Chapter 4

Negotiating the Deal

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Congratulations. Someone wants to buy your company. Now what? This chapter offers a short guide to some of the questions you need to answer before embarking down this road. It addresses the primary negotiating and legal issues that you likely will face during the process of selling your company.

SELL YOUR COMPANY RIGHT

The first point is that as much as you might like to, it doesn't make sense to dip your toe in the water. If you decide to sell your company, then go ahead and sell it the right way. A smart buyer will do everything in his or her power to convince you that you will be better off just negotiating with him or her.

Our reasons for taking this rather extreme position are several. The most important is that sticking a toe in the water is an illusion. Once you head down this road, circumstances start taking on a life of their own. Indeed, this was the logic behind the Camp David peace process. If you can get two parties to negotiate together in good faith, there is a pretty good chance they will do a deal, even if one side doesn't think it is possible going into the process.

AN OPEN SELLING PROCESS

As a buyer, the last thing you want is to have to outbid other potential acquirers. In the same spirit as "Speak now or forever hold your peace," if a company is coming up for sale, many firms will take a look knowing that this is their only chance to buy it. Your company might have been on their distant radar, but now they are forced to pay attention.

Academic evidence suggests that when buyers face competition for a target company, they generally end up overpaying, and, as the seller, that's what you want. The negotiations will end with the synergy and cost savings going to you in the form of increased purchase price rather than to the buyer's shareholders. So that is why buyers prefer to negotiate. Indeed, that is the reason many companies insist on getting a right of first refusal before even beginning the negotiation process.

An open selling process can bring out bidders for all sorts of reasons. Sometimes the aim is to prevent your company from falling into a rival's hands. If you want to sell to Coke, there is nothing like getting Pepsi's interest and vice versa. Indeed, the beverage company SoBe was almost sold to Coke. Pepsi felt excluded from the deal. When Coke balked, Pepsi was excited to be back in the game. SoBe is now part of Pepsi. It is a good bet that Pepsi's eagerness was fueled by their opportunity to beat Coke.

A CLOSED SELLING PROCESS

Now, having said that you should prefer an auction to a one-on-one negotiation, let us give the other side of the argument. We have a client who sold one of his books to a publisher that made a preemptive bid. The publisher understood that it was about to face an auction in which it had an uncertain chance of winning. From the client's side, there was also a chance that the auction would fail. If few bidders showed up, then the publisher would end up bidding less than its preemptive offer. Also, the publisher's excitement for the book would be greatly diminished. That matters when it comes time for marketing budgets. And, in the case of selling a business, it matters to you if your purchase price includes a postclosing payment dependent on the performance of the business, that is, an *earn-out.* Thus, it is possible to get some, or even all, of the benefit of an auction without running one by allowing potential bidders to make a preemptive bid. However, this requires that the bidder believe that it will have to compete in an auction if its preemptive bid fails.

A second reason not to have a full-fledged auction is that your company may have proprietary processes and other sensitive information. Thus, the value of your company will go down if more people really understand how you make money.

One of the key lessons that you know from business is to put yourself in the shoes of the other party. Being a bidder is a big distraction. Some firms might not enter the competition unless they think they have a respectable chance of winning.

PAYING BIDDERS TO PLAY

One strategy you might not have considered is to pay bidders to play. That payment might be in the form of cash, typically through a breakup fee. It might be in the form of a supply contract. That way, the potential buyer knows that its efforts won't go fully unrewarded at the end of the day.

A great example of this occurred during the hostile takeover attempt by Craig McCaw for LIN Communications. The example may be a bit extreme, but it shows what is possible.

LIN's CEO, Donald Pels, was no fan of McCaw and put a poison pill into place to prevent the takeover. As a result, McCaw was thwarted. The problem is that the share price also fell as a result of LIN no longer being a takeover target.

Pels went to Bell South and invited them to make a friendly bid for his company. But the smart folks at Bell South realized that McCaw would most likely outbid them. Sure they would be delighted to buy LIN at the current price, or even at McCaw's first bid. But that wasn't going to be McCaw's best bid. Why go through all the distraction only to have McCaw end up with the company?

LIN gave Bell South 54 million reasons. If their initial bid was topped, they would get a $54 million breakup fee. Under those terms, they agreed to bid. And sure enough, their bid was topped. After they bid approximately $110 a share, McCaw countered with $115. LIN wanted Bell South to bid again, and for another $10 million they were willing to play along. McCaw outbid them again, and this time also paid Bell South $22.5 million to stop bidding. (Keep in mind that LIN was a public company and that different rules apply when bidding for public companies. Consult your attorney for advice on developing bidding incentives in the context of a sale of a private company.)

Bell South did great in that it turned a losing hand into approximately $80 million of profit. Although it is true that Donald Pels ended up paying a lot for this extra competition, McCaw's final bid added an extra billion dollars to LIN's valuation, at which point Pels decided that McCaw wasn't such a bad guy after all.

The takeaway point is that we often assume that bidders will provide their competition for free. That's the American way. Some firms may enter the ring just to have a chance of winning. But you can't presume that you will get enough competition for free. Thus, you should think who else you might like to enter the game and how you can reward that bidder. Eighty million was a bargain price to get McCaw to raise his bid by a billion.

RIGHT OF FIRST REFUSAL

The buyer asks for a last-look provision. Under a last-look (also known as a *right of first refusal* or *right of last offer*), the buyer gets a chance to see all the other bids and if he or she is willing to match the highest bid, can then buy the company at that price.

If so, the buyer knows what he or she is doing. Do everything you can not to give a last-look provision. The reason is that few other bidders will be willing to look at your company if they know that someone else can always outbid them. This will not only depress the value of your company to other bidders, it will also depress how much the bidder with the last-look will pay because this bidder can anticipate how others will react.

RIGHT OF FIRST OFFER

The best solution here is to offer a right of first offer. This sounds similar to a right of first refusal but is quite different. A right of first offer solves some of the same issues as a last-look provision without giving away the store. Under a first offer, the buyer states a price and you can either accept or reject. If you accept, the deal is done. If you reject, you are free to sell the company to any other bidder provided that you can get a higher price. If you can't get a higher price, you don't have to sell. But if you still want to, the first buyer isn't required to keep his initial price on the table. You have to offer the buyer with the right of first offer a chance to buy your company at the best price you've obtained. With a right of first offer in place, other bidders can still buy your company without having to let someone match them—provided they bid high enough. Thus, they are not at such a disadvantage that they won't play.

AN OFFER YOU CAN'T REFUSE

The buyer says: "Sell to me or I will enter your market and compete with you." This can be done as a threat or even in a friendly way: "We think this is a great market. We plan to enter. We'd prefer to enter by buying you, but this is a market we want to be in."

Either way, you are in a tough position. There's good and bad news here. If the buyer is the right buyer for your company, then the threat is more serious. But if the buyer isn't the best one, then you should be less worried. There is often a right time to sell a company. Doing so before a major competitor comes into the market is one of those right times.

PROFESSIONAL HELP

By the way, if some of this confusing to you, this is as good a signal as any that you need professional advice. Although you may have sold a company in the past, chances are that you don't have that much experience in this process. In contrast, your buyer has probably done this before. Good investment banks and (mergers and acquisitions) M&A lawyers have seen all of these contract provisions before, as well.

A second reason to get professional help is that you care too much. As Herb Cohen, author of *Negotiate This,* emphasizes, you should care, really care, but not that much. It is hard to discuss in dispassionate terms something that you've created. In many cases, you will end up having to work with (or for) the buyer when the deal is done. If you are the one doing the negotiation, it is almost impossible to prevent bad feelings, unless you end up being too much of a softy.

EARN-OUTS

Many times buyers will want to include an *earn-out* provision. You have provided them with some estimates for future sales. Part of the payment for the company will be contingent on making those sales forecasts.

How you feel about this provision will depend quite a bit on whether you are planning to stay with the company. If the factors (advertising, sales force) are not in your control, then you are taking a much bigger risk in accepting an earn-out.

However, the earn-out provision can be a great tool for resolving valuation debates. You say that the company is worth $100 million because its sales are projected to grow from $10 million this year to $20 million next year. The buyer says the company is only worth $50 million because they have doubts about the size of the market. In that case, you can say: "Well, then you should have no problem paying us $100 million if we actually hit those targets."

Be careful here. Almost by the very fact that you are running this business, you are an optimist about the future. You may have more facts, but it is hard to be objective. That said, rather than simply accept $50 million, there is no reason not to push for the upside. Indeed, if the buyer was bluffing on this point, this is a good way to find out.

EARN-INS

You can also turn an earn-out around. Consider an earn-in. Many companies will claim that they are a great strategic buyer. They will claim that they can bring your company to the next level. They can give you access to distribution, production, international markets, and more.

The problem is that they may not deliver. This will be especially painful if you find yourself holding their stock as compensation.

A solution here is to give the buyer control of the company subject to hitting certain performance measures. Today the buyer pays for a call option, the right to buy the company at a fixed price. The buyer quite rightly does not want to have to pay a much higher price for the company, having been the one to add this value. But the buyer's ability to exercise the call is contingent on meeting performance goals.

With these negotiating tactics in mind, let's turn to a discussion of the legal aspects of the transaction you are about to enter. The next part of this chapter addresses issues related to the trade-offs between going public versus being acquired, the process of negotiating and putting together a contract, and the key provisions that should be included (or excluded) from the contract. Finally, it touches on the differing implications of being acquired for cash versus stock.

COMMONLY MISTAKEN ASSUMPTIONS

Let's conduct a little practical test. True or False:

1. If I sell my company for stock instead of cash, I can avoid paying capital gains tax.
2. If I sell my company for stock, I can immediately sell the stock I receive.
3. If, instead of selling my company, I undertake an initial public offering (IPO) of my company's stock, I can keep control of my company and sell stock whenever I personally need cash.

If you answered true to any of the above questions, you're wrong. There are many cases in which each statement is incorrect. If you answered false, you're probably wrong, too. There are cases in which the statement is correct. It may come as a surprise to you that the correct answer to each question is a resounding maybe.

How can this be? Is there no certainty on something as fundamental as obtaining liquidity for one's company? The laws—both tax laws and securities laws—that govern the questions posed are complex and have been developed over time. As a result, there is a veritable patchwork quilt of laws and regulations that apply. In some cases, a sale of your company for stock instead of cash is taxable and in other cases not. In some cases, you can immediately resell stock you receive as consideration for the sale of your company and in other cases not.

The important lesson to take away from these questions is that you cannot assume anything, even the most intuitive conclusions, when considering the sale of your company. Each aspect of a potential transaction must be considered from a business standpoint, and then analyzed carefully under applicable corporate, securities, and tax laws.

SALE OR IPO?

America loves an IPO. During the 1998–2000 bubble, during which the NASDAQ Index soared above 5,000 and every week seemed to create a new Internet billionaire, everyone wanted an IPO. The cake being served by the equity markets was so rich that conventional businesses turned their attention away from their core businesses and instead focused on developing an Internet strategy. Wall Street thought, and most of us bought into it, that the Internet would fundamentally and quickly change the way business was conducted. One investment bank ran an ad campaign under the slogan "Are you still calling it the new economy?"

We all now know that the cake was too rich, that the Internet is best viewed as another channel of distribution—adding to and not displacing conventional channels—and that business is, once again, all about making profits.

THE IPO ROUTE

Assume, however, that you've got that remarkable company that can go public. Should you do it? It depends on your objectives. The best reasons for undertaking an IPO are:

- To raise a significant amount of equity capital in order to fund rapid growth
- To have a noncash "currency" that can be used for acquisitions, which is common in rollup and consolidation strategies
- To take advantage of higher valuation multiples that may exist in the public markets for companies in your particular industry
- To facilitate the sale of stock at different times by different family members or owners of the company
- To help create a stock incentive program for employees

Another reason commonly given is that going public will give the company a sales boost because it's easier to compete as a large, public company. But this reason is specious. Once a company is public, the world can see its financial results and thus determine with great certainty precisely how large or small the company is and precisely how strong or precarious is its financial position. Large companies do not point to this reason for going public.

THE SIZE OF YOUR COMPANY MATTERS

A good reason to undertake an IPO is that if the company is large enough, the owner can obtain some liquidity by selling a minority position and still maintain control. The reason the company has to be large is that in order to have a successful offering, the IPO must offer both a relatively large number of shares to ensure a liquid market and a price per share high enough to attract institutional investors.

For example, a company with an equity value of $1 billion can sell 20 percent to the public and have a market float of $200 million. If 10 million shares were offered, the stock would have a price of $20 per share. This would seem to be a sufficiently large market float to offer liquidity and a high enough per share price to attract an institutional following. A 100,000-share lot would cost $2 million and yet constitute only 1 percent of the market float. However, if the company had an equity value of $100 million, a sale of 20 percent would yield a market float of $20 million. If 10 million shares were offered, the stock would have a per share price of $2, which no underwriter would propose. If two million shares were offered, the stock would have a price of $10 per share. While $10 per share seems high enough in the abstract, a $2 million investment would require the purchase of 200,000 shares and constitute a full 10 percent of the market float. Unloading a 10 percent position in any stock is not simple. Although there are plenty of underwriters who would recommend an IPO of 20 percent of a company with a valuation of $100 million, the owners may be surprised by the lack of institutional interest in the stock after the completion of the offering.

The important point here is that $20 million isn't enough to have a liquid market, whether it is one share at $20 million or 20 million shares at $1. Just as you can't make more pizza by cutting it into smaller slices, you can't make a stock more liquid by creating more shares with a lower price. Liquidity is determined by investors' ability to sell some dollar amount of stock in a day. If there is only $20 million of stock that can be traded, it is next to impossible to for an institution or large investor to trade more than $1 million without having a significant impact on the price.

Change of Corporate Structure

What if your company is organized as an LLC or S corporation? Can it maintain that status and still go public? No. A public corporation cannot be an S corporation for federal income tax purposes in the United States. Although there are no strict limits on the number of members of an LLC, except for real estate investment trusts (REITs), the public markets do not want to invest in pass-through entities. You should assume that your LLC or S corporation will have to become a C corporation for federal income tax purposes at the time of its IPO. This means that the company will be taxed at the corporate level going forward.

Reporting Requirements

After an IPO, your company will be subject to the full panoply of the periodic reporting regime of the federal securities laws. With the recent amendments to the securities laws and the regulations promulgated by the Securities and Exchange Commission (SEC) as a result of Congress' enactment of the Sarbanes-Oxley Act of 2002, it has been estimated that the cost of compliance to be public is between $0.9 and $3.5 million. While this seems extremely high, even if your company's costs were 50 percent of those amounts, it's a staggeringly expensive administrative burden. Cutting costs in the compliance area is not an option, especially in light of the new criminal penalties enacted by Congress.

Getting Liquidity Through an IPO

IPOs fall into two categories: primary offerings and secondary offerings. A primary offering is an offering of shares newly issued by the company. The net proceeds of the offering are payable to the company. A secondary offering is an offering of shares held by a shareholder. The net proceeds of the offering are payable to the shareholder. (The terms are not uniformly used. Occasionally, you'll hear underwriters talk of a secondary offering when they mean the sale of shares by a company in an offering after an IPO. The better term for this is a *follow-on* offering.) An IPO can be either a primary offering or a secondary offering, or it can be both. If both, the company would issue some shares to be sold to the public, and the company's existing shareholders would sell some shares to the public.

Can you can sell some of your shares in an IPO so that, at least in part, the IPO of your company is a secondary offering? The answer is maybe. If your company is large enough, the answer is likely to be that you may indeed sell some shares in the IPO. Your stake in the company is probably so valuable that the underwriters can explain to the institutional investor community that you are selling to obtain some modest liquidity and that your stake in the company is still large enough to keep you highly motivated. On the other hand, if your company is more modest in size, the answer is likely to be no. The underwriters will explain to you that the institutional investor community will want all net proceeds of the offering to be used in the business.

Liquidity Constraints

After an IPO, contrary to popular belief, you cannot sell stock anytime you like. First, as part of the IPO, the underwriters will require you to sign a lockup agreement, pursuant to which you agree not to sell any of your shares for at least 180 days following the offering. Second, unless you have rights to require the company to register your shares under the Securities Act of 1933 in order to permit you to resell them to the public (commonly called *registration rights*), the federal securities laws limit the amount of stock that you as a controlling person can sell. In general, in any three-month period, you can sell up to the *greater* of 1.0 percent of the number of outstanding shares or the number of shares equal to the average weekly trading volume (over the most recent four weeks). See the discussion of Rule 144 below. Third, you cannot sell shares at any time when you are in possession of material non-public information, which usually means that you can sell only when the "window is open" under your company's insider trading policy.

Many founders of companies that have gone public take advantage of the SEC's Rule10b-5.1. This rule enables a company insider to sell at regular intervals a set number of shares previously announced to the market without being subject to blackout periods.

IPO UNDERPRICING

What about price? Can you get more for your company in an IPO? Academic research suggests that IPOs are typically underpriced; the 6,249 IPOs between 1980 and 2001 rose by an average of 18.8 percent on their first day of trading.[1] What that means is that you are effectively selling your stock at a discount and this can be thought of as one of the costs of going public. Of course, if you are only selling 10 percent of the company and there is an 18.8 percent discount, then the true cost is still under 2 percent.

You might even think these discounts are good for your company. If there were no discounts, then people would not have any incentive to invest resources to learn about your company (why do research in order to buy shares in a company that is fully priced?). To the extent that fund managers have done well with your stock, they may be more willing to invest in further offerings down the road. There is nothing that makes for less happy investors (and bankers) than starting off with a decline in price so that everyone invited to the party will have lost money.

SELLING RATHER THAN GOING PUBLIC

INTERMEDIARIES

So, after all this, you might have ruled out an IPO. Let's now discuss the sale process from commencement to completion. Do you need an intermediary to help you sell your company? These intermediaries (investment banks, business brokers, M&A advisory firms) charge a fee or commission if the business is successfully sold. From a legal standpoint, you can sell a company without an intermediary. However, the majority of companies owned by entrepreneurs get sold with the help of an intermediary. Why? The reasons include:

- The intermediary's knowledge of the value of the business and hence the sale price that the owner can expect to receive
- The intermediary's knowledge of the likely buyers and contacts within an industry
- The intermediary's experience in closing sale transactions
- The intermediary's time both to prepare a description of the business (often called an *offering memorandum,* or *book*) and to manage the sale process

An intermediary will ask you to sign an engagement letter formally setting out the terms of the intermediary's deal. Do not sign the engagement letter without having it reviewed by counsel. In addition, be careful not to make oral statements to the intermediary that you will retain the intermediary. The case law in this area is riddled with claims by intermediaries who did not have written contracts but who nonetheless sued the seller of a business claiming that the seller owes the intermediary a fee based on an alleged oral contract. In many jurisdictions, these contracts are enforceable.

The fees of intermediaries vary, depending on the size of the deal and the nature of the intermediary. The "bulge bracket" investment banks (including Citigroup, CSFB, Deutsche Bank Alex Brown, Goldman Sachs, JPMorgan, Lehman Brothers, Morgan Stanley, and UBS) usually have high minimum fees that make them logical intermediaries only for deals with transaction values over $100 million, although these institutions often compete for deals with lower transaction values. The middle and small business markets are served by a large number of intermediaries, including boutiques who specialize in selling businesses, often within a particular industry. Many intermediaries ask for an up-front retainer or monthly fee, although some are willing to be paid only if a sale transaction successfully closes, with what is called a *success fee.* Any retainer or monthly fees should be creditable against the success fee. The intermediary's expenses are typically reimbursed, sometimes subject to a negotiated limit.

Engagement letters usually provide for a *tail* period. If you do not successfully sell your company within the period of engagement—usually one year—the engagement letter will specify that the intermediary will be paid if a sale is completed within a period of time after termination of the engagement. This tail period is usually an additional year, although for larger transactions the bulge bracket firms have begun to insist upon two years. You should focus on this provision of the engagement letter because you might have to pay two success fees if you engage a new intermediary and subsequently close a sale. You should try to limit your obligation to pay the first intermediary only for sale transactions closed with parties with whom the intermediary has had meaningful discussions, often limited to those who sign a confidentiality agreement.

Confidentiality Agreements

Your lawyer or intermediary will work with you on the form of a confidentiality agreement that all prospective buyers are asked to sign. It is customary to obtain a signed confidentiality agreement before giving information about your business to any prospective buyer. You may find yourself frustrated with the amount of time spent negotiating what should be a straightforward agreement (or frustrated at having to pay a lawyer to negotiate a number of these agreements). However, it's money well spent. Among other things, these agreements typically impose obligations on prospective buyers to:

- Keep your information confidential
- Not to discuss the fact that you are for sale with any third party
- Not to solicit or hire your employees
- Not to contact your employees, customers, or suppliers except as permitted by you or your intermediary during the sale process
- Acknowledge that you can sell to anyone you like, or choose not to sell
- Acknowledge that you are not obligated to sell until a definitive sale agreement is signed

Offering Memorandums

You and your intermediary will likely prepare an offering memorandum or book on your business. The book typically introduces the company, its industry, and value proposition. Both historical financial statements and projections are typically included. Often, the summary financials will contain adjustments showing expense savings that a prospective buyer will enjoy, such as the elimination of your compensation and benefits or the closing of an administrative office. You should have your counsel review the offering memorandum.

Letters of Intent

A letter of intent in the context of the sale of a business is an expression of mutual intent of the parties to proceed with due diligence and negotiation of a definitive acquisition agreement. The letter of intent usually describes the basic economic deal: how much the buyer will pay, whether the consideration is cash or stock, the structure of the deal (e.g. an acquisition of stock or assets or a merger), and whether the buyer is assuming that the business will have certain attributes, such as minimum working capital or the services of named employees. These provisions are usually expressed to be nonbinding. This means that, at this juncture in the process, the parties do not intend to be legally bound. Ordinarily, the buyer needs to complete its due diligence investigation of the business, as well as to negotiate the terms of a definitive acquisition agreement, before the buyer is ready to be legally bound to buy the business.

It is extremely important to have counsel review any letter of intent before it is signed. The case law is littered with cases brought by would-be buyers or more numerous would-be sellers claiming that the letter of intent created a legally binding obligation. In some states, unless a letter of intent contains language expressly contemplating a subsequent definitive acquisition agreement, it will be held to be binding.

A letter of intent also usually contains binding provisions that relate to the procedure to be followed as the parties move forward to negotiate and sign a deal. A buyer will typically ask for a period of exclusivity, often called a *no-shop*. During the no-shop period, the seller agrees to deal exclusively with the buyer and not to discuss the sale or provide materials on the business to any other potential buyer. A typical no-shop period can be anywhere from 14 to 60 days, depending on the bargaining leverage of the parties. If the seller's business has attracted significant buyer interest, a skilled intermediary will negotiate a short no-shop period.

In the sale of some businesses, the buyer and seller proceed directly to the negotiation of a definitive acquisition agreement, and a letter of intent is not required.

Due Diligence

Due diligence is the process performed by the buyer to investigate the business proposed to be sold. In the context of the sale of a large business—for example, one with a purchase price over $100 million—the intermediary will run a process that will require potential buyers to complete or nearly complete their due diligence prior to submitting final bids. In the sale of a more modest business, a potential buyer will have done some due diligence prior to signing a letter of intent but will not have completed its due diligence investigation.

Normal due diligence will include an investigation of:

- Financial records, including the company's bookkeeping system, accounting ledgers, financial statements, audit work papers (if the company has audited financial statements), and related accounting and financial data
- Legal records, including the company's certificate of incorporation and bylaws, minutes of meetings of the board of directors and shareholders,

and material contracts (such as leases, intellectual property licenses, and significant customer and supplier contracts)
- Environmental matters, if applicable to the nature of the company's business, including possibly an initial investigation by an independent environmental consultant of the company's compliance with applicable environmental laws and regulations and an investigation of the company's facilities
- Tax records, including the company's tax returns and tax work papers
- Employee matters, including employment contracts with key employees, vacation and benefits records, compliance with workplace laws and regulations, and records relating to pension or defined contribution plans
- Capitalization matters, including any debt or capitalized leases and stock and option records
- Intellectual property records, including patents, trademarks, copyrights, and documentation relating to the proper assignment of intellectual property rights from employees to the company
- Other matters, including customer and supplier relationships and industry-specific items

A well-prepared seller will have worked with its intermediary and counsel to prepare due diligence materials in advance of any due diligence investigation. This has two big advantages: First, it facilitates a potential buyer's completion of due diligence and, second, it enables the buyer's advisors (lawyers, accountants, industry consultants) to conclude that the business is well run.

Definitive Acquisition Agreement

The definitive acquisition agreement is the legally binding agreement signed by the seller and the buyer setting forth the rights and obligations of each of them in the purchase and sale of the business. It is usually a long, complicated agreement negotiated between buyer and its counsel, on the one hand, and seller and its counsel, on the other. The form of the deal is important. Sales of businesses are usually given legal effect through one of three ways: asset sales, stock sales, and mergers.

Asset Sale

An asset sale is the sale of the company's assets and assumption by the buyer of certain of the company's liabilities. A definitive acquisition agreement in the form of an asset sale, called an *asset purchase agreement,* lists the assets to be sold to the buyer and the liabilities to be assumed by the buyer. Buyers typically like to structure acquisitions as asset purchases because they can specify the types of liabilities that they are willing to assume (such as trade payables) and not assume (such as, in some cases, debt obligations). Buyers also like asset acquisitions because, for U.S. federal tax purposes, they can step up the tax basis of the acquired assets to fair market value and therefore enjoy a bigger depreciation and amortization deduction.

Sellers are usually amenable to asset acquisitions if the business is organized as an S corporation for tax purposes or LLC because the deal can generally be structured to result in one level of tax, namely, at the shareholder level. However, if the seller's company is organized as a C corporation for tax purposes, an asset sale will result in two levels of tax: one at the company level on the gain from the sale of the assets and, when the proceeds of the sale are paid out by way of a dividend to the stockholders, a second level of tax at the stockholder level. Table 4.1 is illustrative.

Stock Sale

A stock sale is the sale by the company's stockholders (and not by the company) of the company's outstanding shares of capital stock. As a result, the buyer becomes the owner of the company. Unless the company has transferred out certain assets or liabilities prior to the closing of the transaction, the company retains all of its assets and liabilities.

Table 4.1

	C Corporation	S Corporation or LLC
Asset sale proceeds	$10,000,000	$10,000,000
Tax basis of assets	4,000,000	4,000,000
Gain on sale	6,000,000	6,000,000
40 percent corporate tax*	2,400,000	—
Net gain at corporate level	3,600,000	6,000,000
Distribution of net proceeds	3,600,000	6,000,000
20 percent individual tax†	720,000	1,200,000
Net after-tax proceeds	$2,880,000	$4,800,000

*Assumed combined federal and state corporate tax rate.

†Assumed combined federal and state individual tax rate applicable to dividends or capital gains. Actual tax rates may differ, including whether the owners of an S corporation or LLC recognize capital gains or ordinary income on the sale.

A definitive acquisition agreement in the form of a stock sale, called a *stock purchase agreement*, must be signed by each stockholder. A stock sale is feasible if there are a limited number of stockholders, all of whom support the transaction and are willing to be subject to the obligations of the stock purchase agreement. However, it is not feasible if there are a large number of stockholders—even 10 or 20 stockholders can make it unworkable. A stock sale is also not feasible if a single stockholder rejects the terms or refuses to be subject to the obligations of the stock purchase agreement. Although it is legally possible for a buyer to acquire less than all of the outstanding capital stock of a company, buyers ordinarily want to acquire 100 percent of a company and generally do not want to go into business with a former fellow stockholder of the seller. A stock sale usually results in the same net after-tax proceeds whether the business is organized as a C corporation, S corporation, or LLC (in which all outstanding interests are sold). This is because the company is not a party to the transaction and thus does not recognize any gain or loss; the company merely experiences a change in controlling stockholder, from seller to buyer. A buyer generally will not be willing to pay the same purchase price in a stock acquisition as in an asset acquisition. This is because the buyer will not be able to step up the tax basis of the assets as the buyer would be able to do with an asset acquisition.

Merger

A merger is a creature of corporation law and permits one corporation to combine with or merge into another. The company into which another company is merged is called the *surviving corporation.* As part of the transaction, stock held by stockholders of the company whose separate existence ceases is changed into something else, usually, in the case of the sale of a business, the right to receive cash or securities of the buyer. As with a stock sale, the buyer becomes the owner of the company and, unless the company has transferred out certain assets or liabilities prior to the closing, the company retains all of its assets and liabilities.

The primary advantage of a merger is that it permits a business to be sold without the consent of each stockholder. When public companies are sold, the form of the transaction is invariably a merger agreement for the simple reason that it would be impractical for buyer to enter into an acquisition agreement with each stockholder. A definitive acquisition agreement in the form of a merger, called a *merger agreement* or an *agreement and plan of merger*, is only required to be signed by the company, not by each stockholder. It is common that controlling stockholders also sign a merger agreement, but it is not necessary as a matter of law.

Before the company can close a merger transaction, the merger must be submitted to stockholders for approval. In some states, such as Delaware, unless the stockholders have agreed to a higher threshold, a merger can be approved by the holders of 50.1 percent or more of the outstanding capital stock. In other states, the approval requirement is higher, such as two-thirds or 75 percent of outstanding capital stock. Once approved by the required majority, the merger can close and is effective for all stockholders, even for stockholders who vote against the merger, unless a particular stockholder exercises dissent rights. Dissent rights permit a stockholder to ask a court to determine the fair value of his or her shares. Dissent rights are rarely exercised in the case of a sale of a company if the consideration to be received in the merger has been negotiated in good faith at arm's length. This is because it would be difficult for the stockholder to prove that the fair value is greater than the price obtained in an arm's length negotiated sale.

Because mergers can be approved by less than 100 percent of the stockholders of a company, they enable a controlling stockholder to cause a business to be sold even if the minority stockholders do not favor a sale. For this reason alone, in cases in which there are more than a few stockholders, buyers and sellers usually prefer that the form of the transaction be a merger.

Representations and Warranties

In the definitive acquisition agreement, irrespective of the form, the seller will make statements about the company and the condition of the business. These are called *representations and warranties,* which if not true at the time of closing, may entitle the buyer not to close or to make a legal claim against the seller. Typical representations and warranties include:

- The company is duly incorporated and in good standing
- The company has corporate power and authority to conduct its business
- The company has taken any necessary corporate action (such as a stockholder approval) to authorize the transaction
- The consummation of the transactions contemplated by the acquisition agreement will not contravene the certificate of incorporation or bylaws of the company or any of the company's contracts (such as leases, credit agreements with lenders, etc.)

- A statement as to the capitalization of the company, including debt and equity securities, such as stock, warrants, and options
- A list of the company's material contracts
- A list of the company's employees and their compensation arrangements as well as a list of company benefits and benefit plans
- A list of the real property assets owned or leased by the company and a statement as to the condition of the company's facilities
- A list of the personal property assets of the company and a statement of their condition
- A description of any transactions or ongoing arrangements between the company and its affiliates, including its stockholders, directors, and officers
- A list of the company's intellectual property assets and statements as to the ownership, registration, and protection of them
- A statement as to the accuracy of the company's financial statements and, in some cases, the projections or forecasts prepared by management
- A statement as to the company's insurance arrangements
- A statement that the company does not have undisclosed liabilities

Representations and warranties represent a snapshot of the business as of a moment in time. Typically they are required to be made on the date of signing and, if different, on the date of closing of any acquisition transaction.

Covenants

A covenant is an agreement to do or not to do something. It is a promise to take or refrain from taking action. Any acquisition agreement, irrespective of form, will usually contain covenants binding upon either or both of the parties. Some covenants operate only between signing and closing, such as the typical promise by the seller to conduct the business in the ordinary course and not to enter into any material transactions between signing and closing without the consent of the buyer. Other covenants operate after the closing, such as the typical promise by the seller not to compete with the business just sold to the buyer.

Closing Conditions

If the definitive acquisition agreement is signed with the intent of closing it at a later date, the agreement will contain closing conditions. Closing conditions are matters that the parties have agreed must be satisfied or waived in order for the closing to proceed. Some will be applicable to both parties and some will apply only to the buyer or seller. For example, if the transaction has a purchase price of over $50 million, it will likely be subject to antitrust review under the Hart-Scott-Rodino Antitrust Improvements Act of 1976. The buyer and seller will be required to file a prescribed form with the Federal Trade Commission (FTC) and the Department of Justice, who then have 30 days to review it. As a result, a typical closing condition will provide that neither the buyer nor the seller is obligated to close unless the waiting period under the Hart-Scott statute has expired. Other closing conditions, but ones that apply only to the buyer's obligation to close, include:

- The seller's representations and warranties are true on the closing date.
- The seller has taken all action required under the covenants set forth in the agreement to have been taken by the closing date.
- Certain named employees have entered into agreements with the buyer to continue to work for the business after the closing.
- In the case of a merger agreement, holders of not more than, for example, 5 percent of the outstanding shares have exercised their dissenters' rights to demand an appraisal of the value of their shares.

Because the seller's representations and warranties must be true at the time of closing, at least in "all material respects"—which is a commonly negotiated middle ground—sellers must be extremely careful about rushing to sign a definitive acquisition agreement. Typically, a deal is announced after the definitive acquisition agreement is signed and before closing. However, once announced, employees, customers, and suppliers expect that the deal will close. If the representations and warranties are not true on the signing date, the buyer is entitled not to close, and, if the deal does not close, the seller could end up holding a company that in the market is viewed as "damaged goods." In this circumstance, too, a buyer typically will attempt to renegotiate the purchase price or the terms of the deal in exchange for the buyer's waiver of the closing condition.

INDEMNIFICATION

Businesses are not generally sold on an "as is, where is" basis. A buyer customarily will be entitled to be indemnified by the seller for problems that are discovered by the buyer after the closing. Of course, not all problems are indemnifiable, only those problems that amount to a breach of the seller's representations or warranties or a breach of the seller's covenants or agreements. For example, if the seller neglected to include in its representation about material contracts a statement disclosing a material contract pursuant to which the business agreed to supply a significant amount of product at what had become a below-market price, the buyer would likely have a claim against the seller for the burden of fulfilling the obligations under the undisclosed contract. Or, if the seller failed to disclose that the company had received a letter threatening a lawsuit and the lawsuit was subsequently brought, the buyer would have a claim against the seller for the burden of defending the lawsuit and ultimately settling it or paying a damages award.

Why indemnification? Why not just a common law claim for breach of contract? The reason is simple: An indemnification claim usually includes coverage for all costs and expenses, including legal fees.

Is the seller responsible for every penny's worth of problems that the buyer suffers after the closing? In general, no. Most indemnification provisions contain limitations that apply so that the seller is not responsible unless problems aggregate to a particular dollar amount. The buyer and seller usually negotiate whether this amount is a mere threshold beyond which the buyer can recover from the first dollar or is a true deductible or "basket" beyond which the buyer can recover only the excess. In addition, sellers usually try to negotiate a limitation or cap on the aggregate amount of their liability under the indemnification provisions. A logical cap is 100 percent of the purchase price, but many sellers are successful in negotiating a cap that is lower, sometimes significantly lower.

SALE FOR CASH OR STOCK

Often the most misunderstood issue in the mergers and acquisitions world is the importance of the form of consideration; that is, whether the business is being sold for cash or stock or (sometimes) both.

Cash is simple. The sale will be a taxable transaction for U.S. federal and state income tax purposes, and the amount of net after-tax proceeds kept by the seller will depend on the form of the transaction and whether the business is organized as a C corporation or as an S corporation or LLC. (See the discussion above under Definitive Acquisition Agreement—Asset Sale.)

Stock is more complicated. The sale may be a tax-free transaction for U.S. federal and state income tax purposes, but it may not be. The rules are extremely complex, and you must consult a tax advisor for advice in the context of any sale of a business, especially the sale of one for stock. In general, you should not expect the stock portion of any transaction to be tax-free unless more than 50 percent of the aggregate consideration is stock. There is some support for a lower percentage, but most tax advisors generally will insist upon at least 50 percent. This may seem straightforward, but it is not. What happens if the value of the deal consideration is 55 percent stock and 45 percent cash measured at the time of the signing of the deal, yet by the time of closing, the buyer's stock has fallen in value so that the value of the stock has become 40 percent of the deal consideration? It is a good idea to consult a tax advisor early in the sale process.

Can you immediately resell any stock that you receive? As noted early in this chapter, it depends. Let's assume, for purposes of this discussion, that the buyer is a public company. This means that the buyer files periodic disclosure reports (such as 10Ks and 10Qs) with the SEC. Let's also assume that the buyer's shares are traded on an exchange (such as the New York Stock Exchange) or in an interdealer quotation system (such as the NASDAQ National Market). The securities laws in the United States require that any company selling shares of stock must file with the SEC a registration statement for those shares and sell the shares pursuant to a prospectus—or must be entitled to an exemption from the registration requirements. There are considerable regulations and case law dealing with these requirements. You might think that the buyer is not selling shares of stock, but that the buyer is making an acquisition of another business using shares of its stock as its currency. However, the securities laws treat any sale of stock as the same—whether for cash or for consideration consisting of property (i.e., the seller's business). As a result, the federal securities laws apply to the buyer in the case of an acquisition as equally as they apply in the case of a sale of stock for cash. Consequently, whether the buyer is issuing 100 shares or a million shares of its stock, it must register the shares or find an applicable exemption.

In most acquisitions of private companies, the buyer issues shares of its stock pursuant to an exemption. The exemption most often used is the *private placement* exemption, which permits the buyer to issue shares to a limited number of persons, ideally persons who are accredited investors. There is some disagreement among lawyers as to the number of persons to whom a buyer can issue shares in an acquisition and still claim to rely on the private placement exemption. However, in practice, the problem tends not to be the number of accredited investors; the problem tends to be the existence and number of sellers who are not accredited investors.

An individual is an *accredited investor* under federal securities laws if his or her net worth individually or jointly with his or her spouse exceeds $1 million or if that person's net income in each of the two most recent years exceeded \$200,000 or \$300,000 with that person's spouse. There are other rules applicable to entities. Consequently, if every seller is an accredited investor, the buyer will generally rely on the private placement exemption in issuing shares of stock in the acquisition. Buyers will usually require sellers to represent and warrant that they are accredited investors.

If some sellers are unaccredited, the private placement exemption may still be available, but there are procedural requirements that must be followed in the transaction, as well as a 35-person limit on the number of unaccredited sellers. This tends to be an issue in practice because almost all private companies have stockholders who include Aunt Millie, the proverbial widow whom the securities law were designed to protect.

Let's assume that you and a partner are the only shareholders and that you both are accredited investors. The buyer is therefore comfortable that it can rely on the private placement exemption in issuing shares of stock to you and your partner as acquisition consideration. When can you and your partner sell the shares the buyer issues to you?

The shares issued to you pursuant to the private placement exemption will be restricted shares under federal securities laws. Unless the buyer agrees to register the shares for resale, you and your partner cannot sell them on the market for at least one year. The share certificates will likely bear a legend indicating that the shares have not been registered, and no transfer agent or brokerage firm will accept them as good delivery in any market sale. It is possible that you and your partner may be able to sell them in a private transaction, in which the person who buys the shares from you agrees that the shares remain restricted, but the market for such outright sales is limited—other than in connection with hedging transactions, which are discussed in Chapter 7.

If you and your partner hold for a year and then want to sell on the market, can you? Let's assume that you became a director and officer of the buyer and that your partner left the business and became a full-time amateur golfer. Let's also assume that you received 5 percent of the outstanding common stock of buyer and that your partner received 1.5 percent. After one year, you and your partner are each entitled to sell, during any three month period, the *greater* of (1) 1 percent of the outstanding common stock of the buyer or (2) the average weekly trading volume for the buyer's common stock for the four calendar weeks preceding the sale. Therefore, if your partner has not agreed to any other restrictions on his ability to sell, your partner would be able to sell his entire position within six months (i.e., two three-month periods) and possibly less time if the trading volume for the buyer's common stock is high. On the other hand, because your position is larger, it will take longer for you to sell your entire position, potentially as long as 15 months (five three-month periods).

What if you and your partner hold for two years? Because you elected to become a director and officer of the buyer, federal securities law treats you as having become an affiliate of the buyer. After holding restricted stock for two years, your partner could sell his entire position without regard to the volume limitations described above. On the other hand, because you are an affiliate of the buyer, you are still subject to the volume limitations.

Sales of restricted stock in compliance with the SEC's safe harbor described above are called *Rule 144 sales.* Most major brokerage houses have special departments to handle Rule 144 sales. In addition, there are paperwork requirements, including SEC filings and legal opinions. If you will receive restricted stock in any sale of a business, you should contact your broker and tell him or her that you ultimately expect to sell under Rule 144. Your broker should be familiar with the procedures required to be followed or will have a department dedicated to handling Rule 144 sales.

If you and your partner insist upon receiving freely tradable shares, is there any way that a buyer can satisfy your objective? Yes. The buyer can agree to file a resale registration statement in which you and your partner would be identified as the sellers. While the registration statement will describe the buyer's common stock, it will state that none of the proceeds from the sale of the shares covered by the registration statement will be paid to the buyer and that all proceeds will go to you and your partner. The SEC will have to declare the resale registration statement effective before you and your partner can sell. You and your partner will then sell the shares of buyer stock pursuant to a prospectus, which you (through your broker) will be obligated to deliver to any buyer. If you and your partner are successful in convincing the buyer that it must agree to register the shares issued to you in the acquisition, none of the limitations under Rule 144 will apply and you could sell your entire 5 percent interest and your partner could sell his or her entire 1.5 percent interest as quickly as the market trading volume for the buyer's common stock would permit. Again, you have to work through a major brokerage house in a transaction like this because of the prospectus delivery requirement that accompanies each sale.

What if, instead of 5 percent, you received 25 percent of the buyer's common stock in the transaction? You know you will end up holding the stock for some time, but you do not want to be limited to selling under Rule 144.

If the weekly trading volume is not meaningful, you can be limited to 1 percent every three months and thus take more than six years to sell down the entire position. If the buyer agrees to file a resale registration statement covering all of the shares, and to update and maintain the effectiveness of the registration statement until your position is fully sold, then you can sell the shares freely until your entire position is sold down. However, if the buyer refuses to register all of your shares and wants you to have to hold at least some of the shares for a period of time, you could attempt to negotiate registration rights pursuant to which you have the right to require the buyer to register a certain number of shares periodically.

Registration rights fall into two types: *demand* rights and *piggyback* rights. Demand rights give you the right to require the buyer, upon your demand, to register a certain number of shares. The buyer will likely limit the number of demands that it is willing to give to you. Piggyback rights give you the right to ask the buyer to register your shares whenever the buyer itself is registering shares either on behalf of itself or on behalf of others. Registration rights are a way of protecting you against the illiquidity of a large single stock position.

CONCLUSION

The architect Ludwig Mies van der Rohe (1886–1969) is known for his view, "God is in the details." The attention to detail is what turns ordinary work into a work of genius. The flip side is the maxim of pop musician Blixa Bargeld who says, "The devil is in the details."

From either perspective, when it comes to selling your company, the details matter more than you might ever expect. This starts with the negotiation phase all the way through the contract terms of the sale and postsale tax issues.

If you are selling your company, the first detail to attend to is to get professional advice. This may mean retaining an intermediary—an M&A professional at an investment bank—and it will mean retaining an M&A lawyer. An intermediary should know your industry as well as having M&A expertise. Your lawyer may have to be different than your regular counsel. Ideally, your lawyer will have industry expertise, too, but it's more important that your lawyer be an experienced M&A lawyer than an industry insider.

M&A professionals are well versed in the process of selling a private company. Follow their advice. Although you'll pay what may seem like high fees, you're undertaking what may arguably be the most important business transaction of your life. The odds are that it will go more smoothly and that you'll successfully complete a transaction if you build upon the experience of your professional advisors. The topics covered in this chapter should give you a head start in knowing what to look out for and what to ask for.

Notes

1. This data comes from Ritter, Jay, and Ivo Welch. "A Review of IPO Activity, Pricing and Allocations," *Journal of Finance*, August 2002. During the dot-com bubble, those discounts became much larger; some stocks doubled on their first trading day. One response to the IPO discount is to reduce the size of the offering, wait until a market price is established, and then sell more shares in a secondary offering. Another innovation is the IPO auction approach, created by the boutique investment bank W.R. Hambrecht & Co.

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