the purchasing monolith it had been. The full-lining variable was selected with little discussion.

There was nearly unanimous agreement that they wanted nothing to do with a "slave-labor" entry as a "second-line" entry. As for buying up one of the new CAD-CAM companies, they wanted to wait and see how their own CAD-CAM program developed. As for improving their "social image," they were highly critical of the person who suggested the variable.

Effect Minimum Market Penetration. This B-school variable got attention only from Teets, who had picked up the concept at a marketing seminar and

had difficulty explaining it in defending his point allocation. He tried to explain that there was a "share-of-market penetration point" that had to be reached before a firm's size affects its QRC abilities, which would affect margins. But most needed the points elsewhere. The variable was dropped after the second round.

Exploit Full-Lining Potential. This was what they were all waiting for. Adding products and services that could be sold to their present customers had helped firms like Hewlett-Packard to grow year after year. The fabulous success of superstores such as Sam Walton's WalMart and Sam's, with their one-stop shopping, could perhaps be applied in the engineering services business. They could add not only civil and electrical power engineering (which included cogeneration, in which they had already had a good start) but architectural services, land planning, city planning, landscape architecture and environmental engineering services—perhaps even management consulting!

"The list is nearly endless," said Smith in defending his position and his allocation of a humongous 300 points. In the final tally it led all the other complements with 130 points.

OPERATIONS

The supplier clout variable was rejected because the relationship with some of their suppliers was important in securing work, and they had long-standing relationships with them. Although everyone wanted to reduce direct costs, the only way suggested was to convert more paper-and-pencil work to CAD-CAM. The variable was not included because the group was waiting to see how their in-house CAD-CAM group performed. Overhead reduction was a natural, and so was the reduction of downtime. Here again the participants did not have direct knowledge of the possible effects of the CAD-CAM revolution and the actual effect on capital requirements, so reduction of capital costs was not selected as a salient variable.

Customer (Client) Clout. Only Walsh and Henry gave points to this variable, and it was soon dropped from consideration because the other participants did not like the sound of it.

Reduce Overhead. This began as another motherhood-and-apple-pie variable. Who could challenge it? J.T. Smith could and did. Here again, Smith, the CEO, and Jones, the COO, were on opposite sides in the first round. The

CEO held that increased billings would automatically reduce overhead. But the COO and VPF said that it was the *kind* of business that was important. Adding a low volume of electrical engineering (EE) sales, for instance, might not reduce overhead but instead increase it if the company had to absorb the costs of EE marketing, estimating, software, library, and downtime. In contrast, a horizontal acquisition—buying a head-to-head competitor mechanical engineering firm, for example—would probably reduce overhead substantially.

The point score jumped around and the discussion at times was quite heated. In the end, however, the variable lost most of its support as the participants reallocated their point to other, more important variables. It barely survived with 30 points.

Reduce Downtime. This was the only area on which the CEO and COO saw eye-to-eye. Carrying unbillable bodies on the payroll is always a problem for a consulting firm and gets worse as the firms specializes.

There was considerable discussion of why there were two overhead variables. Why was the Reduce Downtime variable not included in Reduce Overhead? The argument was made that it was by far the biggest part of the overhead variable and was very difficult to control; it *had* to be broken out separately.

It was pointed out that careful selection of employees and in some cases cross-training could reduce the downtime problem. Also, salesmen should be told well in advance about the holes in the billable bodies schedule. The variable survived with 70 points as the result of Walsh's application of a massive 300 points in the last round. Downtime was his biggest headache and he didn't need any acquisitions that would give him roomfuls of unbillable bodies.

Overall, the Complements wound up with a score of 450 points out of 1000, leaving 550 for the Supplements, which meant that J.T. Smith probably had more things right with it than wrong.

Strengths (Supplements)

People Variables. All of the people variables made it into the fit chart. Also included was the client fit variable, which was also at least partially people related.

Top Management Fit. This variable gave the CEO and VPE fits. Smith said "I don't care how we make money. It's the bottom line that should matter to all of us."

Walsh responded, "But J.T., that's what you said about the last acquisition that we made. You never even had any of them to dinner!" (The discussion was of a "draftsperson" training school that J.T. Smith had purchased 10 years before and closed down 2 years later with substantial losses and some damage to their reputation.)

Smith answered, "Well, why should I have had them to dinner? Their head guy wore white socks with a business suit and had a *black* handkerchief in the breast pocket of a *black* suit! And they wore point-toed shoes and said 'between you and I'! I couldn't take them to the country club looking and talking like that. I still think it was a good fit. It could have made money. The management was bad, that was all."

But Walsh persisted and was strongly supported by the ExVP and the COO. They asserted that the comfort factor was important in making acquisitions in engineering-related fields. Top management of any potential entry for J.T. Smith should be of a "professional" character in order to communicate and to build teams. In the school acquisition they never met to determine what should be taught, how to teach it, and how to market the graduates. "It was a poor acquisition because the kind of people who run vocational schools are promoters first and instructors second or they don't survive, much less grow," one participant said.

In sum, there was poor *social* fit between J.T. Smith's registered professional engineers and the vocational school managers. This would probably be a problem with any acquisition that J.T. Smith made. The variable drew increasing support in subsequent rounds and wound up in the fourth round as the leading variable with 160 points.

Middle Management Fit. In the opening round, the VPE stated that, in his opinion, J.T. Smith's greatest asset was its carefully built middle management staff. Most of the department heads, like Smith, were in their mid-to-late fifties. Management had made a careful effort to staff up with young engineers with good academic backgrounds, most of whom had been sent back to school for graduate training in engineering administration. Not only where they working, billable professionals, they doubled as supervisors and expediters and had frequent client contact. He felt that their low client turnover was a result of the careful buildup of middle management. Further, they were a source for low-risk manager succession.

In opposition, both Smith and Jones held that it was the department heads who did most of the client contact and project management; middle management simply followed orders and could easily be replaced. They pointed out that the downsizing movement in the automobile industry had concentrated on reductions in middle management and had proved very successful in cutting overhead by getting rid of a lot of deadwood—especially at General Motors.

The EVP and VPF strongly disagreed. It was the corps of competing middle managers that allowed the principals the time to play golf and bring in the business. It was the middle managers that got the jobs out the door. Gradually their view was adopted in subsequent rounds and the Middle Management Fit variable wound up with 140 points.

Staff Skills Fit. There was considerable discussion on where the "profit power" rested at J.T. Smith. At the beginning, all except the COO believed that their greatest strength was in the 400-odd, longtime engineers and draftspersons that had been tried and tested. Jones did not agree. He took the position that present staff skills were unimportant in rating any potential entry. He pointed out that the purpose of the planning meeting was to plan for an expansion. Present staff people and their skills were not important in rating any potential entry or managing it afterward. His argument went as follows:

1. In any horizontal merger (acquiring a competitor), J.T. Smith would also absorb the *target's* staff.
2. In any vertical acquisition (buying a customer such as an architectural design firm), J.T. Smith's staff, in general, would not be useable.
3. In any service extension (a new service sold to their present customers), staff skills would, most likely, be inapplicable.
4. In any geographic market expansion, J.T. Smith would use the target's staff. In addition, if more bodies were needed, they would probably recruit and hire there rather than move people from Detroit, which was expensive. Further, many of their staff in the past had proved highly resistant to relocating.
5. In any free-form extension, the risks were too high to depend on home-office personnel for the success of any entry. It would have to stand on its own.

In opposition, the other participants, each of whom had spent considerable points on the variable, stated that not only was it important to provide second-line engineering managers with opportunities for advancement, but seeding an acquisition with trusted home-office people could also be important. Why? Here is what they said in favor of placing a high value on this variable:

1. It would ensure the quality of engineering work performed.
2. It would ensure truthful reporting of job status.
3. It would yield reliable information on the technical competency of individuals in the acquired organization.
4. It would strengthen the relationship between J.T. Smith's career people and the target's principal customers, preventing the target's key people from splitting off to compete.
5. It would ensure competent succession management in the event of mass defections of the target's staff.

Marketing Fit. There are usually no "salespeople" per se in professional engineering organizations. As at J.T. Smith, the principals do most of the marketing—much of it on the golf course. (Teets' title for many years, rather than VP Marketing, was the euphemistic title "VP for Project Development.") The thrust of the discussion of the variable led to the conclusion that the variable was not important as long as the principals of the target were locked into staying with the new merged entity for sufficient time for J.T. Smith Consultants to develop marketing skills; the variable was dropped.

Customer (Client) Fit. Except for Teets, the VP for Marketing, and Walsh, VP for Engineering, all of the participants spent points on this variable, with Smith leading the pack. Teets, who scored the variable zero in the opening round, came to see what the others saw—that J.T. Smith Consultants should discover what engineering and consulting services other than ME that its current clients bought or might buy in the future. He then scored it 300 points and, along with Walsh, who also went from zero to 300, brought it in at 150 and made it the highest-ranking variable.

Physical Resources. There was very little discussion of the lone variable in this category. Most agreed with the late R. Buckminster Fuller, who had held that *physical* problems were easily solved as compared with the *metaphysical.* Machinery, furniture, and buildings were not important. People were important.

Operations

Only EDP Fit and Synergy survived. Vertical Integration Fit was thrown out; the participants were turned off by the vertical integration mode.

EDP Fit. From Round 1 to Round 4 the point score for this variable doubled. The high score was largely the result of Clarke's 300-point allocation in the final round—up from zero in the first round. Here Clarke was using information from one of his assistants who had hooked up his laptop to the company's mainframe; he had discovered that their CAD and computer-aided manufacture (CAM) jobs were very profitable and had very low personnel turnover. He said, "When you combine these numbers with the prospects for the on-site virtual engineering centers, we must conclude that our EDP capability is one of our prime assets."

There was some good-humored comment that there was collusion between J.T. Smith and Clarke, because even though J.T. had scored the variable zero, he did not take issue with Clarke's 300 points because he was "out of points" by the time he got to that variable. (That is not a valid argument; the monitor should have objected, as this defeats the purpose of the fit chart, which is to weigh one potential entry or field against another. If a participant votes zero points it means that he or she is against it.) As for the variable, the participants felt that they were leaders in the field and had invested substantial funds in both equipment and software, including some developments of their own. They felt that it was one of their top assets, if not their primary one. Although the CAD-CAM skill of top management, middle management, staff, and marketing management had been impounded in those ratings, J.T. Smith's library of proprietary software programs and the very considerable specialized hardware to run it had not.

Synergy. Synergy was a difficult item to handle. The old "two-plus-two equals five" equation was not enough for engineers. The CEO had allocated 200 points to it. He argued that they should not make any entry unless they got some extra benefits from it. His first example was that of merging with another ME firm so that downtime would be reduced, but that was redundant with the downtime reduction variable already treated as a complement. (Double-counting is rate in the WOFC process, but it *can* happen.) The CEO mentioned software utilization, but again, that had already been impounded in the EDP fit variable. Finally, in the last round Synergy was eliminated.

Summary

Based on the Fit Chart Tally sheet alone, it was possible to make a Strategic Statement as follows:

J.T. Smith is looking to complement its weaknesses, first by making an entry that is countercyclical to the automobile industry cycle—a so-called defensive entry. It wants to maintain its present increased billings rate and wishes to enter new, high-grown areas. Further, it wishes to diversify by adding new lines of services that could be marketed to its present customers with the expectation that any such entry would lower overhead and reduce downtime.

J.T. Smith is looking to exploit its strengths by utilizing its top managers who are experts in automation engineering and production planning. They are backed by a highly skilled staff of middle managers seeking opportunities for advancement. J.T. Smith principals believe they have very low client turnover because of their long-tenured staff and believe that they can expand sales to their client base by offering additional engineering-related lines such as electrical engineering (EE) and civil engineering (CE). Finally, their recently developed high-level skills in computer-aided design (including their development of proprietary software and related hardware systems) should result in more business if properly exploited.

Session Five—The Wheel of Opportunity

Each of the participants had submitted candidate opportunity areas for consideration—in some cases they had isolated specific companies as targets. This was particularly true in the area of their specialty, mechanical engineering services provided to automobile manufacturers and their high-volume parts suppliers.

THE MARKET INTENSIFICATION MODE

Horizontal Integration

J.T. Smith's principal competitor, Coleman Engineering, was "available." Its three founder/owners were in their late sixties and early seventies—on average some 14 years older than J.T. Smith's top management. They were looking forward to retirement. Like J.T. Smith, Coleman also was very busy and

currently was making good money. Their principals had explored selling the firm to the employees using an employee stock ownership plan (ESOP) but no one came forward to "honcho" the plan, as most of Coleman's top men were also senior people—about the same age as the principals, and also looking forward to retirement.

Some 50 percent of the target's work was heating, ventilating, and air conditioning (HVAC); it was only 10 percent of Smith's. Coleman had developed one specialty: the design of clean rooms where electronic subassemblies were made in a dust-free atmosphere—this was a growing business, as more and more electronics were added to automobiles. The target's current billings included some "slave labor" contracts where they "rented out" engineers and draftspersons to manufacturers, which provided supervision. Many of those employees were located in cities other than Detroit. The firm was available for a reasonable price with a buyout on the installment plan.

Smith disliked the idea of expanding in the ME area because it wasn't "diversification." However, he acknowledged that Coleman's clean room specialty had worldwide potential and met the diversification criterion. He also observed that "slave labor contracting is unprofessional." But after some discussion, he came to believe that it might be a continuing trend that followed naturally from the downsizing movement and also was a kind of diversification. He also began to give more credence to the rumor that a hotshot West Coast firm was looking at the target in order to expand its own slave labor business. This could threaten Smith's continuum of work if the Big Three went that way and Smith refused to go along.

Market Extension. Automobile manufacture—both parts manufacture and assembly—had been moving out of the Detroit area for many years. New plants, many foreign-owned, were being built on the West Coast and in the Southeast. Smith felt that J.T. Smith should "diversify away from Detroit," which he considered to be a "dead city" in spite of the recent boom, and effect an entry or entries in either the Southeast, in sunny California, or even in South Africa, which he felt, with the death of apartheid, could become a boom area. An entry in China, which is just getting started in the mass production of automobiles, should also be considered. Furthermore, the resurgence of U.S. domestic automobile manufacturing had come as the result of hundreds of innovations that were well-known to J.T. Smith's people. They had eclipsed Japanese and German methodologies. Those skills might be highly marketable in the rest of the world.

Market Intensification Mode (Summary)

Building up billings in the ME field by horizontal integration could be highly profitable. However, as its name implied, it was certainly not "diversification" but its opposite. Although a market extension entry would dilute their tie to the Detroit economy with all of its social problems and was a kind of diversification in that sense, they would still be tied, even with a South African entry, to the automobile cycle, which seemed to run worldwide. However, all recognized that it was by far the least riskiest area of entry for expansion.

THE VERTICAL INTEGRATION MODE

Vertical Backward Integration. J.T. Smith bought the services of other specialized engineering companies, including environmental planning, urban planning, geophysical consulting, surveying, community planning, and architectural design. Of those, environmental planning was tops. It took up to half of J.T. Smith's purchasing dollar, was the company's fastest-growing supplier industry at 20 percent per year, had a large quotient of mechanical engineering in it, and seemed relatively independent of the automobile cycle.

Vertical Forward Integration. J.T. Smith's primary clients were the automobile and automobile parts manufacturers, which absorbed 60 percent of their sales. After that came developers of shopping centers and industrial parks—mostly low-margin HVAC work. Next came turnkey contractors building or modifying plant buildings for automobile parts production and assembly—again, mostly HVAC work. Architectural design firms were the last.

The first three were arbitrarily eliminated. Only moving into architectural services was to be considered.

Vertical Integration Mode (Summary)

While some diversification could result from targeting this mode—for instance, architectural work leads rather than lags the economic cycle—except for environmental planning, growth rates were low, and competition limited profit. Most of the firms were small and they were either very busy or very dead. Further, it was not "diversification" but "intensification." Moving vertically would bind J.T. Smith even more tightly to the automobile industry and its cyclicality and tie the company too closely to the local economy.

THE DIVERSIFICATION MODE

Product (Service) Extension. Adding new services that could be sold to their present clients appealed very much to everyone at J.T. Smith—especially adding electrical engineering (EE). (In most areas of the United States, ME/EE firms were very common, some were very large, and they were consistently profitable.)

In most of the service extension fields shown on the Wheel of Opportunity, J.T. Smith's software could be used or adapted. Exploiting the deterioration of the nation's infrastructure (some estimates of the cost of rebuilding were in the $200–$300 billion range) inferred the addition of civil and sanitary engineering to the company's skills spectrum. However, many believed that the firm's ME skills could be utilized to develop superior road and bridge maintenance and rebuilding methods and equipments. The participants all believed that their skills in project planning and control could be well utilized in highway and bridge rebuilding, although there might be a price to pay in having to deal with government rather than private industry, and J.T. Smith had little experience in marketing to government.

Free-Form Diversification

This was by far the riskiest area of entry. Entering a new geographical territory with a new service had only one benefit: If it failed, the news might not get back to Detroit. Only two entries were proposed: road and bridge engineering in South Africa, which had massive infrastructure problems, and power engineering in China, which had huge and ongoing requirements for electricity. Making a seed entry in these areas was risky, but if a firm could be purchased, they could expand later into automobile-related areas. (Preliminary inquiries had indicated that there were firms for sale in South Africa and in Hong Kong in those selected fields.)

Diversification Mode (Summary)

This area provided the highest change to meet Smith's "diversification" requirement—the concept that got him started on making a long-term strategic plan in the first place. Although expanding in the Detroit area did not appeal to anyone at J.T. Smith, most recognized that it would be relatively easy to

add an EE firm in the Detroit area and *then* go after new geographic markets by acquiring other ME/EE firms by a series of LBOs.

There had been considerable discussion of the difference between a "strategic" entry and an "investment" entry, and the participants agreed that a free-form entry would probably be priced as a stand-alone investment rather than as a strategic entry.

EXHIBIT CASE-1

Schedule for J.T. Smith Strategic Planning Meeting—June 2–4, 2007

Note: Breakfast is at 0700. Sessions start at 0800. Morning and afternoon breaks are at 1000 and 1500, respectively. Lunch breaks are at 1230 each day.

First Day

1800	Reception.
1900	Dinner.
2000	First Session—Orientation.
	Review of Strength and Weaknesses (S&W) sheets and walkthrough of Flow Chart.
2030	Q&A and discussion of S&W sheets and Flow Chart.
2200	Individual study of S&W sheets and Flow Chart.

Second Day

0800	Second Session—Review of S&W sheets.
1015	Third Session—Review of S&Ws continued.
1400	Fourth Session—Conversion of S&Ws to complements and supplements and differential ratings.
1500	Fifth Session—S&W Ratings continued.
1700	Discussion of results of Fit Chart Tally sheet.
1800	Reception.
1900	Dinner.
2000	Individual and group study of Opportunity sheets.

Third Day

0800	Sixth Session—Selection of opportunities.
1015	Seventh Session—Rating opportunities.
1400	Eighth Session—Continue rating opportunities.
1330	Ninth Session—Continue rating. Final totals.

E X H I B I T CASE-2

Company Confidential Author and date JTS 5/20/07
STRENGTH ANALYSIS (FIT CHART SUPPLEMENT)

Every enterprise has its own special strengths—those things that set it apart from others and cause it to remain in business and grow. J.T. Smith is a successful enterprise. However, the industry is changing rapidly. Please describe (using separate sheets) those special strengths that you believe can be exploited for growth and profit in the coming years, breaking it down into short-term—next few years; medium term—next 2–4 years; long-term—next 6–10 years.

Description of strength:
One of our greatest strengths is our client list. We have been doing business with Ford Motor for the past 30 years. We know they are dissatisfied with some of their engineering service vendors—that's the reason they pulled a lot of their work in-house. But now they want to outsource everything they can. (They have hinted that they would like to see us buy out their principal EE services contractor, which is always late and has excessive turnover.) We should use our "installed base" of clients to lead us in the right direction.

Why do you believe this?
I just can't believe that Ford would suggest a buyout of one of their long-term suppliers if we weren't held in high regard there. This would give us a solid EE entry that we could use as a base to expand in other geographical areas and thus get some diversification away from Detroit.

Who are the competitors (if any)?
There are many EE companies, but most of them are small and can't gear up for the big jobs. Further, they don't seem too aggressive as far as technology is concerned. One of our top MEs worked for that Ford supplier and says that their top people are very hide-bound and don't want to change. This is probably the same with the other four EE firms in our immediate market area—they're all running scared and don't want to risk anything on innovation. Even if we did an EE startup without an acquisition, I think we'd prevail.

Give a specific example.
On the Porto job, the EE people were always late. They refused to deal themselves into the PERT program even though it was in their contract that they have to. I believe that if we had our own EE department we could get jobs done faster, cheaper, and better. My perspective is long-term—we should become an ME/EE firm permanently.

How should this be marketed?
All of our top ME people know *something* about EE work, since we have to subcontract a lot of it ourselves—small jobs, admittedly, but remember, we bid them.

Where can J.T. Smith principals read about this? (List and attach any literature, memoranda, news stories, etc.)
We subscribe to most of the EE journals—they're in our library.

Session Comments:

That our clients were our greatest asset was generally agreed to. The only trouble was that it tied us more tightly to Detroit and the automobile business. This was of considerable concern.

E X H I B I T CASE-3

Company Confidential Author and date JTS 5/25/07
WEAKNESS ANALYSIS (FIT CHART COMPLEMENT)

Every enterprise has its own special problems—those things that hold it back from profitable growth. Reality escapes the best of us at times and the recognition of inherent weaknesses is a precondition to profitable growth.

Description of Weakness:

Our greatest weakness is our time to the automobile cycle. We have just been through five good years after seven very bad years. It's not going to change. It seems to be a worldwide phenomenon. It may get worse as the world's economies become more dependent on each other and share the same information.

Why do you believe this?

I've seen it in my paycheck. I've seen our billings at times drop by half. Although the automobile cycle tends to follow the world economic cycle, it usually leads it and lags it and is always higher in amplitude than the economy itself.

Is this weakness industry, company, or management related?

It is industry related. However, management is much to blame, as it spends its good-time profits on management bonuses and finances losers pushed by Wall Street brokers. It seems that the kind of people who can produce good automobiles are the kind of people who have very little long-term trend sensitivity. It's a curse.

Give a specific example.

When, in the mid 1980s, the Japanese voluntarily restricted imports, Chrysler made all kinds of money, which it promptly spent on bonuses and some crazy acquisitions. They should have invested in something countercyclical or simply anticipated the downturn, conserved their cash, and spent money on technical innovation or made capital investments that would allow them to compete with the Japanese and Germans.

How can this weakness be compensated for?

J.T. Smith has to diversify away from automobiles and the Detroit economy. When Times are bad governments spend money on infrastructure improvements. For instance, we should look overseas for growing economies such as those of China, Indonesia, and perhaps even South Africa, now that their apartheid problems have been solved.

Session Comments:

There was general agreement that they all should look for opportunities to diversify at least 50 percent of their billings to nonautomotive work.

E X H I B I T CASE-4

Description of Potential Variables

Following is a list of variables abstracted from the Strength and Weakness Analysis sheets and converted to Complements and Supplements, along with suggested legends to be used on the Fit Chart to identify the variable if and when selected.

COMPLEMENTS

A complement, according to *Webster's New Collegiate Dictionary,* is "the quantity or number required to make a thing complete." Inherent in the WOFC process is the targeting of industries and their component companies, with products or services that will offset or "complement" the weaknesses of the acquiring company.

Cyclical Complements

Weakness: The automobile industry, which supplies 70 percent of our billings, is *cyclical.* It follows the capital spending cycle very closely.
Complement: Enter a countercyclical industry—sometimes called a "defensive" industry—that is drive by the entertainment, retail food, fast food, automobile parts rebuilding, government-stimulated social programs, defense spending industries, etc.
Fit Chart Legend: Countercyclical Entry.

Weakness: Our industry is *seasonal.* The winter months are especially difficult; J.T. Smith must lay off people just as Christmas approaches.
Complement: Enter an industry—that has peak activity in the winter.
Fit Chart Legend: Opposite Season Entry

Weakness: The "product life" of our services seems to be short and we are constantly required to update our in-house knowledge about environmental concerns, new physiological constraints in the workplace, restrictive economic constraints on costs, and new OSHA and local fire and underwriters codes for hundreds of new materials; all these, and many more, are complicating our operations.
Complement: Find an entry in a "commodity-type" or "assembly-line" operation where we can institutionalize design processes.
Fit Chart Legend: Commodity-Type Entry

Weakness: Sales and backlog seem affected by random factors such as weather, political happenings, fads, and fashions in design.
Complement: Increase our involvement with industries affected by random forces and thus decrease the net randomness. This is why insurance companies exist. Do this both by extending our geographic base and by dispersing our services over more industries.
Fit Chart Legend: Effective Dispersive Entries

(continued)

EXHIBIT CASE-4 *(continued)*

Weakness: We are too dependent on three long-time customers—20 percent of our customer base provides 80 percent of our work. Although the jobs are bigger and longer-running, like garbage-raised seagulls who die when the town dump is replaced by an incinerator, we have grown too dependent on our larger clients. Some of our best client-executives are retiring. There is no way we're going to keep those accounts when J.T. retires—and maybe before: We could have serious problems in a year or two. Remember that switching costs for our clients are quite low.
Complement: Make an entry where the average order is smaller and more frequent and can be sold by junior people.
Fit Chart Legend: Reduce Customer Clout or Broaden Client Base.

Entry and Exit Threats
Weakness: We have no major proprietary items. Except for some of our software and a few matching pieces of hardware, J.T. Smith's plans and drawings belong, in general, to the client. While competing defections have been few, we must develop more specialties that defy casual transfer. We must also fear vertical backward competitive entry by our three prime types of customer. ADP, CAD, and other high-tech, computer-aided processes, which can be proprietary, may help us to avoid this threat.
Complement: Raise entry barriers by raising the level of technology and service and continuously lower costs to us and clients.
Fit Chart Legend: Create Entry Barriers

Weakness: We have high barriers to exit. Many of our jobs run over years. Our ongoing task-order contract with Ford Motor Company has low margins and would be hard to end. If we wanted to build up business in the Southeast, for instance, and shut down the Ford contract, which may become only marginally profitable in a year or two, we would have a hell of a time doing it unless we could sell it off to our principal competitor. (The engineering consulting services industry is characterized by noneconomic exit barriers—sons carrying on the family name, the panache of being a *registered* Professional Engineer, and so on.)
Complement: Effect an entry where exit problems are not so pronounced.
Fit Chart Entry: Lower Exit Barriers

Growth Variables
Weakness: We are in a mature industry. This is giving us problems in attracting new employees and keeping the old. While J.T. Smith's profits, according to trade industry figures, have been above average lately, we are investing excess cash flows in things that are foreign to our base business. This has diverted top management's attention away from building our basic business.
Complement: Enter either high-growth (or at least higher-growth) areas: either industries or geographic areas.
Fit Chart Legend: Effect Billings Growth Entry

Weakness: While our profits have been above the norm for our industry, it stems from our long-term relationship with Ford and Chrysler. Further, some areas of professional practice have higher net profit margins than ours, for instance, computer-aided-design (CAD). The higher profit may come because of higher risk. Maintaining our CAD proficiency means substantial continual investment not only in maintaining our equipment but in training. And due to the specialized nature of the personnel, much higher-than-normal downtime *may* result. Both of these factors may affect our profit stream in the future, but the upside potential, long-term, does appear to be great.
Complement: Enter higher-margin, higher-markup, higher-profit areas—either geographic or skill-wise.
Fit Chart Legend: Profit Improvement

Marketing
Weakness: We are in a fragmented industry with low overall entry barriers and very little potential economies of scale. The learning curve has very little slope. Our clients have special industry/area specific needs with only limited transferability to other industries and geographies, and there are few benefits that increases in size alone can wring from our suppliers. And there are some diseconomies of scale; for instance, quick reaction capability (QRC) keeps our clients happy and the net margins up. But, the larger we get, the less quickly we can respond. What we don't know is what the optimum market share should be. (We should not call it the "optimum" market share, but the "minimum" market share to ensure survival and continued growth.)
Complement: Maintain Minimum Market Share. In the J.T. Smith case, it means having at least 400 billable bodies at work that at $110,000 average yields $44 million minimum. We are currently billing about three times that in total. We have about 12 percent of the Detroit market.
Fit Chart Legend: Attain Minimum Market Share or Attain Critical Billing Mass

Weakness: In accordance with classic PIMS (profit impact of marketing strategy) theory, in neither of our markets have we attained sufficient market share to ensure our long-term survival. In other industries, that seems to be at the 35 percent market penetration figure. We don't know whether that statistic applies to us in our industry in the particular geographical areas we serve; we have the additional problems of defining the relevant market and getting usable numbers.
Complement: Attain that market share that will allow us to give our customers maximum service, that will optimize our overhead spreads, and that will not trigger large capital expenditures for either special buildings or equipment or, for that matter, will cause us to move from our present locations.
Fit Chart Legend: Attain Maximum Market Penetration

(continued)

EXHIBIT CASE-4 *(continued)*

Weakness: Although we have some clients that give us work on a noncompetitive basis, we cannot get a premium for it. In other words, we have no "pricing independence" except that our overheads are lower, and thus our net margins higher than the norm for the industry because of a flow of work that we do not have to prepare bids for. Only one or two firms competing in the mechanical engineering field have this advantage. But it may hold true in other fields that we are considering entering due to the nature of the work, the growth rate, the inexperience of the competition, and so on. We should either merge with them and thus compound the advantage or make sure in the event that we make a diversifying entry that either the sector or the target company has a large proportion of such work.
Complement: We should attain a higher percentage of noncompetitive work by differentiating ourselves from the competition, by upping the level of QRC, or by other means yet to be discovered.
Fit Chart Legend: Attain Pricing Independence

Weakness: We are entirely dependent on three classes of clients, generally in the heavy industry area, except for the developers who are mostly in mall development. We need to serve other than such architects, developers, and turnkey contractors. We need more *kinds* of clients. For instance, we have no historical restoration work at all, no alteration work, no modernization work, no plant rebuild work, no bridge rebuild work, no cogeneration work, no playground or recreation work, no golf courses or country clubs, and so on. We need to broaden our client base. (This may imply the opposite of specialization with its supposedly higher net margins.)
Complement: We should try to broaden our client base by entering de novo or by acquiring firms that serve different clients in different markets than we now serve.
Fit Chart Legend: Broaden Client Base

Weakness: The dollar amount of all mechanical engineering consulting work for developers, turnkey contractors, and architectural design firms that we are contracting with is probably not more than $100 million in each area. If we got it all, we would still not be a BIG company. If we could establish ourself in, say, the bridge rehabilitation business, where the market is in the *billions,* we would not suffer this restriction. We could go national or international and have some chance of attaining gross revenues in the $500 million to $1 billion level. In other words, while we're scheming and dreaming, let's dream and scheme BIG.
Complement: We should enter only those markets (either by industry or geography) that are truly big and bigger in absolute size than our present markets.
Fit Chart Legend: Enter Larger Markets

Weakness: Although we have "salespeople" in our offices, they are really only office workers scanning industry reports and building permit applications and

feeding the results to the middle managers, who figure the job and then pass the results to the principals of the firm, who then do the real selling. All of our *real* marketing is personal and done on golf courses and in the better clubs in the city. We do not advertise and we have never laid out a nickel for a public relations campaign. Being tied to such a restricted marketing methodology, although it has been successful so far, may not allow us to survive the retirement or death of our principal partners. If we are to expand by the acquisition route, we should look for firms that get either leads or work by some method other than one-on-one personal contact. (Note that some of our competition have hired public relations firms, have developed traveling exhibits, are writing articles for trade journals, and have junior partners serving on hospital boards and in other public-sector activities. And some are beginning to advertise now that the stigma has gone from this one-time nonprofessional approach to marketing.)
Complement: We must develop marketing methodologies that do not depend on personal social contact and explore entries into sectors that market by methods other than those we presently employ.
Fit Chart Legend: Add Marketing Method

Weakness: In addition to the Big Three, there are only a limited number of developers, architectural design firms, and turnkey contractors in our present market area. We have a very limited client universe and have developed great dependence on those clients. We should try, in our diversification program, to enter activities where the *number* of potential clients is larger.
Complement: Enter industries with a large potential client base.
Fit Chart Legend: Increase Clients by Number

Weakness: Our services are too narrow. Confining ourselves to mechanical engineering services only has some advantages in that, as a "boutique," our clients can more easily focus on our abilities; however, in their attempts to lower their costs of contract negotiation and administration, clients are leaning toward broadening their subcontractors' responsibilities. That this has not yet been sensed by our competition should not deter us from becoming an "engineering conglomerate" or at least a major assembler of engineering services, as there are substantial savings to be realized in marketing, administration, and recruitment.
Complement: Develop a full line of engineering services probably beginning with the addition of electrical engineering services, which in much of the country are combined with mechanical engineering services. Next add civil engineering, foundation engineering, sanitary engineering, and so on. (In the alternative, in the event that such full-lining is too expensive to build due to high prices of target acquisitions, we should consider becoming an assembler or a "bundler" of engineering services—an engineering general contractor.)
Fit Chart Legend: Develop Full-Lining Potential

(continued)

EXHIBIT CASE-4 *(continued)*

Weakness: There are some areas of activity that will not support our overhead structure and that will dilute our image as a top-of-the-line mechanical engineering design outfit. However, other people are making money at it. "Slave-labor" contracting, where design bodies are supplied like Kelly Temporary Services workers on a daily, weekly, or monthly basis, is an example. Although we would not like the name of J.T. Smith to be associated with this kind of activity, we should consider this as a so-called second line. We could start such an outfit de novo or enter by acquisition and not integrate it into our operations, but operate it as a stand-alone. We continuously run into situations where we are asked to supply such services. We can supply these leads to such a service, and from time to time we ourselves need such services but have refrained from using them due to cultural, noneconomic, arbitrary decisions of the firms' founder-owners.
Complement: Create or acquire a "slave-labor" operation and operate it as a stand-alone.
Fit Chart Legend: Make Second-Line Entry

Weakness: The advent of CAD (computer-aided design) might give us some problems. Although we have successfully entered the field, we are encountering some resistance from some of our old-line employees. For many jobs it is much faster and thus bills out at lower cost to the client. This is, in a very real sense, a "functional competitor" to our standard methods of pencil-on-paper design. With new equipment and new software coming out daily we must face up to the fact that some of the smaller firms that compete with us don't have any pencil-on-paper work at all. It could be that they will eventually cut prices and do us in. Rather than sit back and wait for that guillotine, let us target one of the better shops and again, as in the preceding entry on "slave-labor," operate it separately as a stand-alone and feed it some of leads and even some of our regular work that might better be done by CAD.
Complement: Meet potential CAD competition by entering the CAD market with a full-scale entry exclusively engaged in CAD services.
Fit Chart Legend: Effect CAD Entry

Weakness: Due to our association with the automobile companies in Detroit with their years-long resistance to safety, fuel economy, comfort, repairability, and beauty; with the increasing advent of smog-filled cities, ozone problems, the greenhouse effect, acid rain, and other pollution problems; with long lines at the gas pump at times, and huge trade deficits caused by petroleum imports; and with our work for me the oil and petrochemical companies in the Gulf, our image as a benefactor of humanity is deteriorating and we are finding it increasingly difficult to recruit the better engineers. We do know that this was a major reason that the second generation of Smiths refused to join our firm. We should enter—or accelerate or expand our activity if we are presently involved—areas of social responsibility

such as retirement housing, environmental engineering, recreation facilities, and so on—doing more that is identified with the public rather than with the private benefit.
Complement: Make an entry that will enhance our image as a community benefactor.
Fit Chart Legend: Improve Social Image

Regulatory Legal Aspects
Weakness: Our industry, with the exception of the licensing requirements for professional engineer status, is relatively unregulated and has no government subsidy and no government-sanctioned monopolistic benefits such as are granted to public utilities. However, one of the most exciting things to come along in many years was the U.S. government's PURPA regulation (Public Utilities Regulation Policies Act) that forced local public utilities to take power generated by industry in so-called cogeneration projects, usually using waste heat from the process industries. We have had only a peripheral acquaintance with this growing field—generally in the design of heating and air conditioning systems.
Complement: Exploit cogeneration potential.
Fit Chart Legend: Exploit Cogeneration Potential

Weakness: Ours is a fractionated industry with thousands of small shops nationwide. Most are poorly managed. Some are heavily niched, either serving special geographic-dependent needs or having a lock on some very large accounts. But this may be changing. Two forces at work are the advent of CAD and broadband communications that will allow us to transmit designs quickly and inexpensively. With a central storage system that can store millions of proprietary design details that can be recalled any place in the world in minutes, the design of a maharaja's palace can be assembled in Detroit and sent to New Delhi by satellite. CAD is going to allow the concentration of the industry.
Complement: Exploit the concentration potential of our industry.
Fit Chart Legend: Exploit Concentration Potential

Weakness: Unfortunately, we have very little tax shelter available to us out of our operations. But when we are involved in a merger, acquisition, or buyout—especially a highly leveraged buyout—there are a number of ways to shelter income that should be explored. For instance, the very generous tax shelter provisions of the ESOP programs should be explored. And in some cases acquired assets can be "stepped up" and amortized at rates higher than their true economic rate. It should also be noted that the tax attributes of the generation of intellectual properties including Research and Development Partnerships (RDLPs) and tax credits for research have not been explored.
Complement: Exploit tax shelter potential.
Fit Chart Legend: Exploit MAB Tax Shelter Potential

(continued)

EXHIBIT CASE-4 *(continued)*

Weakness: We have only one patent, no technology that can be transferred for money, no trademarks or copyrights, and very little proprietary technology. We should, if we can, target an entry where we can pick up some protections on our potential income streams.
Complement: Target industries that are characterized by the generation of intellectual property rights (IPR).
Fit Chart Legend: Exploit IPR Potential

Weakness: Our headquarters are in heavily unionized Detroit. We have not completely escaped the long arm of the union and came near losing the election last year, thus escaping ongoing problems in recruitment, training, and so on. Today, Chrysler and GM are having major problems in their design groups with contract workers side-by-side with UAW members. We have some people on-site in our virtual engineering centers. We don't want them to be unionized.
Complement: Explore only those entries in those geographic areas where there is no strong tendency to unionize professionals.
Fit Chart Legend: Nonunion Entry

Operations
Weakness: Only 20 percent of our sales are from the resale of subcontracted services. Some services such as environmental planning, our largest purchase sector, are in short supply and jobs and billings have been held up because of it. *Percentage-wise* they make more money than we do. If we grow by horizontal acquisition, say double our present sales, we will probably double our purchases. We have the problems as to whether that will give us more clout on our suppliers because we're buying more, or less clout because their services are in more demand than ever. The other factor is that in some cases, where we must bid on a job, the premiums that we must pay because of high subcontractor costs have lost us the job.
Complement: We must lower our price dependence on our subcontractors.
Fit Chart Legend: Develop Supplier Clout

Weakness: We have very little clout with our customers except that we are the archivists for their designs, but they may call for them at will. The fact that we are local and they are, in general, multiplant, multinational, or multiarea operators gives us very little clout—only the social clout of the principal partners is important. With the present movement in the world, and especially in the United States in this deconglomerating age, toward decentralization, we still have trouble in getting a job in Winston-Salem, North Carolina, to be run out of Detroit—the Winston-Salem operators want local talent on the job. But that talent is often expensive because it is inexperienced and does not have the CAD-supported data bank that we believe will be

important in the future. Further, we should gain clout by emphasizing our skills in what used to be called "supervision" but that is now, because of liability, called "inspection." Such services not only tie the clients to us by making the more dependent on us, but are also very profitable, and we should be able to cash in on industry's movement toward the reduction of in-house supervisory services and the purchase of "inspection" services.
Complement: Develop more services that will cause our clients to increasingly depend on us.
Fit Chart Legend: Develop Client Clout

Weakness: We seem to be locked into an invariate operating cost structure because draftspersons are hard to find and get increasing rates of pay. Scale economies are hard to develop and the slope of our learning curve is not very steep. However, CAD may change all that. The ratio of one professional to five draftspersons is reduced to one to three where CAD had been introduced, and is heading downward. Today, CAD content can run from 20 percent to 80 percent, averages about 40 percent, but has been growing about 10 percent per year. In five years it will *average* 80 percent. Thus we will unlock the structure and will substantially reduce our costs and get the job out the door faster.
Complement: Develop our CAD skills and resources to reduce operating costs.
Fit Chart Legend: Reduce Direct Costs

Weakness: Reduction of direct costs is important, but it is overhead—usually in the form of fixed costs such as rent—that affects the bottom line and that, in hard time, is the primary reason for engineering business failures. We must learn to operate lean and mean *and* learn how to reduce our indirect costs by expansion of our present activities. One of the best ways of doing this is vertical and horizontal integration and full-lining. That is the way the competition is going not only in Detroit but all over the country.
Complement: Use the merger/acquisition process to reduce overhead.
Fit Chart Legend: Reduce Overhead

Weakness: Downtime (that is, unbilled bodies) is the curse of the consulting business. Although such charges usually go directly to overhead accounts, because they are so important in our business they are listed separately. (The participants are warned not to double-count.) Downtime seems to decrease as the number of billable bodies goes up, so the reductions in staff that we anticipate from CAD may exacerbate the problem. Probably horizontal merger is the best way to go to reduce downtime. Market extension entries, although not as sensitive to downtime reduction as are pure horizontal mergers, still can be effective absorbers of downtime bodies provided that the job is sufficiently priced to pay for the transportation and maintenance. We should also have a carefully contrived program to absorb downtime in our CAD training program.

(continued)

EXHIBIT CASE-4 *(continued)*

Complement: Reduce downtime by emphasizing the Market Intensification Mode.
Fit Chart Legend: Reduce Downtime

Weakness: One of the problems in any program of expansion is the capital it takes to finance it. In our business, the marginal, incremental capital cost to add one more dollar of sales is about 11 percent for working capital and 13 percent for fixed capital. (The working capital number has been constant for many years but the fixed capital number is double the historical number because of the CAD revolution, which requires very expensive machinery and training that has to be capitalized.) Although the numbers are hard to come by, some of our newer personnel claim that our numbers are higher than the competition. Others are not so sure. An educated guess says that the incremental capital cost is a function of size and that the bigger the operation the lower the incremental capital cost due to more rigid billing and collection procedures and more economical purchasing.
Complement: Reduce the marginal, incremental capital costs to add sales dollars.
Fit Chart Legend: Reduce Capital Costs

SUPPLEMENTS*

Strength: We have highly skilled people at the top, both at board level and as managers. Six have taken advanced degrees in "engineering management" with a heavy accent on human relations—rare in this industry. With the exception of the comptroller, all are registered professional engineers. Their experience, without exception, is in engineering-related enterprise. It is a general feeling that our top management is underutilized, that these managers can do considerably more with their talents.
Supplement: We should learn how to exploit our top management skills. But we should ensure that the deal involves something our managers *want* to do and are good at.
Fit Chart Legend: Top Management Fit

* A supplement is, according to *Webster's New Collegiate Dictionary*'s first definition, "something that completes or makes an addition [to]." In the WOFC process, this word describes the action that must be taken to exploit basic strengths. Just as a "dietary supplement" adds to the strength and well-being of a person, so, in the merger/acquisition area, any entry move must supplement the basic strengths of the organization. As might be expected, people-strengths are by far the most important, and they are treated first. (Please note that excess resources or underutilized resources fit better into the *complement* side of the fit chart because there is something wrong with an operation that has excess machinery, equipment, property, and so on. However, experience has shown a very strong tendency to classify as a strength of *supplement* any underutilized resource. In the long run, it does not matter which side it is entered in so long as the participants understand the variable for what it is.)

Strength: We have a highly skilled, dependable group of middle managers who double as both line (billable bodies) and staff (administrators). Some have spent their entire working lives here. We must ask and answer this question: How important is it that we enter a field of endeavor where their skills and knowledges can be utilized?
Supplement: Learn to exploit our middle management skills.
Fit Chart Legend: Middle Management Fit

Strength: We have a large staff of draftspersons who are, in general, familiar with our work. Some are in school getting their engineering degrees. We must ask and answer the question: How important is it that we enter a field where their skills can be utilized?
Supplement: Learn to exploit our staff skills.
Fit Chart Legend: Staff Skills Fit

Strength: We have a small staff of white-collar people including librarians, bookkeepers, secretaries, and typists, and some blue-collar janitorial and service people. We must ask and answer the question: How important is it that we enter a field of endeavor where their skill can be utilized?
Supplement: Learn to exploit our white-collar and blue-collar skills.
Fit Chart Legend: Staff Skills Fit

Strength: We have an experienced group of "project development" people who really function as "salespeople," although that word is taboo in the solicitation of professional engineering services. They scan Dodge Reports, building permits, and the like for leads, write them up, and then point the partner principals toward the power that will award the job. The partners do the closing. We must ask the question: How important is it to utilize our present staff of "project development" people in any expansion move?
Supplement: Utilize project development staff.
Fit Chart Legend: Salespeople Fit

Strength: Our customers made us what we are; they pay out rent, educate our children, and put food on our table. To ignore their wants and needs is to ignore our very existence. Friction and a modicum of stress are natural components of an economic relationship that has profit as its goal. Old friends are the best because they have learned to cross-nurture and to communicate. And good communications are the stuff of which profitable relationships are made. One of our greatest strengths is our client lists. It seems logical that we would first find out what services our present customers are buying or want to buy before chasing rainbows looking for the legendary pot of gold at the end.
Supplement: Exploit our present client relationships by entering those areas that synchronize with their needs.
Fit Chart Legend: Customer (Client) Fit

(continued)

EXHIBIT CASE-4 *(concluded)*

Physical Resources Fit
Strength: We have excellent facilities in Detroit (we own our Detroit headquarters). With the contemplated reduction in staff brought about by CAD, we should have ample room to expand in additional areas of engineering activities at minimal expense. How important is it that we enter a field where we can utilize this resource?
Supplement: Utilize our present physical plant.
Fit Chart Legend: Workplace Fit

Operations Fit
Strength: We are constantly doing work for some of our subcontractors and some of our clients become subcontractors from time to time. We "borrow" people from each other as we "assemble" a job. So we have a kind of de facto vertical integration. The first question to be asked is this: Can we wring more profit out of the marketplace if we actually merged operations—or at least the major ones? And the second question is: Where is the profit vertically in our industry?
Supplement: Will our operations improve if we integrate vertically?
Fit Chart Legend: Vertical Integration Fit

Strength: Our computer installation is becoming more important each day as our electronic data processing system is expanded to interface and interact with our CAD system. We must answer the question: How important is it that we utilize the machinery, equipment, personnel, software, and communications links that we have developed in any entry?
Supplement: Utilize our present EDP complex
Fit Chart Legend: EDP Fit

Strength: We have a high level of intelligence in the organization and have been exposed to hundreds of different environments all over the world, even though we are based in Detroit. This exposure and experience has to be of some value. We must look for synergistic situations where 2 + 2 = 5.
Supplement: Exploit synergistic potential.
Fit Chart Legend: Synergy

Many more variables were written up in the laundry list of fit chart variables that appeared in the Fall 1977 issue of *Mergers and Acquisitions.* They include factors such as scale, industrial relations, financing considerations, budgeting, and many different kinds of information flows. However, these concerns have been distributed out to the variables discussed above or have been arbitrarily dismissed as inapplicable or only remotely applicable to this J.T. Smith case study.

E X H I B I T CASE-5

Company Confidential Author and date T.J. 6/1/07

OPPORTUNITY DESCRIPTION

Description

Coleman Engineers, Ltd., might be for sale at a reasonable price. I spoke to Steve Coleman and he said that their attempt at an ESOP had failed. Their backlog is way up and they're billing about $12 billion a month. Their clean room work is up a good 100 percent and their "slave labor" work has about doubled. He thinks that kind of outsourcing is a permanent change in the way that the Big Three do business. There are a few problems, however—the unions. Wants a long-term payout. Will stay one year.

Customers

Their clients are the same as ours with a heavier emphasis on services sold to foreign companies establishing plants in the United States. They tried to establish in-plant service centers but their computer expertise is much lower than ours and they had communications problems. He hinted that they were talking to a West Coast outfit. It's probably true.

Suppliers

He buys the same kind of services that we do and uses the same sources. Does not want to "diversify"; just wants to retire and play golf. Believes that buying suppliers is a bad idea. "They don't make any money because their backlog is so spotty."

Competitors

We're their biggest competitor for ME work. He feels that our growing sophistication in CAD could be a threat to their future. He feels that a merger of the two firms would be welcomed by everyone at Coleman and wondered if "Coleman-Smith Engineering" would be a good trade name. I told him I thought it sounded great.

What are the principal technical journals?

The same as ours. However, many more HVAC materials and few automation materials.

Why do you believe this is a good fit?

HVAC will always be good. If we can go in-plant with virtual engineering centers in HVAC we should be able to work anywhere in the world. The clean room business is high-tech and bound to grow. Again, this movement is worldwide. It does bind us more tightly to the Detroit economy, but it may help us move out globally. I just think that we can double our billing base and increase profits because of less downtime and overhead.

Candidates

N.A.

Sessions comments

A good move if the price is right and the potential for world business is there.

EXHIBIT CASE-6

Instant Delphi Tally Sheet for Fit Chart

	Complements								
	Cycle Res.	Bill-ings Growth	Profit Improve-ment	Min. Mkt. Share	Full-Lin'g Pot'l	Cust-omer Clout	Reduce Over-head	Reduce Down-time	Sub-total
ROUND 1:									
J.T. Smith, CHRM & CEO	0	0	100	0	300	0	0	100	500
Tom Jones, Pres. & COO	200	200	100	0	0	0	100	100	700
H. Miller, Ex. VP	150	150	100	0	0	0	0	0	400
H. Teets, VP Marketing	100	100	100	200	200	0	0	0	700
W. Clarke, VP Finance	0	100	100	0	0	0	100	100	400
J. Walsh, VP Eng'g	0	50	100	0	0	50	80	70	350
Carole Henry, Comptroller	100	100	100	0	200	90	0	0	590
Total	550	700	700	200	700	140	280	370	3640
Average	79	100	100	100	100	29	40	53	520
ROUND 2:									
Bill Smith, CHRM & CEO	0	70	30	0	300	0	0	100	500
Tom Jones, Pres. & CEO	200	200	0	0	0	0	100	100	600
H. Miller, Ex. VP	150	150	0	0	100	0	0	0	400
H. Teets, VP Marketing	100	100	0	200	300	0	0	0	700
W. Clarke, VP Finance	0	100	110	10	0	0	100	80	400
J. Walsh, VP Eng'g	10	50	0	0	0	0	140	150	350
Carole Henry, Comptroller	100	100	0	0	70	70	80	60	480
Total	560	770	140	210	770	70	420	490	3430
Average	80	110	20	30	110	10	60	70	490
ROUND 3:									
Bill Smith, CHRM & CEO	80	100	X	X	300	X	0	0	480
Tom Jones, Pres. & COO	200	240	X	X	100	X	100	0	640
H. Miller, Ex. VP	150	200	X	X	100	X	100	0	550
H. Teets, VP Marketing	100	100	X	X	300	X	0	0	500
W. Clarke, VP Finance	0	200	X	X	40	X	200	100	540
J. Walsh, VP Eng'g	0	0	X	X	0	X	90	200	290
Carole Henry, Comptroller	100	0	X	X	0	X	0	190	290
Total	630	840	X	X	840	X	490	490	3290
Average	90	120	X	X	120	X	70	70	470
ROUND 4:									
Bill Smith, CHRM & CEO	100	200	X	X	300	X	0	0	600
Tom Jones, Pres. & COO	200	200	X	X	100	X	0	0	500
H. Miller, Ex. VP	150	200	X	X	100	X	10	40	500
H. Teets, VP Marketing	100	40	X	X	300	X	0	0	440
W. Clarke, VP Finance	50	200	X	X	0	X	200	100	550
J. Walsh, VP Eng'g	0	0	X	X	10	X	0	300	310
Carole Henry, Comptroller	100	0	X	X	100	X	0	50	250
Total	700	840	X	X	910	X	210	490	3150
Average	100	120	X	X	130	X	30	70	450

Supplements

Top Mg't Fit	Mid. Mg't Fit	Staff Skills Fit	Market-ing Fit	Client Fit	EDP Fit	Syn-ergy	Sub-total	Effic-iency	Rank Order
0	0	100	0	200	0	200	500	1000	—
100	0	0	0	100	100	0	300	1000	—
200	100	100	0	50	50	0	600	1000	—
0	0	110	90	0	0	100	300	1000	—
0	100	180	0	200	0	120	600	1000	—
300	150	100	50	0	50	0	650	1000	—
100	0	110	0	150	50	0	410	1000	—
700	350	700	140	700	350	420	3360	7000	—
100	50	100	20	100	50	60	480	1000	—
0	0	100	X	200	0	200	500	1000	—
300	100	0	X	0	0	0	400	1000	—
200	150	100	X	100	50	0	600	1000	—
0	0	0	X	300	0	0	300	1000	—
0	0	110	X	40	300	150	600	1000	—
300	200	0	X	100	50	0	650	1000	—
40	250	40	X	100	90	0	520	1000	—
840	700	350	X	840	490	350	3570	7000	
120	100	50	X	120	70	50	510	1000	—
100	0	0	X	200	20	200	520	1000	—
300	60	0	X	0	0	0	360	1000	—
200	200	40	X	10	0	0	450	1000	—
0	200	0	X	300	0	0	500	1000	—
10	0	0	X	0	300	150	460	1000	—
200	10	100	X	300	100	0	710	1000	—
100	360	0	X	100	140	10	710	1000	—
910	830	140	X	910	560	360	3710	7000	—
130	119	20	X	130	80	51	530	1000	—
300	30	X	X	70	0	X	400	1000	—
300	200	X	X	0	0	X	500	1000	—
200	210	X	X	0	90	X	500	1000	—
0	200	X	X	300	60	X	560	1000	—
20	0	X	X	130	300	X	450	1000	—
200	40	X	X	300	150	X	690	1000	—
100	300	X	X	250	100	X	750	1000	—
1120	980	X	X	1050	700	X	3850	7000	—
160	140	X	X	150	100	X	550	1000	—

EXHIBIT CASE-7

Fit Chart: J. T. Smith Consultants

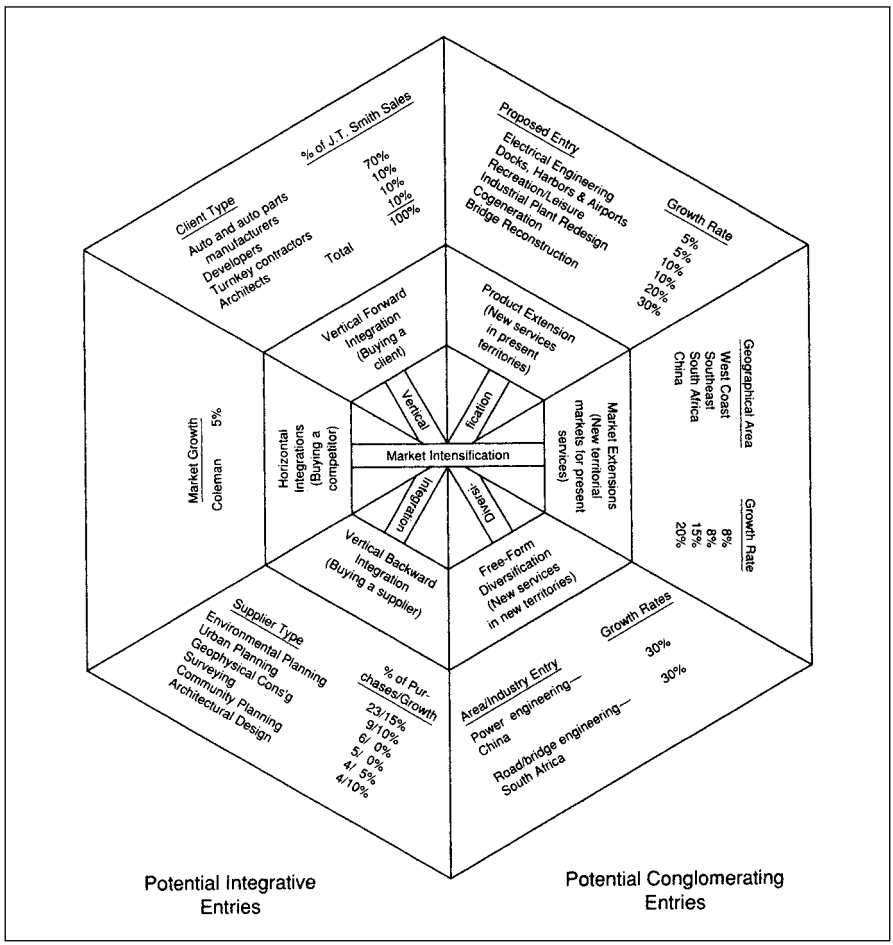
[Growth Rates in Brackets]	Cycle Res.	Bill-ings Growth	Profit Improve-ment	Min. Mkt. Share	Full-Lin'g Pot'l	Cust-omer Clout	Reduce Over-head	Reduce Down-time	Sub-total
	Complements								
COLUMN NUMBER	**1**	**2**	**4**	**5**	**6**	**7**	**8**	**9**	
1st approximation	79	100	100	29	100	20	40	53	520
2nd approximation	80	110	20	30	110	10	60	70	490
3rd approximation	90	120	X	X	120	X	70	70	470
Final (4th approximation)	100	120	X	X	130	X	30	70	450
HORIZONTAL INTEGRATION									
Coleman, Detroit	60	120	X	X	40	X	30	70	320
MARKET EXTENSION									
West Coast [8%]	0	40	X	X	30	X	10	30	110
Southeast [8%]	80	80	X	X	30	X	10	30	230
South Africa	80	120	X	X	0	X	0	0	200
China [20%]	100	120	X	X	0	X	0	0	220
SUBTOTAL MARKET INTENSIFICATION MODE									
VERTICAL BACKWARD INTEGRATION									
Environmental planning [15%]	40	40	X	X	0	X	10	10	100
Urban planning [10%]	40	40	X	X	0	X	10	10	100
Geophysical consulting [0%]	0	0	X	X	0	X	0	0	0
Surveying [0%]	0	0	X	X	30	X	20	0	50
Community planning [5%]	40	40	X	X	0	X	10	20	110
Architectural design [10%]	0	0	X	X	130	X	30	70	230
VERTICAL FORWARD INTEGRATION									
Auto and Auto Parts Mfg. [5%]	0	0	X	X	0	X	0	0	0
Architectural design svcs [8%]	0	0	X	X	130	X	30	70	230
Turnkey contractors [5%]	0	0	X	X	0	X	0	0	0
Developers [0%]	0	0	X	X	0	X	0	0	0
SUBTOTAL VERTICAL INTEGRATION MODE									
PRODUCT OR SERVICE EXTENSION									
Electrical engineering [5%]	0	0	X	X	130	X	30	70	230
Docks, harbors, and airports [5%]	60	0	X	X	60	X	20	60	200
Recreation/leisure [10%]	40	40	X	X	0	X	20	40	140
Industrial plant redesign [15%]	40	30	X	X	60	X	30	70	230
Power engineering [20%]	40	60	X	X	130	X	10	50	350
Bridge/Reconstruction [30%]	100	120	X	X	60	X	20	40	300
FREE-FORM EXTENSION									
Power engineering—China	50	120	X	X	60	X	0	0	230
Road/bridge engineering—South Africa	100	120	X	X	60	X	0	0	280
SUBTOTAL DIVERSIFICATION MODE									

Supplements

Top Mg't Fit	Mid. Mg't Fit	Staff Skills Fit	Market-ing Fit	Client Fit	EDP Fit	Syn-ergy	Sub-total	Effic-iency	Rank Order
10	11	12	13	14	15	16	17	18	19
100	50	100	20	100	50	60	480	1000	—
120	100	50	0	120	70	50	510	1000	—
130	119	20	X	130	80	51	530	1000	—
160	140	X	X	150	100	X	550	1000	—
160	140	X	X	150	100	X	550	870	1
160	70	X	X	0	50	X	280	390	
100	70	X	X	0	50	X	220	450	
40	0	X	X	0	50	X	90	290	
40	0	X	X	0	50	X	90	310	
								Average: 480	
40	35	X	X	50	50	X	175	275	
40	35	X	X	50	50	X	175	275	
0	0	X	X	0	50	X	50	50	
80	35	X	X	100	50	X	265	315	
40	35	X	X	50	50	X	175	285	
120	70	X	X	100	100	X	390	620	3
0	0	X	X	0	0	X	0	0	
120	35	X	X	100	100	X	355	585	4
100	70	X	X	50	100	X	320	320	
100	35	X	X	50	100	X	285	285	
								Average: 334	
100	70	X	X	150	100	X	420	650	2
150	70	X	X	25	100	X	345	545	
100	70	X	X	50	100	X	320	460	
50	105	X	X	50	100	X	305	535	
50	70	X	X	0	100	X	220	570	5
50	70	X	X	0	100	X	220	520	
80	70	X	X	0	100	X	250	530	
80	70	X	X	0	50	X	200	480	

EXHIBIT CASE-8

A Wheel of Opportunity for J. T. Smith Consultants



Landmark and Recent M&A Legal Cases

The M&A field is rich with opportunity, but it also carries considerable legal risk. Any merger transaction can be second-guessed by plaintiffs. Indeed, one-fourth of all D&O liability insurance payouts happen because plaintiffs challenge the legality of some aspect of a merger or acquisition.[1] In the United States, these challenges hinge on state law, federal law, or common law made through judicial decisions.

This section highlights significant cases from the U.S. Supreme Court as well as state, federal, and chancery (business) courts in the United States—especially the state of Delaware, which hosts a dominant percentage of large U.S. public companies.

Organized by topic, each section begins with one or more landmark cases from the last century, followed by one or more recent ones (from 2000 and beyond). Landmark cases are reprinted (with any necessary updates) from previous books in the Art of M&A series.[2] Delaware cases from 2005 and 2006 are provided by the law firm of Morris, James, Hitchens & Williams LLP, Wilmington, Delaware.[3]

Taken together, the landmark and recent cases make an important point. While the fundamental concepts of justice and jurisprudence never change, their judicial interpretation does evolve over time as new situations are seen through new perspectives.

I. Cases Alleging Impropriety in a Merger or in The Acquisition of a Business or Controlling Shares

Landmark Cases
Recent Cases (2000 to present)

II. Cases Alleging Impropriety in the Valuation and/or Sale of a Business, Assets, or Controlling Shares

Landmark Cases
Recent Cases

III. Cases Involving M&A Agreements or Other Contracts

Landmark Cases
Recent Cases

IV. Cases Alleging Violation of Antitrust Laws

Landmark Cases
Recent Cases

V. Cases Alleging Violations of Health, Safety, and Labor Laws

Landmark Cases
Recent Cases

VI. Cases Dealing with Jurisdiction or Right to Sue Following a Merger

Landmark Cases
Recent Cases

VII. ADDITIONAL RECENT CASES

Recent Cases Involving Payment of Fees For M&A
Recent Cases Alleging Violation of Tax Law
Recent Cases Involving Insolvent Companies
Recent Cases Involving International Transactions

I. Cases Alleging Impropriety in a Merger or in the Acquisition of a Business or Controlling Shares[4]

Landmark cases

Ernst & Ernst v. Hochfelder 425 U.S. 185, 208 (1975). *Mere negligence does not imply manipulation.*

Hochfelder was a customer of First Securities Company. The president of the company, Nay, convinced Hochfelder to invest funds in escrow accounts that would yield a high rate of return. Nay asked Hochfelder to write out checks in Nay's name. When Nay committed suicide, Hochfelder learned that there were no escrow accounts—not even phony ones. Nay's suicide note itself described First Securities as bankrupt, and the escrow accounts as "spurious."

Hochfelder filed suit in district court for damages against Ernst & Ernst under Section 10(b) of the Securities Exchange Act of 1934, charging that Ernst & Ernst had aided and abetted Nay by failing to conduct proper audits. The district court dismissed the case on the grounds that Ernst & Ernst's accounting procedures conformed to those in general use. The U.S. Court of Appeals reversed this decision, holding Ernst & Ernst liable for a breach of fiduciary duty of inquiry and disclosure under common law and statutory law.

The U.S. Supreme Court disagreed. It held that mere negligence was not a "manipulative device," and therefore not a violation of Section 10(b) and good faith was indeed a valid defense. Furthermore, the Court held that a private right of action is not possible under Section 10(b) or Rule 10b-5, unless there is an intent to deceive, manipulate, or defraud (scienter).

Escott v. BarChris Construction. Co., 283 F. Supp. 643 (S.D.N.Y. 1968). *It is not reasonable to rely on management for key data. Data must be double-checked through an independent investigation. Even outside directors must ask for reasonable assurances that facts are correct.*

When BarChris Construction company, a bowling alley builder, went bankrupt, bondholders accused its directors and officers of violating Section 11 of making material misstatements and omissions in their registration statement. They sued the auditors, the underwriters, and all those who had signed the statement—namely the company's directors, including five officers and the company's controller.

The court found auditing firm liable for not following generally accepted accounting principles. It also found the underwriter liable for failing to prevent the material misstatements. The court asked, "Is it sufficient to ask

questions, to obtain answers which, if true, would be thought satisfactory, and let it go at that, without seeking to ascertain from the records whether the answers, in fact, are true and accurate?" Its answer: "The Purpose of Section 11 is to protect investors. To that end, the underwriters are made responsible for the truth of the prospectus. If they may escape that responsibility by taking at face value representations made to them by management, then the underwriters among those liable under Section 11 affords the investors no additional protection."

Citing Section 11, the court found that there were misstatements and omissions in both the expert and nonexpert portions of the registration statement. It held the inside directors and financial officers responsible for the expert portions, declaring, "There is nothing to show that they made any investigation of anything which they may not have known about or understood. They have not proved their due diligence defenses." Furthermore, the court held the outside directors liable for the nonexpert portions. Directors showed different degrees of diligence, none high enough. One director, Coleman, who had been an investor banker for the company earlier, had checked with the company's lenders and Dun & Bradstreet, read extensive documents, and interviewed the underwriter. Once he became a director, though, he began to rely on others, including a junior associate from the company's outside law firm. "When it came to verification," said the court, "he relied upon his counsel to do it for him. Since counsel failed to do it, Coleman is bound by that failure."

Feit v. Leasco Data Processing Corp., 332 F. Supp. 544 (E.D.N.Y. 1971). *Directors must conduct an adequate investigation of an acquisition candidate.*

In 1968, Leasco Data Processing Equipment Corporation began negotiations to acquire Reliance Insurance Company. Leasco was particularly attracted to Reliance's "surplus surplus," the portion of surplus beyond what is required by law to maintain the integrity of an insurance operation. Because insurance companies at that time were not permitted to engaged in noninsurance business, the surplus surplus (as a highly liquid asset) had to be separated from the insurance operation. Leasco intended to form a parent holding company and to transfer the surplus surplus to it.

After some initial disagreements between the two managements, Leasco obtained 90 percent of Reliance in a tender offer. None of the various prospectuses (a supplement was issued each time the tender exchange period was extended) made any mention of the Reliance surplus surplus, an amount estimated by experts to have been between $100 and $125 million. Feit, a Reliance stockholder, brought a lawsuit to recover damages. The lawsuit centered on (1) the materiality of the surplus surplus question to the Leasco

prospectus sent to holders of Reliance stock, and (2) the accountability of Leasco's directors for the decision to include no mention of the surplus surplus in the prospectuses.

The defendants contended that they were unable to get a good estimate of Reliance's surplus surplus because of poor relations with Reliance's management. They further argued that, in any case, an estimate of the surplus surplus in the prospectuses would have only made Reliance shareholders more eager to tender, since Leasco was known to be aggressive in employing liquid assets. Finally, they asserted, this kind of information could have violated SEC standards for prospectuses and turned this one into a "selling document."

The court rendered a decision in favor of the plaintiff Feit, according him monetary damages. Relying on the due diligence portions of *Escott v. BarChris* (1968), the court held that the director defendants "failed to fulfill their duty of reasonable investigation . . . and had no reasonable grounds to believe that an omission of an estimate of surplus surplus was not materially misleading." This case showed, said one expert, that officers and inside directors "are highly unlikely ever to sustain a due diligence defense."[5]

Koppers Co. v. American Express Co., 689 F. Supp. 1371 (W.D. Pa. 1988). *Companies do not have a duty to disclose all information, merely all* material *information.*

Koppers Co., Inc., brought an action against American Express, Shearson Lehman Brothers, and others seeking to enjoin the parties' hostile tender offer based upon Kopper's allegations that the tender offer violated federal securities laws (more specifically, certain disclosure requirements). American Express and the other defendants requested a preliminary injunction ordering Koppers to correct allegedly misleading statements regarding the tender offer.

The U.S. District Court in the Western District of Pennsylvania went to great lengths in the opinion to state that the case was difficult, the facts were intricate and complicated, and the law was unclear. The court stated that it will not hesitate to enjoin a tender offer until compliance with securities laws can be determined. Citing the purpose and intent of Congress in enacting the various securities laws and regulations, the Court also concluded that "it is more prudent to err on the side of disclosure than obfuscation."

But the court also noted that The Williams Act (of 1968, regarding tender offers) does not require that a tender offer disclose all information that it possesses about itself or the target company. Rather, it is only required to disclose those material objective factual matters that a reasonable stockholder would consider important in deciding whether to tender shares.

Laven v. Flanagan, 695 F. Supp. 800 (D.N.J. 1989). *Outside directors have a "lesser obligation to conduct a painstaking investigation than an inside director with intimate knowledge of the corporation."*[6]

Plaintiffs alleged that directors had approved a flawed registration statement without enough diligence. The court however found that the directors had made a reasonable effort to verify the facts alleged in the statement. This case is one of several cases finding that "what constitutes a reasonable investigation is measured largely by the common practices in the industry: i.e., one looks at the standards that have evolved among lawyers, accountants, and investment bankers generally in doing due diligence."[7] The directors' activities in this case, for example, showed more diligence than the passive and total reliance on company management that defeated the due diligence defense in the landmark case of *Escott v. BarChris Construction Corp.*

Software Toolworks Sec. Lit., 50 F.3d 615 (9 Cir. 1994). *Keeping records of due diligence investigations can support a due diligence defense.*

The court stated that suspicious facts or transactions require inquiry, and offered a list of red flags that should raise suspicion in a reasonable person.[8] The court awarded a summary judgment to the underwriter after the underwriter provided extensive records showing its due diligence investigations.[9] William F. Alderman and John Kanberg of Orrick, Herrington, & Sutcliffe, San Francisco, were friends of the court in this case, representing the Securities Industry Association.

Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985). *The protections of the business judgment rule are available only when directors show a certain level of due care.*

Shareholders brought a class action against the board of directors of Trans-Union Corporation alleging that the board was grossly negligent in its duty of care to the shareholders for recommending that the shareholders approve a merger agreement at $55 per share. Although the price per share was well above current market values, shareholders alleged that it was inadequate. The Delaware Court of Chancery granted the directors summary judgment and the shareholders appealed. The Delaware Supreme Court indicated that it would closely scrutinize the process by which the board's decision was made.

Historically, courts would not substitute their judgment for that of a corporate board; however, this case eroded that principle and the court embarked down a road of increasing judicial scrutiny of business decisions. The court struck down the long-accepted practice of affording corporate directors the presumption that, in making business decisions, the directors

acted on an informed basis, in good faith, and in the best interests of the company and shareholders. The court held that the determination of whether the business judgment of a board of directors is informed turns on whether directors have informed themselves, prior to making business decisions, of all material information reasonably available to them. The court went on to say that, under the business judgment rule, there is no protection for directors who have made uninformed or unadvised judgments.

Recent cases

Certainteed Corp. v. Celotex Corp., 2005 WL 217032 (Del. Ch. Jan. 24, 2005). *Court of Chancery holds claims accrue upon receipt of inquiry notice of wrongful act.*

The plaintiff entered into an asset purchase agreement (APA) with defendant. The defendant had assumed indemnification obligations relating to the assets sold. After the sale, plaintiff experienced various losses that it believed fell to the defendant to cover. This suit then ensued. The plaintiff brought a breach of contract action against defendant sellers under their asset purchase agreement for indemnification of losses and other related claims. The court dismissed some on account of late disclosures and the lateness of the complaint itself. However, it did accept environmental remediation–work claims as well as a products liability claim involving third-party indemnification based on the plaintiff's injuries incurred as a result of defendant's sale of defective materials prior to the APA.

Delaware Open MRI Radiology Associates, P.A. v. Kessler, C.A. 2006 LEXIS 84 (Del. Ch. Apr. 26, 2006). *Court of Chancery finds remedy for breach of fiduciary duty identical to appraisal award.*

This case was described by Vice Chancellor Strine as "another progeny of one of our law's hybrid varietals: the combined appraisal and entire fairness action." The court was tasked with determining whether the share price in a squeeze-out merger was fair, and, if not, what the extent of the underpayment to the minority shareholders was. The court found that the merger price was unfair, and finding no difference between the award the petitioners/plaintiffs would receive in appraisal or in equity, the court awarded an amount equivalent to petitioners' pro rata share of the company's appraisal value on the date of the merger.

Finkelstein v. Liberty Digital, Inc., 2005 WL 1074364 (Del. Ch. April 25, 2005). *Court of Chancery decides atypical appraisal proceeding in which parties had stipulated to all but one asset of merging company.*

This appraisal case involved the fair value of shares of a company, Liberty Digital, Inc., that was merged with an acquisition subsidiary of Liberty Media Corporation and survived the merger as a wholly owned subsidiary of Liberty Media. What was atypical about this appraisal case was that the parties were able to stipulate to the value of all but one of Liberty Digital's assets.

In re J.P. Morgan Chase & Co. S'holder Litig., 2005 WL 1076069 (Del. Ch. April 29, 2005), *aff'd*, 2006 WL 585606 (Del. Mar. 8, 2006). *Court of Chancery dismisses stockholders' claims because claims were derivative and demand was not excused.*

J.P. Morgan Chase & Co. (JPMC) and Bank One agreed to a business combination that was expected to create the second largest financial institution in the country. JMPC paid a premium over the market share price for Bank One, effectively making JPMC the acquirer and the Bank One the target. After the merger was completed, the stockholders of the acquirer sued its directors, alleging breaches of fiduciary duty with regard to the acquisition. Their claims stemmed from the allegation that the directors paid too much for the acquired bank. The defendants moved to dismiss the complaint on the basis that the claims were derivative, not direct, and that demand was not excused. The court granted defendants motion to dismiss.

Omnicare. Inc. v. NCS Healthcare, 818 A.2d 914 (Del. 2003). *Deal protection mechanisms that fully lock a merger and contain no fiduciary out are unenforceable and a breach of fiduciary duty.*

NCS Healthcare and Genesis Health Ventures had sought to protect their proposed merger through a lockup of the majority stockholders under a voting agreement, coupled with a merger agreement requirement that a stockholder vote be held even if the board withdrew its recommendation because of a superior offering. Subsequent to signing, Omnicare emerged with a superior proposal. In light of this new proposal, the NCS board of directors withdrew its prior recommendation in favor of the Genesis transaction. Nevertheless, under the terms of the "force the vote" provision, NCS proceeded with the stockholders meeting and submitted the Genesis merger to its stockholders for their consideration. Since the lock-up agreements committed more than a majority of the outstanding NCS shares to vote in favor of the Genesis merger and neither the merger agreement nor the lock-up agreements contained fiduciary out clauses, stockholder approval of the Genesis merger was virtually assured. Omnicare subsequently instituted a lawsuit to enjoin the consummation of the Genesis merger.

The Delaware Supreme Court held that the absence of a fiduciary out provision in the merger agreement made the deal protection measures (i.e., the force the vote provision coupled with the stockholder voting agreements that represented a majority of the votes on the merger) both preclusive and coercive, a violation of the *Unocal* test.

UbiquiTel v. Sprint Corporation, 2005 WL 3533697 (Del. Ch. Dec. 14, 2005, *rev'd* Dec. 19, 2005). *Court denies motion to dismiss claims for tortious interference and civil conspiracy in connection with telecommunications merger.*

UbiquiTel was the exclusive operator of Sprint's wireless network in several states pursuant to a management agreement. In December 2004, Sprint announced that it intended to merge with Nextel and that Nextel or its successor entity would be taking over much of the work that had previously been performed by UbiquiTel. In response, UbiquiTel sued Sprint and Nextel alleging a number of claims, including tortious interference and civil conspiracy against Nextel. Nextel moved to dismiss for failure to state a claim.

II. Cases Alleging Impropriety in the Valuation and/or Sale of a Business, Assets, or Controlling Shares

Landmark cases

Credit Managers Ass'n of Southern Cal. v. Federal Co., 629 F. Supp. 175 (C.D. Cal. 1985.) *Just because a company sold is undercapitalized does not mean that the conveyance of the company is fraudulent.*

In 1980, Cresent Food Co., a cheese importation and distribution entity wholly owned by Federal Company, entered into a management-led leveraged buyout. The stock purchase price was over $1.4 million. Cresent received an additional loan from new management of $189,000, as well as approximately $10 million from General Electric Credit Corp. Cresent's debt service increased significantly because of the buyout. Finding itself with insufficient cash to continue operations, Cresent eventually shut down and executed an assignment of its assets for the benefit of creditors. The plaintiff brought action against Federal, alleging that the buyout was a fraudulent conveyance.

The question before the court was whether or not the transaction was a fraudulent conveyance. The U.S. District Court in California held that the law does not require that companies be sufficiently well capitalized to withstand

any and all setbacks to their business; it requires only that the companies not be left with unreasonably small capital at the time of conveyance.

Edelman v. Fruehof Corp., 798 F.2d 882 (6th Cir. 1986). *The court rebuked directors for approving a management buyout without considering other possible buyers.*

In February 1986, the Edelman Group began acquiring Fruehauf stock on the open market. Edelman attempted a friendly acquisition, which Fruehauf's board of directors rejected. Subsequently, members of Fruehauf's management negotiated a two-tier leveraged buyout along with Merrill Lynch. A special committee of Fruehauf's outside directors approved the management-led buyout. Edelman sought a preliminary injunction restraining Fruehauf from completing the buyout.

The question before the court was whether the outside directors breached their fiduciary duty to the company. The Sixth Circuit Appeals Court held that Fruehauf's board of directors, in using corporate funds to finance the buyer, did not act in good faith to negotiate the best deal for shareholders and thus breached their fiduciary duty to the shareholders. Moreover, the court stated that once it becomes apparent that a takeover target will be acquired by new owners, it becomes the duty of the directors to see that the shareholders obtain the best possible price.

Hanson Trust PLC v. SCM Corp., 774 F.2d 47 (2d Cir. 1985). *The court denied the protections of the business judgment rules to directors who approved a lockup option.*

Hanson Trust PLC tendered a $60 per share offer for any and all shares of SCM Corp. The offer was followed by a counteroffer by the SCM board and their white knight, Merrill Lynch Capital Markets. Hanson then increased its offer to $72 each, contingent upon SCM's agreement not to enter into a lockup agreement. The SCM Merrill counteroffer was revised to $74 along with a lockup option for an SCM crown jewel. Hanson terminated its offer as a direct result of the lockup option. (A lockup option is an agreement that says the option holder, Company A, will acquire all or part of Company B, and that Company A will realize an economic gain if another company buys company B or a specified part of Company B.)

The question before the court was whether SCM's board of directors could be protected under the business judgment rule when they approved of the lockup option. The business judgment rule is a judicial doctrine under which reasonable decisions by directors are insulated from second-guessing by the courts. The Second Circuit U.S. Court of Appeals denied protection

under the business judgment rule on the grounds of SCM directors' "paucity of information" and the swiftness of their decision making, which strongly suggested a breach of the duty of care.

Humana v. Forsyth, 525 U.S. 299 (1999). *The Racketeer Influenced and Corrupt Organizations Act may be extended to cover a failure to conduct full due diligence.*

Shareholders sued Humana, a hospital system, and several hospitals that Humana had sold to Columbia-HCA Healthcare Corp. in 1993.

Apparently, in conducting its due diligence study of the Humana-owned hospitals, Columbia had not discovered that some of the hospitals had failed to pass on an insurance discount they were getting for certain customers. A class-action suit against Humana and against the acquired hospitals (now owned by Columbia-HCA) alleged that the absence of the discount was an attempt to defraud the customers. The plaintiffs sued Humana and Columbia under a federal law called the Racketeer Influenced and Corrupt Organizations Act (RICO), a criminal law that exacts triple damages from defendants who are found guilty.

The RICO case went all the way to the Supreme Court, which had to decide whether the plaintiffs had standing to sue under this federal law. A trial court had said no, because the federal law allows more severe penalties than the state law. But the Appeals Court in San Francisco reversed the decision, saying that it did not matter. The Supreme Court upheld this view. Justice Ruth Bader Ginsburg, writing for the court, said "RICO's private right of action and treble-damages provision appears to complement Nevada's statutory and common law claims for relief."

In re Healthco International, 208 B.R. 288, 300 (Bankr. D. Mass. 1997). *Director-shareholders who show due care in approving a buyout are not negligent if they exercised due care.*

In the spring of 1990, Healthco was involved in a struggle for corporate control with Gemini Partners L.P. In June 1990, a minority shareholder of Healthco, alleging that the price of Healthco's stock was undervalued, began a proxy contest to remove the incumbent board. In September 1990, Healthco entered into a merger agreement with HMD Acquisition (an acquisition vehicle of Hicks Muse) subject to several conditions including shareholder approval, realization of projected earnings, and the securing of financing. In January 1991, Healthco issued a proxy statement projecting unspecified losses, causing Gemini Partners L.P. to withdraw its bid, leaving HMD as the sole bidder. HMD acquired Healthco for $15 per share—$4.25 per share less than Gemini's highest offer.

In March 1991, the new Healthco board, which included directors who were Healthco stockholders, experienced operating problems. Shareholders brought suit against Healthco, alleging material misstatement in the proxy statement. The question before that court was whether or not the projections of unspecified losses constituted fraud under Rule 10b-5 of the U.S. federal securities laws. Finding in favor of the defendants, the District Court held that "optimistic, vague projections of future success which prove to be ill-founded" do not by themselves trigger Rule 10b-5 liability. This liability is triggered when such overly optimistic projections "imply certainty" or rely on "statements of facts which prove to be erroneous."

In June 1993, Healthco filed for relief under Chapter 11 of the U.S. Bankruptcy Code. Then, in September of that year, the case was converted to Chapter 7 and the company was liquidated, causing severe losses to the company's creditors.

In June 1995, the bankruptcy trustee for the creditors began legal action (independent of the previous securities law suit) in U.S. bankruptcy court against virtually all the participants in the company—65 defendants in all, including the company's directors, who were accused of violating their duty of loyalty. The plaintiffs alleged that the directors' ownership of stock in Healthco rendered them "interested" in its sale. The directors, citing legal precedent and documenting their decision-making process, argued that they had fulfilled their duties of loyalty and care. They asked the bankruptcy court for a summary judgment dismissal, but the court refused, holding that the directors were indeed "interested" parties by law.

Two years later, the case came to trial again in U.S. District Court in Worcester, Massachusetts, where the Court declined to adopt the Bankruptcy Court's ruling, and ordered a jury trial. The directors repeated their defense, this time bringing in an expert witness on behalf of the directors, Dr. Robert Stobaugh, Emeritus Professor at Harvard Business School. He testified Healthco directors had met generally accepted practice with respect to both their duty of loyalty and their duty of care. After a seven-week trial, the jury returned a verdict in favor of all the defendants on all of the claims in the bankruptcy case.

Levinson v. Basic, 786 F.2d 741 (6th Cir. 1986), *vacated and rem'd*, 485 U.S. 224 (1988). *Untruthful denial of merger talks violates 10b-5.*

The plaintiff was a group of Basic, Inc., shareholders who sold stock in Basic, Inc., prior to formal announcement of a merger that caused Basic stock to rise. Basic spokespersons had denied that the merger was under consideration. The stockholders brought an action under Rule 10b-5 alleging material misrepresentation.

The question before the court was whether the public statements denying merger talks constituted material misrepresentation. The U.S. Supreme Court ruled that it is not proper to deny that a company is engaged in merger talks when, in fact, it is so engaged. In handing down its ruling, the U.S. Supreme Court rejected the "bright line" test for materiality offered in an earlier Sixth Circuit Appeals Court decision. Materiality must be decided on a case-by-case basis, opined the high court.

In this instance, negotiations were material—even though the talks had not yet resulted in any agreement on the price and structure of the transaction. The Supreme Court said that the appropriate response to an inquiry about undisclosed merger talks is either "no comment" or disclosure that the talks are taking place.

Paramount Communications v. Time Inc., 517 A.2d 1140 (Del. 1990). *Directors, not shareholders, manage a firm, and may take actions against the wishes of a majority of shareholders if the actions are in the best interests of the firm, as directors understand that interest.*

In July 1989, the Delaware Chancery Court ruled that Time Inc. should be allowed to proceed with its planned $14 billion acquisition of Warner Communications, Inc., despite protest from would-be hostile acquirer Paramount, alleging violation of various securities laws. In a landmark 79-page decision affirmed later by the Delaware Supreme Court, Chancellor William T. Allen declared that "corporation law does not operate on the theory that directors, in exercising their powers to manage the firm, are obligated to follow the wishes of a majority of shares. In fact, directors, not shareholders, are charged with the duty to manage the firm."

This decision was widely considered to be an affirmation of the so-called business judgment rule, a judicial doctrine that protects decisions of directors, in their exercise of discretion based on informed judgment, from second-guessing by plaintiffs and judges. On the other hand, several legal commentators noted at the time of the decision that it did not necessarily cover instances of a sale or change of control, as in the classic case of *Revlon.*

Sure enough, in a 1994 case involving Paramount and QVC, the court drew this change-of-control distinction, denying the protections of the business judgment rule to Paramount directors because the transaction they were considering did involve a change of control. (See *QVC Network,* next.)

QVC Network Inc. v. Paramount Inc., Viacom Inc., et al., 637 A.2d 34 (Del. 1994) *aff'ing* 635 A.2d 1245 (Del. Ch. 1993). *Directors must seek the best price in a change of control, but not all transactions involve such a change.*

On September 12, 1993, the board of Paramount Communications Inc. announced a proposed merger with Viacom Inc. Viacom was offering $69.14 per share in cash for controlling interests, with the remainder of the purchase price to be paid in stock. On September 27 Paramount directors rebuffed a comparably structured $80 per share bid from QVC Network Inc., saying they would not talk unless QVC could show evidence of financing. On November 15, Paramount directors refused a revised $90 per share offer on the grounds that it was too conditional.

Meanwhile, Paramount and Viacom continued to plan their merger. As Viacom's offer rose to the $85 per share level, Paramount granted Viacom an option to buy Paramount stock and promised to pay a termination fee in the event Paramount rejected Viacom for bidder. Paramount also made plans to redeem a shareholder rights ("poison pill") plan.

QVC sued Paramount and Viacom in the Chancery Court of Delaware, seeking to prevent these actions. The court upheld the termination fee, which it found a "fair liquidated amount to cover Viacom's expenses," but it handed QVC a victory on the other two points. The Chancery Court decision was upheld by the Delaware Supreme Court in a December 9 order, followed by a formal opinion on February 4, 1994.

In its opinion, the Delaware Supreme Court, concurring with the Chancery Court, stated repeatedly that directors in a "sale or change of control" must seek to obtain "the best value reasonably available to the stockholders." In cases that do not involve a sale or change of control, however, the court recognized "the prerogative of a board of directors to resist a third party's acquisition proposal or offer." (The *Paramount* decision spurred Paramount directors to set forth bidding rules in a contest to be decided by shareholders by a certain date. Viacom offered shareholders $105 per share, with certain protections against loss in share value. QVC offered $107 per share, but without such protections. The market chose Viacom, and the rest is history.)

Treadway Companies, Inc. v. Care Corp., 638 F.2d 357 (2d Cir. 1980). *Directors have certain duties to stockholders in tender offers.*

In 1978, Care Corp. started acquiring shares of stock in Treadway Co., leading Treadway to believe that Care was mounting a hostile takeover. In response to this action, Treadway put certain officers of Care on its board. Then, without fully informing the Care representatives, the Treadway board sought other merger candidates and struck a deal with Fair Lanes. Care filed an action alleging violations of Section 13(d) of the 1934 Securities Exchange Act, breach of fiduciary duties, and misuse of confidential information.

The question before the U.S. District Court for the Southern District of New York was whether the directors had acted improperly in their actions

arising out of a struggle for control of their company. The District Court entered a judgment in favor of Care Corp., two of its directors, and Cowin. The U.S. Court of Appeals for the Second Circuit held that a director does not breach his or her fiduciary duty merely by supporting an effort or promoting a change of management. Moreover, a director does not owe his or her fiduciary duty directly to shareholders with respect to shares of stock they own and has no obligation to afford other shareholders an opportunity to participate in sale of stock.

Recent cases

Abraham v. Emerson Radio Corp., 2006 WL 1879205 (Del. Ch. July 5, 2006). *Court of Chancery clarifies right to buy control.*

This decision makes it clear that a controlling stockholder may sell control without fear of liability for the actions of the buyer after the transaction closes, with few exceptions. While it has long been the rule that a stockholder may deal with its shares as it sees fit, case law recognized that a controlling stockholder has a fiduciary duty to its company and the minority owners by virtue of the controller's ability to control what the company does. How that duty applied in the sale of control context is the question addressed in this case.

Abry Partners V v. F&W Acquisitions, C.A. No. 1756-N, (Del. Ch. Feb. 14, 2006) published at 891 A.2d 1032 (Del. Ch. 2006). *Court of Chancery holds "anti-reliance" contract provisions cannot exclude liability for fraudulent misrepresentations.*

The plaintiff in this case sued for rescission of a corporate acquisition contract. The court articulated the law of recessionary relief and limitations in damage recovery for misrepresentations, focusing on the contract's exclusive indemnity-limiting provision.

The court reconciled two competing forces: the power of privately ordered contracts to allocate risk between the parties, and the power of Delaware's public policy disfavoring a bar on recessionary remedies and damages for willful misrepresentations. Additionally, the court examined the elective remedies available to the plaintiff-buyer. In the end, the court held that "anti-reliance" contract provisions cannot exclude liability for fraudulent misrepresentations.

Andaloro v. PFPC Worldwide, 2005 WL 2045640 (Del. Ch. Aug. 19, 2005). *In appraisal action, Court of Chancery employs discounted cash flow and comparable companies' methods to value shares purchased by 98 percent owner in cash-out merger.*

This was a consolidated appraisal and equitable fiduciary duty action (the court did not address the fiduciary claim in this opinion). It arose out of a merger in which PFPC Worldwide, Inc. (PFPC), was acquired by its parent PFPC Holding Corp. (Holding), which held over 98 percent of PFPC's stock before the merger. (The merger was also approved by PFPC's ultimate parent and Holding's immediate parent, PNC Financial Services Group, Inc. [PNC].) The merger resulted in the elimination of the minority shareholders' position in PFPC for $34.26 per share.

Calpine Corporation v. The Bank of New York, 2005 WL 3454729 (Del. Ch. Nov. 22, 2005). *Corporation's use of sale proceeds violates language in indenture agreements.*

The plaintiff, an energy company, attempted to use proceeds from sale of certain assets to fund a series of purchases of natural gas for burning in its power plants. Plaintiff's noteholders objected to those purchases because the relevant indenture agreements only allowed sale proceeds to be used for certain purposes. In response to the noteholders' objection, the indenture trustees refused to authorize release of any additional monies to plaintiff for those purchases. Plaintiff subsequently sued the indenture trustees seeking declaration that corporation's past and proposed use of proceeds was permissible.

Crescent/Mach I Partnership v. Turner, 2005 WL 3618279 (Del. Ch. Dec. 23, 2005). *Court of Chancery grants partial summary judgment with respect to claims that former controlling stockholder extracted excess compensation from acquirer in exchange for supporting merger.*

Former stockholders who were cashed out in connection with merger sued the corporation's former controlling stockholder and the acquirer for breach of fiduciary duty and aiding and abetting breach of fiduciary duty, respectively. Plaintiffs complained of numerous side deals, allegedly negotiated by the controlling stockholder. Plaintiffs also complained that the controlling stockholder breached his fiduciary duty by supplying growth projections that he knew to be unduly pessimistic and inconsistent with management's view. Defendants moved for summary judgment, which the court granted in part and denied in part.

Gesoff v. IIC Indus., 2006 WL 1458218 (Del. Ch. May 18, 2006). *The Court of Chancery finds merger between controlling stockholder and subsidiary unfair.*

The plaintiff filed a class action, claiming a merger was the subject of unfair dealing and produced an unfair price. Another plaintiff filed a statutory appraisal claim based on the same merger.

Gilliland v. Motorola, 873 A.2d 305 (Del. Ch. 2005). *Court of Chancery outlines quasi-appraisal remedy for minority shareholders cashed out in a short-form merger.*

Plaintiff sought a class-wide "quasi-appraisal" remedy for minority stockholders eliminated in a short-form merger. Statutory appraisal was impractical for two reasons. First, formalistically, the minority stockholders no longer owned shares in the merged subsidiary and without the shares, they could not make the demand required by the appraisal statute. Second, from a practical standpoint, the two-year delay made it impossible to recreate the factual context necessary to have statutory appraisal. Therefore, Vice Chancellor Lamb granted the quasi-appraisal remedy and outlined its procedure.

Homan v. Turoczy, 2005 WL 2000756 (Del. Ch. Aug. 12, 2005). *Court of Chancery holds that purchasers of small business failed to prove that sellers defrauded them.*

Plaintiffs bought a small printing and copying business from defendants, who ran the business successfully for 19 years. However, plaintiffs were not so successful. A year after the sale they filed for bankruptcy, closed down the business, and liquidated the company's assets. In their complaint, plaintiffs alleged that the defendants and their agent fraudulently misrepresented the condition of the business and thus sought rescission of the sales agreement. The court held that by waiting over a year before suing, the plaintiffs forfeited any right to seek actual rescission. As a result, the court's opinion after trial only considered whether plaintiffs were entitled to an award of damages for fraud.

In re LNR Propert Corp. Shareholders Litigation, 2005 WL 3418631 (Del. Ch. Nov. 4, 2005, *rev'd* Dec. 14, 2005). *Entire fairness applied to third-party merger transaction where controlling shareholder acquired minority stake in resulting company.*

Former shareholders filed fiduciary class action in connection with a cash-out merger, naming corporation and former directors as defendants. The complaint alleged that the corporation's controlling shareholder negotiated to sell the company to a third-party investment firm in an all-cash deal. The complaint further alleged that, as part of the transaction, the controlling shareholder and other members of company management agreed to invest approximately $184 million to acquire a 25 percent equity stake in the surviving entity. Defendants moved to dismiss for failure to state a claim.

Kosseff v. Ciocia, 2006 WL 2337593 (Del. Ch. Aug. 3, 2006). *Court of Chancery sustains complaint attacking settlement that included spin-offs.*

In this decision, the Court dealt with a complaint attacking the transaction implemented to settle a proxy contest. The proxy contest was settled by an agreement that put the dissidents on the board and had the CEO resign. However, the CEO was given the right to buy certain lucrative businesses of the company, a right he later exercised. The complaint alleged that this deal was improvident. After reviewing the complaint, the Court allowed the case to proceed.

Minnesota Invco of RSA #7 v. Midwest Wireless Holdings, 2006 WL 1596675 (Del. Ch. June 7, 2006). *Court of Chancery upholds drag along rights.*

In this case, the Court of Chancery was required to interpret complex agreements between the members of a Delaware limited liability company. The court held that the defendant holding company had the right to "drag along" holders of a minority interest in an operating subsidiary of the holding company in connection with the sale of the holding company.

Oliver v. Boston University, 2006 WL 1064169 (Del. Ch. Apr. 14, 2006). *Court of Chancery awards $4.8 million, plus interest, to minority shareholders for damages suffered from director defendants' breach of the fiduciary duty of loyalty.*

Defendant Boston University (BU) was the controlling shareholder of Seragen, a financially troubled biotechnology company. Plaintiffs, a group of former minority stockholders of Seragen's common stock, challenged certain transactions before Seragen was merged and the process by which the merger proceeds were divvied up. The plaintiffs contended that the BU defendants breached their fiduciary duties to Seragen's common shareholders by approving various financial transactions, which were not fair to the common shareholder as a matter of price and process. The Court of Chancery awarded damages in excess of $4.8 million plus interest for breaches of the fiduciary duty of loyalty.

III. Cases Involving M&A Agreements or Other Contracts

Landmark cases

Electro Optical Industries v. White, 90 Cal. Rptr. 2d 680 (1999). *An employer may prohibit an employee from accepting employment with a competitor if the new employment will "inevitably" lead the employee to rely on the competitor's trade secrets, said the judicial panel in this case. But the panel did not find such inevitability here.*

The plaintiff, Electrical Optical Industries (EOI), supplied infrared testing devices to the military and to defense contractors. A key employee—Stephen White—abruptly left after 15 years to join Santa Fe Barbara Infrared, Inc. (SBIR), one of EOI's direct competitors. EOI asked the trial court for a preliminary injunction precluding White from participating in sales or development of infrared testing devices at SBIR. EOI argued that White knew trade secrets and, if permitted to work for SBIR, would inevitably use them. The trial court denied preliminary junction and EOI appealed.

In an Appeals Court decision rendered December 3, 1999, a three-panel judge adopted the doctrine of "inevitable disclosure," but said that instances must be decided on the basis of fact, and that the facts in this case favored the defendant. The court acknowledged that White possessed knowledge of certain EIO information. Some of the information was technical—namely existing and future product designs, production methods, materials and process, and the status of patent applications. The court agreed that this information was a trade secret, but it stated that (a) White lacked the training to pass on the information, and (b) SBIR did not need the information. Some of the information was nontechnical, such as customer lists, sales prices, production costs, marketing plans, and sales strategies. But the court said these did not constitute trade secrets. As for customer preferences and specifications, the court said that this information was not a trade secret or, if it were, it would belong to the customer.

Revlon v. McAndrews & Forbes Holdings, 506 A. 2d 173 (Del. Supr. 1985). *Directors have a duty to seek the best offer once a company is known to be for sale.*

In June 1985, Pantry Pride approached Revlon to propose a friendly acquisition. Revlon declined the offer. In August 1985, Revlon's board recommended that shareholders reject the offer. Revlon then initiated certain defensive tactics. It sought other bidders. Pantry Pride raised its bid again. Revlon negotiated a deal with Forstmann Little, which included a lockup provision and relief from Cumulative Convertible Exchangeable Preferred Stock. Revlon also provided Forstmann additional financial information that it did not provide to Pantry Pride.

Eventually, an increased bid from Pantry Pride prompted an increased bid from Forstmann Little. The new bid was conditioned upon, among other things, the receipt by Forstmann Little of a lockup option to purchase two Revlon divisions at a price substantially lower than the lowest estimate of value established by Revlon's investment banker. It included a "no shop" provision that prevented Revlon from considering bids from any third party. The board immediately accepted the Forstmann Little offer even though Pantry Pride had increased its bid.

The questions before the court were (1) whether the lockup agreements were permitted under Delaware law and (2) whether the Revlon board acted prudently. The Delaware Supreme Court held the following:

- Lockups and related agreements are permitted under Delaware law where their adoption is untainted by director interest or other breaches of fiduciary duties.
- Actions taken by directors in this case did not meet that standard.
- Concern for various corporate constituencies is proper when addressing a takeover threat.
- Proper concern for multiple constituencies is limited by the requirement that there be some rationally related benefits accruing to the stockholders.
- There were no such benefits in this case.
- When sale of a company becomes inevitable, the duty of a board of directors changes from preservation of the corporate entity to maximization of the company's value at a sale for the stockholders' benefit. This final point has come to be called the Revlon Doctrine.

Texaco v. Pennzoil Co., 729 S.W.2d 768 (Tex. App. 1987), *cert. denied*, 485 U.S. 994, (1988). *A handshake M&A deal can be legally binding.*

In December 1983, Pennzoil announced a tender offer for 16 million shares of Getty Oil common stock at $100 per share. Subsequently, Pennzoil met with Getty Oil representatives to discuss the tender offer and possible sale of Getty Oil to Pennzoil. Then, over a period of several days, the following occurred:

- On January 2, 1984, as a result of the meetings, Pennzoil and Getty Oil representatives signed a memorandum of agreement for the sale of Getty Oil to Pennzoil, subject to approval by the board of directors of Getty Oil.
- On January 3 Pennzoil revised its offer to $110 per share, plus a $3 stub. Getty Oil's board of directors rejected the offer but made a counterproposal for a $5 stub. Pennzoil agreed and a memorandum of agreement was executed.
- On January 4 both parties issued a press release.
- On January 5 Texaco contacted Getty Oil representatives to inquire about a possible sale to Texaco for $125 per share.
- On January 6 Getty Oil's board of directors voted to withdraw its Pennzoil offer and accept Texaco's offer. Texaco purchased Getty Oil stock and Pennzoil brought an action for tortious interference.

The question before the court was whether Pennzoil and Getty Oil had a binding agreement absent a definitive purchase agreement. On approval, the Court of Appeals for Texas, citing the language in the prospective stock buyer's draft and the term "agreement in principle" in the press release, found that there was a binding agreement.

Recent cases

Appriva Shareholder Litigation Co. v. ev3, Inc., 2006 WL 2555348 (Del. Super. Ct. Aug. 24, 2006). *The Delaware Superior Court dismisses suit by a corporation representing former shareholder.*

An entity controlled by certain former stockholders of an acquired corporation sued the acquirer alleging breach of merger agreement and fraud. Upon motion by the defendant acquirer, the court dismissed the action on ground that plaintiff lacked standing.

The court noted that the merger agreement appointed two individuals as shareholder representatives who were required to act in concert, one of whom the complaint reflected was not affiliated with plaintiff in any way. The court also noted that the merger agreement did not permit assignment of the shareholder representatives' rights without defendants' consent, which was never given. Finally, the court rejected plaintiff's argument that it be permitted to bring the action as a third-party beneficiary as inconsistent with the merger agreement's express terms.

ATS v. Bachmann, C.A. No. 2374-N (Del. Ch. October 11, 2006). *Delaware's Court of Chancery interprets common merger clause.*

Delaware corporations frequently ask the Court of Chancery to decide if a proposed course of action is appropriate, particularly when the board of directors' fiduciary duties are implicated. In this decision the Court focused primarily on when the Court may provide that guidance and when the matter is not ripe for judicial action. The Court has rejected becoming involved in hypothetical issues not framed by a real world transaction, but more of a "what if" set of questions. Here, the Court accepted one question for its review and rejected others, thereby illustrating how it will deal with those situations.

The opinion is also interesting in its interpretation of a fairly common clause found in merger agreements that might have been held to operate much like a "no talk" provision. The Court held that as the directors do have a fiduciary duty to consider alternatives to a merger and that in light of the negotiations that had led to this particular clause, the agreement did not bar the board from considering a competing merger offer. Given the wording of the

clause in question, this conclusion was not free from doubt and provides guidance to drafters of such merger agreements.

Facchina v. Malley, 2006 WL 2328228 (Del. Ch. Aug. 1, 2006). *Court of Chancery affirms application of Delaware law to LLC.*

A California corporation merged with a Delaware corporation, and the California corporation ceased to exist. Stockholders of the California corporation wanted to enforce an agreement signed prior to the merger. The Court of Chancery affirmed that Delaware law applies to the internal affairs of any Delaware LLC. In this case, the LLC was the result of a merger of a California corporation into a Delaware LLC. The California entity had a stockholders' agreement that the defendants wanted to enforce. The court rejected their arguments because the California entity had ceased to exist in the merger.

Flight Options Int'l. v. Flight Options, 2005 WL 2335353 (Del. Ch. Sept. 20, 2005). *Court of Chancery enjoins consummation of purchase agreement pending arbitration.*

Plaintiff sought preliminary injunction against consummation of purchase agreement pending arbitration of its substantive disputes with defendant.

Frontier Oil Corporation v. Holly Corporation, 2005 WL 1039027 (Del. Ch. April 29, 2005). *Court of Chancery finds that substantial litigation expenses are not a sufficient material adverse effect to rescind a contract.*

Frontier Oil Corporation and Holly Corporation are petroleum refiners that sought to merge. In conducting its due diligence review of Frontier, Holly discovered that activist Erin Brockovich was planning to bring a toxic tort suit claiming that an oil rig that had been operating for decades on the campus of Beverly Hills High School caused the students to suffer from a disproportionately high incidence of cancer. This raised concerns for Holly because a subsidiary of Frontier had previously operated the Beverly Hills drilling facility. Although the terms of the merger agreement were modified to address the situation, including broadening the representation to apply to litigation that would reasonably be expected to have a material adverse effect (MAE) on Frontier, the court found that substantial litigation costs were not a MAE and therefore the contract could not be rescinded.

Horizon Personal Communications v. Sprint Corp., 2006 WL 2337592 (Del. Ch. Aug. 4, 2006). *In a postmerger setting, Court of Chancery expands duty to act in good faith.*

Prior to its 2005 merger with Nextel, Sprint had made certain promises to affiliates. In this case the Court of Chancery examines the contract between the parties, determines what is required to act in good faith, and awards an injunction to preclude a breach of that duty. In doing so, the court's analysis provides a road map for how to honor contracts made prior to a merger.

In re IBP Inc. Shareholders Litigation, 789 A.2d 14 (Del. Ch. 2001). *The party seeking to terminate an agreement on account of the fact that the other party had suffered a material adverse event (MAE) has the burden of proving that the MAE had occurred. Also, a broad MAE clause protects an acquirer only from "unknown events" that "substantially threaten" the target's earnings ability in a "durationally-significant manner."*

IBP Inc. and Tyson Foods Inc. entered into a merger agreement whereby Tyson agreed to acquire IBP in a cashout merger. In conducting its due diligence of IBP, Tyson learned of several potential issues with IBP's business going forward. These potential issues included that IBP was likely heading into a downturn in its beef business, and that there might be significant accounting issues at one of IBP's subsidiaries. Tyson nonetheless proceeded to sign the agreement to acquire IBP. After signing the agreement, for a variety of reasons, Tyson sought to terminate the agreement. IBP resisted these attempts.

Because Tyson was aware of the subsidiary's accounting problems and the cyclical nature of the livestock industry, these risks could not qualify as "unknown risks" for the purposes of establishing whether IBP had suffered an MAE. Additionally, the short-term drop in IBP's earnings did not "substantially threaten" its overall earnings potential and thus did not constitute an MAE. In addition, the court granted IBP the remedy of specific performance, ordering Tyson's acquisition of IBP to go forward.

In re Toys "R" Us Shareholder Litigation, 877 A.2d 975 (Del. Ch. June 24, 2005). *Court of Chancery denies motion for temporary injunction where breakup fee is alleged to be too high.*

The Court of Chancery considered a motion to enjoin a vote of the stockholders of Toys "R" Us, Inc. to consider approving a merger with an acquisition vehicle formed by a group led by Kohlberg Kravis Roberts & Co. Pursuant to the terms of the merger agreement, the Toys "R" Us stockholders would receive $26.75 per share for their shares. The $26.75 per share merger consideration constituted a 123% premium over the price of TRU stock when merger negotiations began in January 2004. Plaintiffs charged the board did not act reasonably in pursuit of the highest attainable value. The Court of

Chancery denied the motion to enjoin a stockholder vote on the proposed merger, saying stockholders could stop the merger by voting if they thought it was unfair.

In re PNB Holding Co. Shareholders Litigation, C.A. No. 28-N (Del. Ch. August 18, 2006). *Court of Chancery awards both appraisal and equitable relief in a merger.*

As it has several times in recent years, the Court of Chancery has decided a case combining appraisal rights and a class claim for inequitable treatment in a merger. The court held that when directors get together to freeze out the other stockholders the entire fairness test applies even when they do not own a majority of the stock. This follows because the interests of those directors in remaining shareholders differs from the other shareholders who will be frozen out. Absent some insulating procedure such as a majority of the minority vote, the directors then have the burden of proving the merger was entirely fair.

Mehiel v. Solo Cup Co., 2005 WL 3074723 (Del. Ch. Nov. 3, 2005). *Court enforces provision in merger agreement permitting arbitration of disputed representation-and-warranty and working-capital claims.*

Following the closing on a merger, several disputes developed between the shareholder representative of an acquired company and the acquirer involving working-capital-adjustment issues and the accuracy of seller's representations and warranties. The merger agreement contained two separate arbitration provisions for working capital adjustment disputes and disputes regarding the parties' respective representations and warranties. The acquirer first attempted to submit its disputes with the shareholder representative to arbitration as working-capital claims. The arbitrator refused to consider those claims, however, based on the acquirer's failure to comply with certain procedural requirements. In response, the acquirer submitted the same claims to the separate arbitrator for representation-and-warranty claims. The shareholder representative subsequently filed a complaint asking the court to issue an injunction barring the second arbitrator from hearing the disputed claims.

Shamrock Holdings v. Arenson, 2006 WL 2802913 (D. Del. Sept. 29, 2006). *District Court applies exception to Tooley test and rejects argument that exculpatory provisions create contractual obligations.*

This case involved a dispute between the Class A and Class B members of a Delaware LLC called ALH Holdings. The dispute arose after ALH faced financial trouble and the Class A members voted to sell the company over the objections of the Class B members, who eventually threatened to sue.

To preempt such a suit, the Class A members brought an action for a declaratory judgment that, among others, they did not breach their fiduciary duties or the LLC's operating agreement. In response, the Class B members counterclaimed, alleging breaches of the same. Plaintiffs subsequently moved for summary judgment as to four of the counts in their complaint, and they moved to dismiss the defendants' counterclaim. The court denied the motion to dismiss and denied the motion for judgment on the pleadings in part (and granted it in part).

W.L. Gore & Associates, Inc. v. Wu, C.A. No. 263-N (Del. Ch. September 15, 2006). *Court of Chancery grants 10-year injunction in trade secret case.*

The extent to which a court will enjoin the violation of a confidentiality agreement covering trade secrets is often questioned. In this decision, the Court of Chancery issued an injunction that for ten years barred the defendant from working in a business that might permit him to use the trade secrets he had stolen from his employer. In part, the remedy was based on the useful life of the stolen materials.

IV. Cases Alleging Violation of Antitrust Laws[10]

Landmark cases

Ford Motor Co. v. United States, 405 U.S. 562 (1972).

The Court condemned Ford's attempted acquisition of Autolite, a spark plug manufacturer, and emphasized the heightened barriers that the merger would pose to other companies that attempted to enter the market. The Court also emphasized that Ford's argument that the acquisition had made Autolite a more effective competitor was irrelevant.[11]

Olin Corporation v. Federal Trade Commission, 986 F.2d 1295 (9 Cir. 1993). *The Federal Trade Commission has the right to order divestitures.*

In 1985, the Olin corporation entered into an agreement with the FMC corporation to purchase FMC's swimming pool chemicals business. Since the late 1970s, Olin had been experiencing considerable difficulties in the manufacture of certain swimming pool sanitizing chemicals. The FMC assets that Olin was purchasing included the manufacturing plant for sanitizers.

The FTC challenged the acquisition on the grounds that it would violate federal antitrust laws. The FTC ordered Olin to divest itself of the assets it had acquired from FMC. An administrative law judge agreed with the

Commission and concluded that the acquisition would likely result in a substantial lessening of competition in the sanitizers' market place. Olin appealed the FTC's divestiture order.

The issue before the Court of Appeals for the Ninth Circuit was whether the FTC had the right to order Olin to divest itself of assets acquired through a merger and whether the acquisition would likely result in substantial lessening of competition. The Court of Appeals affirmed the FTC's ruling that Olin's acquisition of the assets would result in a substantial lessening of competition in the relevant markets. As such, the deal would violate Section 7 of the Clayton Act, 15 U.S.C. 18, and Section 5 of the Federal Trade Commission Act (FTC Act), 15 U.S.C. 45. The court went on to state that the FTC acted within its proper authority in ordering Olin to divest itself of the assets.

United States vs. Philadelphia National Bank et al., 374 U.S. 321 (1963). *A merger may be rejected on competitiveness grounds, even if it gives economic benefits.*

In November 1960, the Philadelphia National Bank and the Girard Trust Corn Exchange Bank were the second and third largest commercial banks in the city of Philadelphia. The boards of directors for the two banks approved a merger of Girard into Philadelphia. The U.S. Department of Justice enjoined the merger, alleging that the consolidation violated the Sherman Anti-Trust Act and the Clayton Act. The U.S. District Court for the Eastern District of Pennsylvania ruled in favor of the banks, and the United States appealed. The question before the Supreme Court was whether a merger that created anticompetitiveness and a monopoly violated the Clayton Act.

The Supreme Court, speaking through Justice William J. Brennan Jr., rejected the banks' arguments on the basis of the social good. A merger that substantially lessens competition is not saved from violation of the Clayton Act because, on some ultimate reckoning of social or economic debits and credits, it may be deemed beneficial. The court also stated that growth by internal expansion is socially preferable to growth by acquisition.

Recent cases

Texaco Inc. v. Dagher et al. and ***Shell Oil Co. v. Dagher et al.*** Docket Nos. 04-805 and 04-814. Reversed: The Ninth Circuit. Argued: January 10, 2006. Decided: February 28, 2006. *Pricing decisions of a legitimate joint venture do not fall within the narrow category of activity that is per se unlawful under Section One of the Sherman Act.*[12]

Is it *per se*[13] illegal under Section 1 of the Sherman Act for a lawful, economically integrated joint venture to set the prices at which the joint venture sells its products? No. *Per se* liability is reserved for only for those agreements that are "so plainly anticompetitive that no elaborate study of the industry is needed to establish their illegality." Price-fixing agreements between two or more competitors, otherwise known as horizontal price-fixing agreements, fall into the category of arrangements that are *per se* unlawful. These cases do not present such an agreement, however, because Texaco and Shell Oil did not compete with one another in the relevant market—namely, the sale of gasoline to service stations in the western United States—but instead participated in that market jointly through their investments in Equilon [the joint venture]. In other words, the pricing policy challenged here amounts to little more than price setting by a single entity—albeit within the context of a joint venture—and not a pricing agreement between competing entities with respect to their competing products.

V. Cases Alleging Violations of Health, Safety, and Labor Laws

Landmark cases

Accardi v. Control Data, 658 F. Supp. 881 (S.D.N.Y. 1987), *rev'd and rem'd,* 836 F.2d 126 (2d Cir. 1987). *An acquirer has the right, under certain circumstances, to discontinue benefits to acquired employees.*

The plaintiffs were former employees of International Business Machines (IBM) who worked for the BTSI division. In accord with the Employee Retirement Income Security Act of 1974 (ERISA), they received certain benefits. When IBM sold BTSI to Control Data Corporation (CDC), they entered into a "benefits agreement" under which CDC agreed to continue making benefits payments to the former employees of the division. On June 30, 1985, CDC sold BTSI to Automatic Data Processing (ADP) and the benefits payments stopped. The former BTSI employees requested continuation of their benefits.

The question before the court was whether the plaintiffs were entitled to continued overall benefits under the IBM/CDC benefits agreement, and whether the denial of the plaintiff's request for continued benefits was arbitrary and capricious. The U.S. Court of Appeals of the Second Circuit, affirming a decision by the U.S. District Court in the Southern District of New York, stated that the plaintiffs were no longer eligible employees according to

the terms of the benefits agreement. The court rules that denial of continued benefits was not arbitrary and capricious.

Adcock v. Firestone Tire & Rubber Co., 616 F. Supp. 409 (D.C. Tenn. 1985), *aff'd in part and vacated in part,* 822 F.2d 623 (6th Cir. 1987). *A termination pay plan for employees ("tin parachute") may be enforceable following a merger.*

The plaintiffs were nonunion salaried employees of Bridgestone Tire and Rubber Co. On January 1, 1983, Firestone Tire & Rubber Co. sold its Lavergne plant to Bridgestone for $55 million. The 75-page sales agreement included an "employee termination pay plan" stating that Firestone would not terminate the employment of any employee prior to the sale. It also stated that if Bridgestone reduced its workforce, any employee who lost his or her job would receive termination pay. At the time of the suit, Bridgestone had not reduced its workforce, so the plaintiffs remained employed. Nonetheless, they sought to receive termination pay.

The question before the court was whether the termination pay plan was arbitrary and capricious. The U.S. Court of Appeals in the Sixth Circuit, affirming the District Court of Tennessee's interpretation of the federal common law, stated that Bridgestone's application of the termination pay plan was consistent with a fair reading of the plan, and that Firestone's interpretation and application of the termination pay plan was not arbitrary and capricious.

Blau v. Del Monte Corp., 748 F.2d 1348 (9th Cir. 1984). *An employer that denies benefit plans to employees fired following a merger may be found liable for breach of contract under common law.*

In 1966, Del Monte Corp. purchased Granny Good, which became a wholly owned subsidiary of Del Monte. The employees of Granny Good became eligible for coverage under various Del Monte pension and benefit plans. In December 1980, Del Monte sold Granny Good to a group of investors. The new owners kept all but four employees. The four severed employees sued Del Monte for their severance benefits.

The question before the court was whether the denial of the severance benefits violated ERISA and whether the denial was arbitrary and capricious. The Ninth Circuit Court of Appeals held that the actions by Del Monte were arbitrary and capricious, and that ERISA preempted state common-law theories of breach of contract.

Blessit v. Retirement Plan for Employees of Dixie Engin. Co., 817 F.2d 1528 (11th Cir. 1987), *rec'd in part and rem'd,* 836 F.2d 1571 (11th Cir.

1988) *vacated* 848 F.2d 1164 (11th Cir. 1988). *An employer under certain conditions has a right to reduce benefits to reflect fewer years of service following post-acquisition termination.*

The plaintiffs were employees of Dixie Engine Co. when it established an ERISA plan in 1972. Dixie Engine Co. was sold in 1982 and the ERISA plan was terminated. Employees brought action against their employer for violation of ERISA claiming that upon termination of a defined benefits plan they were entitled to receive the full, unreduced pension benefits they would have received had they continued to work until normal retirement age.

The question before the court was whether ERISA requires the defined benefits plan to pay an employee the full, unreduced benefits the employee would have received had he or she continued to work until normal retirement age. The U.S. Court of Appeals in the Eleventh Circuit held that when a plan terminates, ERISA does not require that employees receive full benefits, only the benefits provided for under the plan (that is, the benefits calculated on the basis of their actual years of service as of the termination date).

Fall River Dyeing and Finish Corp. v. NLRB, 482 U.S. 27 (1987). *An acquirer does not have to bargain with a union unless the union is certified and continues to represent a majority of employees.*

In 1952, Sterlingwale began operating a textile dyeing plant; the plant continued to run for the next 30 years. For nearly its entire existence, the production and maintenance personnel of Sterlingwale were members of a union. Sterlingwale, along with the entire textile dyeing industry, began to suffer adverse economic conditions in late 1979. In February 1982 Sterlingwale laid off its employees and made an assignment for the benefit of its creditors.

In the fall of 1982, a former officer of Sterlingwale, together with the president of a creditor, formed an entity that purchased the assets of Sterlingwale from the auctioneer. Over time, the entity employed many former employees of Sterlingwale. The union requested that the entity recognize it as the bargaining agent for the employees, and the entity refused. The union then filed unfair labor practice charges with the National Labor Relations Board.

The question before the court was whether a successor employer is obligated to bargain with a union representing its predecessor's employees. The U.S. Supreme Court held that the successor employer's obligation to bargain with the union representing its predecessor's employees is contingent not only upon certification of the union but also on whether a majority of its employees were employed by its predecessor.

B.E. Tilley v. Mead Corp., 927 F.2d 756 (4th Cir. 1991). *There is an important distinction between contingent liabilities and accrued benefits in the termination of a pension plan.*

The plaintiffs were employees of Lynchburg Foundry Company prior to its buyout by Mead Corporation. The employees then fell under the Mead retirement plan, which provided for early retirement benefits commencing at age 55. Subsequently, Mead sold off the foundry and terminated the plan. The plaintiffs received a sum of money equal to their portion of the present value of the plan reduced by 5 percent for each year the participant was under the age of 65. Plaintiffs sued Mead in Virginia state court alleging that Mead's failure to pay the present value of the unreduced early retirement benefits violated ERISA. Mead removed the case to the Federal District Court for the Western District of Virginia where the court granted Mead summary disposition, holding that the plaintiffs were not entitled to the unreduced early retirement benefits. The Court of Appeals for the Fourth Circuit reversed the District Court, and the Supreme Court reversed and remanded to the Court of Appeals.

The Court of Appeals held that, under the terms of ERISA, unreduced early retirement benefits that employees would have been eligible for upon reaching age 62 were "contingent liabilities" that had to be satisfied prior to reversion of the plan's surplus assets to the employer upon termination of the plan. They were not "accrued benefits" that employees had a vested right to receive in full upon plan termination.

Recent cases

Halliburton Co. Benefits Committee v. Graves, 463 F.3d 360 (5th Cir. 2006). *A merger agreement constituted an amendment of the target's welfare plan under ERISA, and therefore the merger agreement's no-third-party beneficiaries clause did not apply.*

Halliburton acquired Dresser Industries in 1998 via a forward triangular merger. Dresser's retiree medical benefits were superior to Halliburton's at the time of the merger. In order to preserve Dresser's superior benefits, the merger agreement provided that Dresser's nominees to the combined companies' board would maintain such benefits for Dresser employees for three years following the transaction. The parties included a standard no-third-parties-beneficiaries clause, meaning that the clause did not create rights for any party other than the two constituent corporations (e.g., employees and retirees).

Halliburton sought a declaratory judgment in 2003 in the U.S. Federal Court in the Southern District of Texas to affirm its right to reduce Dresser retirees' benefits to those of Halliburton's. The district court held that the Halliburton-Dresser merger agreement constituted an amendment to Dresser's

welfare plan under ERISA. Because of this amendment, the no-third-party-beneficiaries rule did not apply. The constituent corporations had placed specific time limits on the benefits that active Dresser employees were to receive, but did not impose such limitations on retirees' medical benefits. Accordingly, the court concluded that the provision of the merger agreement that allowed Halliburton to change retiree medical benefits only if the company made similar changes to medical benefits for current employees was a revision to the retiree medical program plan documents that restricted Halliburton's otherwise unfettered right to make changes to the Dresser retiree medical program. The 5th Circuit Court of Appeals upheld the lower court's decision.

Yolton et al. v. El Paso Tennessee Pipeline Co. 435 F.3d 571 (6th Cir. 2006). *Courts examine claim of "lifetime retiree benefits" under collective bargaining agreement.*

Tenneco serves as the plan administrator for a medical benefits plan that covers a closed group of retirees of the Case Corporation who retired on or before June 30, 1994. Case was formerly a subsidiary of Tenneco, Inc. that was spun off prior to our acquisition of Tenneco in 1996. In connection with the Tenneco-Case Reorganization Agreement of 1994, Tenneco assumed the obligation to provide certain medical and prescription drug benefits to eligible retirees and their spouses. We assumed that obligation as a result of our merger with Tenneco. However, we believed that our liability for these benefits was limited to certain maximums, or caps, and costs in excess of these maximums should be assumed by plan participants. In 2002, Tenneco and Case were sued by individual retirees in federal court in Detroit, Michigan in an action entitled Yolton et al. v. El Paso Tennessee Pipeline Co. and Case Corporation. The suit alleges that El Paso and Case are required to pay all amounts above the cap, alleging that the retiree medical plan was a vested lifetime benefit. Case further filed claims against El Paso asserting that El Paso is obligated to indemnify, defend, and hold Case harmless for the amounts it would be required to pay. In separate rulings in 2004, the court ruled that, pending a trial on the merits, Case must pay the amounts above the cap and that El Paso must reimburse Case for those payments. In January 2006, these rulings were upheld on appeal before a 3-member panel of the U.S. Court of Appeals for the 6th Circuit. Tenneco plans to file for a review of this decision by the full panel of the U.S. Court of Appeals for the 6th Circuit as a result of conflicting precedent within the circuit as well as with other circuit courts. It has indemnified Case for any payments Case makes above the cap. Although such amounts will vary over time, the amounts above the cap are currently about $1.7 million per month. Also, as a precaution, it recorded in the fourth quarter 2005 an after-tax charge of approximately $200 million ($350 million on a pre-tax basis).

A Supreme Court Case is pending (*El Paso Tennessee Pipeline Co. v. Yolton, et al.,* No. 06-201 Supreme Court of the United States).

VI. Cases Dealing with Jurisdiction or Right to Sue Following a Merger

Landmark cases

Gollust v. Mendell, 498 U.S. 1023 (1991). *Under 16b, an ex-stockholder of a company has standing to sue as long as it owns a security traded by the defendant.*

Mendell filed a 16b (insider trading) complaint against a collection of limited partnerships, general partnerships, individual partners, and corporations alleging that these entities, acting as one, were liable for 16b violations with regard to trading activities of Viacom stock. Six months after the complaint was filed, Viacom was acquired by another company and Mendell exchanged his Viacom stock for the new stock. The question before the court was whether a 16b action can be pursued by any party other than an issuer or holder of a security.

The U.S. Supreme Court held that it was not necessary for a plaintiff to continue to hold stock of the issuer in order to maintain a 16b action where the plaintiff has a financial stake in the parent corporation of the issuer. However, the Court also stated that the plaintiff who seeks to recover insider profits must own a security of the issuer whose stock is traded by the 16b defendant.

Virginia Bankshares, Inc. v. Sandberg, 501 U.S. 1083 (1991). *Even if a shareholder does not vote for a merger, the shareholder may sue over any material misstatements made about the transaction.*

This case occurred as part of a proposed "freeze-out" merger, in which First American Bank of Virginia (Bank) would be merged into petitioner Virginia Bankshares, Inc. (VBI), a wholly owned subsidiary of petitioner First American Bankshares, Inc. (FABI). The Bank's executive committee and board approved a price of $42 a share for the minority stockholders, who would lose their interests in the Bank after the merger. Virginia law required only that the merger proposal be submitted to a vote at a shareholders' meeting, preceded by a circulation of an informational statement to the shareholders. Nonetheless, Bank directors solicited proxies for voting on the proposal.

This solicitation urged the proposal's adoption and stated that the plan had been approved because of its opportunity for the minority shareholders to

receive a high value for their stock. Respondent Sandberg did not give her proxy and filed suit in District Court after the merger was approved. She sought damages from petitioners for, among other reasons, soliciting proxies by means of materially false or misleading statements in violation of 14(a) of the Securities Exchange Act of 1934 and the SEC's Rule 14a-9.

Among other things, Ms. Sandberg alleged that the directors believed they had no alternative but to recommend the merger if they wished to remain on the board. At trial, she obtained a jury instruction, based on language in *Mills v. Electric Auto-Lite Co.,* 396 U.S. 375 (1970), that she could prevail without showing her own reliance on the alleged misstatements, so long as they were material and the proxy solicitation was an "essential link" in the merger process. She was awarded an amount equal to the difference between the offered price and her stock's true value. The remaining respondents prevailed in a separate action raising similar claims.

The Court of Appeals affirmed, holding that certain statements in the proxy solicitation, including the one regarding the stock's value, were materially misleading, and that respondents could maintain the action even though their votes had not been needed to effectuate the merger.

Recent cases

Berger v. Intelident Solutions, 2006 WL 1132079 (Del. Apr. 26, 2006). *Delaware Supreme Court reverses forum non conveniens dismissal.*

Plaintiff, a minority shareholder in a Florida corporation, filed a breach of fiduciary duty action in connection with a freeze-out merger. The sole defendants were a Nevada limited partnership, which was the ultimate controlling entity of the Florida corporation, and a Delaware corporation formed to serve as an intermediate holding company in connection with the merger. Defendants moved to dismiss based on *forum non conveniens,* arguing that forcing them to litigate in Delaware would impose an overwhelming hardship. The Court of Chancery granted that motion, finding that the dispute would be more appropriately litigated in Florida and that Defendants had met the exacting standard applied in assessing *forum non conveniens* motions.

Examen, Inc. v. VantagePoint Venture Partners 1996, 873 A.2d 318 (Del. Ch. 2005). *Court of Chancery applies internal affairs doctrine to stockholder vote on merger.*

The plaintiff, a Delaware corporation, sought a judicial declaration that Delaware law governed a stockholder vote on a pending merger because if the vote was governed by Delaware law, common stockholders and preferred stockholders would vote on the merger as a single class. The defendant, a

large venture capital firm owning 83% of the corporation's preferred stock, argued that California law controlled because if California law were to apply in determining the voting rights of the Delaware corporation's stockholders in connection with the proposed merger, the preferred stockholders would have the right to vote as a separate class, effectively giving the defendant a veto over the merger. The court granted plaintiff's motion for judgment on the pleadings finding that Delaware law applied because this case was governed by the internal affairs doctrine.

Johnson v. VantagePoint Venture Partners 1996, 2005 WL 1653959 (Del. Ch. July 7, 2005). *Court of Chancery denies request for permanent injunction against shareholder seeking to challenge merger after merger is consummated.*

This case arose out of an earlier dispute in which VantagePoint Venture Partners (VantagePoint), an investor holding the majority of a series of preferred stock in Examen, Inc. (Examen), a Delaware corporation, sought to veto a merger between Examen and a Delaware subsidiary of Reed Elsevier Inc. VantagePoint argued for a determination that under California law the holders of the series of preferred stock issued by Examen had a right to a class vote in the merger. But the Court of Chancery held that California law did not apply and that all of the stockholders were permitted to vote on the proposed merger.

Neuberger Berman Real Estate Income Fund, Inc. v. Lola Brown Trust No. 1B, Civil No. AMD 04-3056 (D. Md. Oct. 22, 2004). *The Investment Company Act of 1940 does not preclude a closed-ended investment company from adopting a poison pill.*

Investment trusts affiliated with Stewart Horesji began to accumulate shares in the Neuberger Berman Real Estate Income Fund (the Fund), a close-ended investment fund incorporated in Maryland. The Horesji group filed a Schedule 13D stating that the trusts had acquired 10.05 percent and intended to buy over 50 percent, intended to replace the directors, and intended to replace the Fund's adviser with Horesji affiliates. The Horesji trusts started a tender offer for 1,825,000 shares, enough to bring the group's ownership up to 50.01%. After a committee of independent directors of the Fund concluded the tender offer was not in the best interests of stockholders, the board adopted a rights plan ("poison pill") with an 11 percent threshold.

The Horesji trusts brought suit, alleging that the poison pill violated section 18(d) of the Investment Company Act of 1940 (ICA). Under this section, the only warrants that a registered management company is permitted to

issue are warrants that expire not later than 120 days after issuance and that are issued ratably to all shareholders.

The rights issued by the Fund expire on the 120th day after execution of the rights agreement. The Horesji trusts argued that the rights weren't issued ratably to all shareholders, because shareholders owning above 11 percent would end up being treated differently from other shareholders. The court rejected this argument, noting that courts have consistently found that poison pills do not violate state statutes containing antidiscrimination provisions similar to those in section 18(d). The court noted that the rights were issued proportionately to a class of shareholders, with one right being attached to each share. "A voluntary act of a shareholder to acquire holdings of both the poison pill trigger does not violate section 18(d)'s requirement that rights be issued ratably." For similar reasons, the court rejected the Horesji trusts' argument that the rights plan violated section 18(i) of the ICA, which requires that each share have equal voting rights. The poison pill did not change the fact that all shares were granted equal voting rights. According to the court, the triggering of the pill has nothing to do with the voting rights of the shares themselves.

OSI Systems, Inc. v. Instrumentarium Corp., 2006 WL 656993 (Del. Ch. Mar. 14, 2006). *Court of Chancery finds violation of GAAP claim subject to arbitration because claim was actually a breach of warranty and representation.*

In this case, plaintiff buyer and defendant seller in the sale of a business argued over the type of contractual arbitration that should be used to solve a disagreement over the form of arbitration each preferred. The Court of Chancery granted seller's motion on the pleadings because buyer's claims were for breaches of representations and warranties, which fell under the indemnity provisions of the contract and the form of arbitration set forth in those provisions, must be used by buyer.

VII. ADDITIONAL RECENT CASES

Recent cases involving payment of fees for M&A

Barker Capital LLC v. Rebus LLC, 2006 WL 246572 (Del. Super. Ct. Jan. 12, 2006). *Superior Court finds that plaintiff was entitled to advisory fee pursuant to contract.*

The plaintiff, Barker Capital LLC (Barker), a Delaware LLC, sued Rebus LLC (Rebus), also a Delaware LLC, Mark A. Fox (Fox), and Twinlab Corporation (Twinlab), a Delaware corporation, alleging breach of contract, *quantum*

meruit, tortious interference with contract, and unjust enrichment. Rebus and Barker entered into an Engagement Agreement, pursuant to which Barker would act as Rebus' nonexclusive financial advisor to identify and consummate a transaction to purchase two medical newsletters. Under the terms of the Engagement Agreement, Barker was entitled to an Advisory Fee in the amount of 2.5 percent of the transaction's value. Both sides moved for summary judgment. The court found that Barker was entitled to 2.5 percent of a $12 million loan associated with the deal, but was not entitled to a percentage of a $35 million loan connected with the deal. The court also found against the plaintiff on the *quantum meruit* claim because the plaintiff had been made whole when the court ruled in his favor on the breach of contract claim. Turning to the tortious interference claim, which was only alleged against Fox, the court found that it did not have the subject matter jurisdiction to pierce the corporate veil.

California Public Employees' Retirement System v. Coulter, 2005 WL 1074354 (Del. Ch. April 21, 2005). *Court of Chancery finds change of control payments are reasonable if a majority of a board of directors ceased to be "Existing Directors."*

Defendant Lone Star Steakhouse & Saloon, Inc. agreed to make change of control payments to certain employees if a majority of its board of directors ceased to be "Existing Directors." Existing directors were those directors in office at the time of the change of control agreements and those new directors who were approved by existing directors. The views of new directors who were not approved as existing directors would not be considered in determining whether subsequent new directors would be considered existing directors. The question is whether such a provision contravenes the teachings of *Carmody v. Toll Brothers, Inc.,* 723 A.2d 1180 (Del. Ch. 1998), which concluded that directors may not be granted distinctive voting powers unless they are authorized by the certificate of incorporation, something Lone Star's certificate of incorporation does not do.

Delaware Ins. Guar. Ass'n v. Christiana Care Health Services, 2006 WL 196382 (Del. Jan. 24, 2006). *Delaware Supreme Court reverses Superior Court and finds that defendant became an "insured" for purposes of 18 Del. C. § 4211(2)(a) by operation of law after named insured merged into defendant.*

The Delaware Insurance Guaranty Association (DIGA) sought reimbursement from Christiana Care Health Services (CCHS) pursuant to one of the Delaware Insurance Guaranty Association Act's provisions for claims paid on behalf of an insolvent insurer. In this case the insolvent insurer had insured a corporation that merged into CCHS. The Superior Court granted

CCHS's motion for summary judgment, finding that CCHS was not an "insured" under the insurance policy. Reversing the lower court, the Delaware Supreme Court found that a court must consider the purpose and intent of 18 Del. C. Section 4211 when determining if a company is an "insured." A court may not rely on terms in an insurance policy that are inconsistent with the purpose and intent of Section 4211. The Supreme Court found that CCHS became an insured after the named insured merged into the defendant, and CCHS is obligated to reimburse DIGA pursuant to Section 4211.

In re Cox Communications Inc. Shareholders Litigation, 879 A.2d 604 (Del. Ch. June 6, 2005). *Court of Chancery slashes fees to plaintiffs' counsel where complaint was filed on negotiable merger proposal.*

Vice Chancellor Strine ruled on a fee request in a case arising out of a proposal by the Cox Family to take Cox Communications private. The Family proposed a merger on fully negotiable terms with an opening bid of $32. The proposal was immediately followed by a flurry of class action lawsuits, as well as the formation of a special committee to review and evaluate the terms of the offer. The Family tentatively agreed with a special committee of independent directors to a price of $34.75 per share subject to approval by a majority of the minority stockholders and conditioned on settlement of the outstanding lawsuits, a final fairness opinion, and agreement on the terms of a final merger agreement.

Counsel for the plaintiffs eventually agreed that the $34.75 price accepted by the special committee was fair, accepted the other terms of the transaction, and agreed to settle their claims. After settlement, the Cox family agreed not to oppose a request by plaintiffs' counsel for payment of attorneys' fees of up to $4.95 million. Certain Cox stockholders, however, did object to the fee request and the Court of Chancery heard their objections. The Court slashed a $4.95 million fee request to an award of $1.275 million and advised the plaintiff's bar to consider that award "generous."

Matthews v. Groove Networks, Inc., 2005 WL 3529317 (Del. Ch. Dec. 8, 2005). *Liquidation preference in certificate of incorporation was found to not apply to merger proceeds.*

Subsequent to merger between corporate Defendant and Microsoft, a common stockholder objected to payment of liquidation preference in favor of the corporation's preferred stockholders. The certificate of incorporation stated that, in the event of a merger, the preferred stockholders would be paid from the corporation's "Distributable Assets, whether from capital, surplus or earnings." The certificate clarified that in the event of a sale of a majority of the corporation's assets, the distributable assets would be the net proceeds of

such sale. But the certificate did not contain a corollary statement clarifying what would constitute distributable assets in the event of a merger. The common stockholder sued, arguing that the merger consideration was not intended to be part of the assets of the corporation.

Recent cases alleging violation of tax law

Indopco, Inc. v. C.I.R., 503 U.S. 79 (1992). *Expenses incurred in a specific friendly acquisition may be capital expenditures that created a benefit, not ordinary business expenses, and so may not be tax-deductible.*

In 1977 Indopco, formerly named National Starch and Chemical Corporation, and Unilever United States, Inc., entered into a "reverse subsidiary cash merger" specifically designed to be a tax-free transaction for National Starch's largest shareholders.

In its 1978 federal income tax return, National Starch claimed a deduction for the approximately $2.3 million in investment banking fees it paid to Morgan Stanley & Co. as ordinary and necessary expenses under Section 162(a) of the IRC. The IRS disallowed the deduction and National Starch sought a redetermination including the $490,000 legal fees it paid its attorney as well. The question before the court was whether National Starch could deduct its expenses as ordinary and necessary business expenses.

The U.S. Tax Court and the Third Circuit Court of Appeals denied the deduction, saying that the expenses did not "create or enhance . . . a separate or distinct additional asset." The U.S. Supreme Court granted *certiorari* and held that investment banking, legal, and other costs incurred by the target corporation were not deductible as ordinary and necessary business expenses, but instead should be capitalized as long-term benefits to the corporation.

Newark Morning Ledger Co. v. United States, 507 U.S. 546 (1993). *An asset is depreciable if it can be valued, and if the value declines over time.*

In 1976, the Herald company purchased substantially all of the outstanding shares of Booth Newspapers, Inc. The Herald company, which was succeeded by the Newark Morning Ledger, claimed depreciation in the amount of $67.8 million, which represented the depreciable value of the future income stream from the newspaper's current subscribers.

The question before the court was whether an intangible asset such as a subscriber list can be depreciated. The Federal District Court for the District of New Jersey entered a judgment in favor of Newark Morning Ledger Co. and the Court of Appeals for the Third District reversed. The U.S. Supreme Court reversed the Court of Appeals, stating that an asset is depreciable if it

is capable of being valued and if the asset's value diminishes over time. The court concluded that if a taxpayer can prove that a particular asset can be valued, and that the asset has a limited useful life, the taxpayer may depreciate the asset's value over its useful life regardless of how much the asset appears to reflect the expectancy of continued patronage.[14]

Recent cases involving insolvent companies

AT&T Corp. v. Clarendon America Insurance, 2006 WL 2685081 (Del. Super. Ct. Sept. 18, 2006). *Superior Court grants defendant insurers' motion to dismiss because employees who served as directors and officers suffered no loss to which D&O insurance coverage applies.*

This case is part of a larger insurance coverage dispute involving D&O coverage purchased from certain of the defendants by plaintiff AT&T Corp. (AT&T) and the company of which AT&T was the majority stockholder, the now-bankrupt At Home Corporation (At Home). AT&T sought D&O coverage in connection with several underlying shareholder suits brought against it and certain directors and officers of AT&T and At Home. The court previously decided the potential coverage liability under the AT&T D&O policies but not the At Home policies. See *AT&T Corp. v. Clarendon America Ins. Co.,* 2006 WL 1382268 (Del. Super. Ct. Apr. 13, 2006, amended Apr. 25, 2006). At issue in this case are the D&O policies issued by the five defendant insurers to At Home, including the primary insurer and the four excess insurers (collectively, the At Home Insurers). The At Home Insurers moved to dismiss AT&T's complaint.

North American Catholic Educational Programming Foundation v. Gheewalla, C.A. No. 1456-N (Del. Ch. September 1, 2006). *Delaware Court of Chancery limits creditor fiduciary duty claims.*

This is another in a series of Court of Chancery decisions that limit the claims that creditors may make based on the theory the directors owe the creditors a duty when their corporation is insolvent or in the vicinity of insolvency. Ever since the famous footnote in *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.,* 1991 WL 277613 (Del. Ch. Dec. 30, 1991), creditors have argued that directors should owe them a fiduciary duty to take their interests into account when the creditors are the residual interest holders in a corporation that is insolvent or nearly so. A series of recent decisions have limited those creditor arguments. See, e.g., *Production Resources Group v. NCT Group, Inc.,* 863 A.2d 772 (Del. Ch. 2004) (holding most creditor claims must be brought as derivative claims). This new decision further limits creditor claims by holding that creditors may not bring a direct claim for breach of fiduciary duty based on the theory the entity is in the vicinity of insolvency.

Further, the decision holds that for clearly insolvent companies, only creditors whose claims are beyond fair dispute may claim the directors owe them a duty.

Trenwick America Litigation Trust v. Ernst & Young, 2006 WL 2333201 (Del. Ch. Aug. 10, 2006). *Delaware Court of Chancery rejects "deepening insolvency" theory in case involving a postmerger bankruptcy.*

The Delaware courts have struggled for the last fifteen years over the scope of the duties of directors to creditors when their company is in the vicinity of insolvency. In two landmark decisions, the first in 2004, and just recently in this case, the Court of Chancery sought to define the limits of that duty. Indeed, in this decision, involving a company that became insolvent after a merger, the Court rejected the very idea that there is a duty to avoid taking risks that may have the effect of deepening the insolvency of a Delaware corporation, at least in most circumstances.

Big Lot Stores v. Bain Capital Fund VII, 2006 WL 846121 (Del. Ch. Mar. 28, 2006). *Court of Chancery dismisses complaint because a creditor erroneously asserted derivative claims as direct in the hope of escaping bankruptcy court jurisdiction.*

In 2000, in a sponsored management buyout, a corporation sold a subsidiary business that operated a chain of toy stores (KB Toys) in exchange for $257.1 million in cash and a $45 million note due in 2010. In 2002, the new owners refinanced the business and distributed approximately $120 million to the buyout sponsor, affiliates, two officers and directors of the subsidiary that invested in the buyout, and others. In 2004, the KB Toys filed for Chapter 11 bankruptcy. Plaintiff Big Lots, Inc., an unsecured creditor and holder of the $45 million note, brought this action asserting direct claims of breach of fiduciary duties, fraud, and civil conspiracy. The plaintiff sought recovery for the amount due on the note and restitution for alleged unjust enrichment. The Court of Chancery dismissed the complaint namely because the claims were derivative in nature, not direct, and thus belong to the bankruptcy estate.

Flowserve Corp. v. Burns Int'l Servs. Corp., 2006 WL 739886 (D. Del. Mar. 22, 2006). *District Court enjoins plaintiff from initiating third-party proceedings against defendants and from pursuing global settlement strategy in pending asbestos cases.*

Plaintiff filed a complaint seeking a declaratory judgment of its right to indemnification in asbestos litigation under the terms of a stock purchase agreement executed by its predecessor-in-interest, which had acquired a subsidiary of Borg-Warner Corp. (BWC). Defendant Burns International Services

Corp. (Burns), which had purchased BWC's insurance assets at a liquidation sale, filed a counterclaim alleging that its indemnification obligations to plaintiff only arose out of a later letter agreement, and that once BWC's insurance was exhausted, plaintiff had to pay the costs of defending and resolving the asbestos claims. During the pendency of the instant case, plaintiff informed Burns that (1) it had terminated the counsel chosen by Burns to defend the asbestos claims; (2) it was choosing its own counsel; and (3) it was directing its new counsel to file third-party complaints against defendants and to pursue global settlements in the underlying asbestos cases (together, the "threatened actions"). Burns then sought a temporary restraining order and preliminary injunction to enjoin plaintiffs from taking the threatened actions.

Recent cases involving international transactions

Unisuper v. News Corp., 2005 WL 3529317 (Del. Ch. Dec. 20, 2005). *Court refuses to dismiss suit to invalidate corporation's extension of poison pill.*

In the context of converting from an Australian corporation to a Delaware corporation, News Corp.'s board adopted a policy that if a shareholder rights plan were adopted following reincorporation, the plan would have a one-year sunset clause unless shareholder approval was obtained for an extension. The policy also provided that if shareholder approval were not obtained, the company would not adopt a successor shareholder rights plan having substantially the same terms and conditions. Several weeks later, News Corp.'s board adopted a poison pill in response to a specific third-party takeover threat. One year later, the board extended the poison pill without a shareholder vote, in contravention of its prior policy.

Alstom Power v. Duke/Fluor Daniel Caribbean, 2005 WL 407206 (Del. Super. Ct. Jan. 31, 2005). *Superior Court holds that it has personal jurisdiction over foreign limited partnership because of forum selection clause in contract.*

The plaintiff brought a breach of contract action in Superior Court. The defendant moved to dismiss for lack of personal jurisdiction. The court accepted the plaintiff's argument that it was appropriate for the court to exercise personal jurisdiction based on a forum selection clause in the contract.

Madison Real Estate Immobbilien-Anlagegesellschaft Beschrankt Haftende KG v. GENO One Financial Place, 2006 WL 456779 (Del. Ch. Feb. 22, 2006). *Court of Chancery denies motion for expedited preliminary injunction hearing for lack of "colorable claim" demonstrating imminent irreparable harm.*

The plaintiff is a German entity organized under that country's laws, as is the second named German limited liability defendant. The latter party is also a general partner in the first defendant entity. The plaintiff was one of two bidders that made an unregulated tender offer for a part of the first-named defendant's Delaware limited partnership interest. Plaintiff filed a motion in the Court of Chancery for expedited injunction proceedings, seeking to enjoin the defendant's general partner.

Blechner v. Daimler-Benz AG, 2006 WL 167835 (D. Del. Jan. 24, 2005). *District Court dismisses potential securities fraud class action involving only foreign parties.*

Plaintiffs, on behalf of themselves and other foreign shareholders who invested in securities of DaimlerChrysler AG, filed a class action complaint alleging securities fraud in connection with the merger of Chrysler Corporation and Daimler-Benz AG. Defendants moved to dismiss the complaint.

The court rejected the plaintiffs' argument that the complaint alleged sufficient conduct occurring in the United States to warrant the exercise of extraterritorial jurisdiction, and on those grounds dismissed the case. Specifically, the court held that because the conduct complained of took place primarily outside of the United States and because the plaintiff investors were foreign investors who had no connection to the United States, did not surrender any shares on an American market, and did not suffer any effects from the alleged fraud in the United States, the exercise of extraterritorial jurisdiction was inappropriate.

The Wharf (Holdings) Ltd. et al. v. United International Holdings, Inc., et al., Certiorari to the United States Court of Appeals for the Tenth Circuit No. 00-347. Argued March 21, 2001–Decided May 21, 2001.

The Wharf (Holdings) Limited verbally promised United International Holdings, Inc., an option to buy 10 percent of the stock in Wharf's Hong Kong cable system if United rendered certain services, but internal Wharf documents suggested that Wharf never intended to carry out its promise. United fulfilled its obligation, but Wharf refused to permit it to exercise the option. United sued in Federal District Court, claiming that Wharf's conduct violated, *inter alia,* Section 10(b) of the Securities Exchange Act of 1934, which prohibits using "any manipulative or deceptive device or contrivance in connection with the purchase or sale of any security." A jury found for United, and the Tenth Circuit affirmed. The court held that Wharf's secret intent not to honor the option it sold United violates Section 10(b) of the Securities Exchange Act

of 1934. The Court must assume that the "security" at issue is not the cable system stock, but the option to purchase that stock, because Wharf conceded this point below. That concession is consistent with the act's language defining "security" to include both "any . . . option . . . on any security" and "any . . . right to . . ."

Ethypharm S.A. France v. Bentley Pharmaceuticals, Inc., 388 F. Supp. 2d 426 (D. Del. 2005). *District Court rules that Spanish subsidiary of Delaware parent corporation is an indispensable party to allegations under DUTSA.*

United States District Court for the District of Delaware considered motions to dismiss for failure to join an indispensable party and a motion to dismiss various common law counts are precluded by the Delaware Uniform Trade Secret Act (DUTSA).

NOTES

1. Source: Tillinghast-Towers Perrin, www.towersperrin.com/tp/getwebcachedoc?webc=TILL/USA/2006/200601/DO_2005_Exec_Sum.pd For trends through 2006, see also www.captive.com/service/ace/Focus_Securities_k.pdf.
2. For a more complete list of landmark cases, see Alexandra R. Lajoux and Charles Elson, *The Art of M&A Due Diligence* (New York, McGraw-Hill, 2000).
3. For the full discussion of the cases by Morris James attorneys, see www.delawarebusinesslitigation.com.
4. For commentary on the merger guidelines, see www.ftc.gov/os/2006/03/CommentaryontheHorizontalMergerGuidelines March2006.pdf. The American Bar Association lists the following guidelines as most important for the Department of Justice:
   - *Antitrust Guidelines for Collaborations Among Competitors.* "This set of guidelines was issued in April of 2000. They explain how the Agencies analyze various antitrust issues that arise when business competitors collaborate and address issues that arise within the context of horizontal mergers and acquisitions, including joint ventures and strategic alliances."
   - *Horizontal Merger Guidelines.* "These guidelines were first issued in April of 1992 and revised in April of 1997. They outline the Agencies' then-current enforcement policies and analytical framework with respect to horizontal acquisitions and mergers subject to provisions of the Sherman Act, Clayton Act and FTC Act."
   - *Non-Horizontal Merger Guidelines.* "The Non-Horizontal Merger Guidelines were originally issued by the Antitrust Division as Section 4 of the

'U.S. Department of Justice Merger Guidelines' in June of 1984."
See Chapter 2 for more details.

5. Joseph McLaughlin of Brown & Wood LLP, cited in the introduction to this appendix.
6. www.mayerbrownrowe.com/publications/article.asp?id=2525&nid=6.
7. Other cases named by McLaughlin in this vein are: *In re International Rectifier Securities Litigation* [1997 Tr. Binder] Fed. Sec. L. Rep. (CCH) par. 99, 469 (C.D. Cal. 1997); Monroe v. Hughes, 31 F.3d 772 (9th Cir. 1994); *Weinberger v. Jackson,* [1990–91 Tr. Binder] Fed. Sec. L. Rep. (CCH) par. 95, 693.
8. For guidance on financial statement review, see Chapter 6 on due diligence.
9. Similar cases exonerating underwriters include: *Weinberger v. Jackson* [1990–91] Fed. Sec. L. Repp. (CCH) par. 95, 693 at 98, 255 (D.D. Cal. 1990); *In re Worlds of Wonder Sec. Litig.,* 814 F. Supp. 850 (N.D. Cal. 1993), *affd. in part, rev'd in part,* 35 F.3d 1407 (9th Cir. 1994), *cert. denied,* 116 S. Ct. 185 (1995); *Phillips v. Kidder, Peabody & Co.,* 933 F. Supp. 303 (S.D.N.Y. 1996); In re International Rectifier Sec. Litig., [1997] Fed. Sec. L. Rep. (CCH) par. 99, 469 at 97, 135 (C.D. Cal. Mar. 31, 1997); and *Picard Chemical Inc. Profit Sharing Plan v. Perrigo Co.* 1998 U.S. Dist. LEXIS 11783 (W.D. Mich. June 15, 1998). The citations in this list were provided by William F. Alderman and John Kanberg, Orrick, Herrington, and Sutcliffe LLP, San Francisco, who served as counsel to the defendants in Software Toolworks (writing a friend-of-the-court brief for the Securities Industry Association), as well as *Worlds of Wonder.*
10. For commentary on the merger guidelines, see www.ftc.gov/os/2006/03/CommentaryontheHorizontalMergerGuidelines March2006.pdf.
11. This is one of three U.S. Supreme Court cases under the Clayton Act against vertical mergers. *United States v. E. I. du Pont de Nemours & Co.,* 353 U.S. 586, 77 S. Ct. 872, 1 L. Ed. 2d 1057 (1957), and *Brown Shoe Co. v. United States,* 370 U.S. 294, 82 S. Ct. 1502, 8 L. Ed. 2d 510 (1962).
12. This case summary is reprinted verbatim from the American Bar Association website for public education.
http://www.abanet.org/publiced/preview/summary/home.html
13. *Per se* is from the Latin "for itself." Per se liability means liability if no other factors are considered.
14. This case is consistent with later tax law.

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Note: page numbers with "n" indicate note

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