a. Preliminary Negotiations and Investigation
   a. Initial Contact
      i. Identification of Buyer
      ii. Qualification of Buyer
      iii. Confidentiality Agreement
         1. Before any confidential information is exchanged, the prospective buyer should agree to keep all information confidential.
      iv. Submit Information to Buyer
   b. Confidentiality Agreement (P.583)
      i. “Confidential Information” means any information, data or facts concerning the business, finances, prospective finances and/or assets of the Company, including, but not limited to, all information relating to the financial condition, marketing strategies, condition of assets, financial projections, business plans, labor relations, contracts with program suppliers, contractual arrangements with lenders and prospective transactions with third parties.
      ii. What Prospective Seller wants:
         1. Protect confidential proprietary material information from disclosure
            a. Covenants Against Disclosure. (a) For a term of ten (10) years beginning on the date of this Agreement, the Investigator and its Affiliates shall not:
               i. Disclose, divulge or communicate any Confidential Information to any individual or Entity;
               ii. Utilize any Confidential Information for any purpose whatsoever, except for the purposes contemplated by this Agreement;
               iii. Disclose to any individual or Entity the existence of any discussions concerning a prospective transaction by and between the Investigator or any of its Affiliates and the Company.
            b. Return of All Confidential Information. Upon the written request by the Company to the Investigator, all Confidential Information shall be returned to the Company in a manner designated by the Company in such written notice. In addition, all notes, summaries, analyses and reports prepared by or for the Investigator or any of its Affiliates shall be destroyed and such destruction shall be certified in writing to the Company by the Investigator.
            c. Irrespective of any recovery of monetary damages and in addition to all other remedies available to the Company, the Company shall be entitled to enjoin any prospective or continuing violation or breach of this Agreement by the
Investigator or any of its Affiliates by obtaining from any court of competent jurisdiction an immediate restraining order or injunction.

2. **Protect against the use of proprietary information**
   a. See “ii” above for contract provision

3. **Prevent disclosure of potential transaction**
   a. See “iii” above for contract provision
   b. **Breach by Affiliate.** For all purposes of this Agreement, any disclosure or other breach of the provisions of this Agreement by an Affiliate of the Investigator shall be deemed a breach by the Investigator, allowing the Company to recover damages against the Investigator to the same extent as though such breach was directly committed by the Investigator.

4. **Non-interference with Business**
   a. **Restrictions Against Hiring Key Employees.** In addition to the other covenants contained in this Agreement, for a period of three (3) years following the date of this Agreement, Investigator and its Affiliates shall not, directly or indirectly, hire or solicit for employment any Key Employee of the Company for employment with or by the Investigator or any of its Affiliates.
      i. Definition of “Key Employee” should follow.
   b. You agree that for a period of three years from the date of this Agreement, that you will not in any manner (1) acquire, agree to acquire, or make any proposal to acquire any securities or property of the Company, unless such acquisition, agreement or making of a proposal shall first have been expressly approved by the Company’s Board of Directors, (2) except at the specific written request of the Company, propose to enter into, directly or indirectly, any merger or business combination involving the Company or any of its subsidiaries, (3) otherwise act, alone or in concert with others, to seek to control or influence the management, Board of Directors or policies of the Company, (4) disclose any intention, plan or arrangement inconsistent with the foregoing or (5) assist, advise or encourage any other person in doing any of the foregoing.

5. **To not be committed**
   a. **Company's Right to Terminate.** It is acknowledged that the Company is under no obligation to supply any particular information to the Investigator. Furthermore, the Company shall have the right at any time in its sole discretion to terminate all discussions and negotiations with the Investigator and its Affiliates concerning a possible transaction. The Company's refusal to supply further information or the termination of such negotiations or discussions shall not
terminate or otherwise affect the obligations of the Investigator
and its Affiliates pursuant to this Agreement.

b. **No Representations.** The Company is not making any
representation or warranty with respect to the accuracy of any
Confidential Information given to the Investigator, it being
acknowledged that any representations or warranties of the
Company will be set forth in definitive agreements involving
any prospective transaction which is mutually agreed to by and
between the parties.

   iii. **What Prospective Buyer wants**
   1. **Access to evaluation material**
   2. **Answers to relevant questions**
   3. **Protect information independently received or developed**
      a. Provision: “Provided, however, Confidential Information does
         not include information which
         i. becomes **generally available to the public** through no
            wrongful act of the Investigator or any of its Affiliates;
         ii. **was known by the Investigator prior** to the date of this
            Agreement, as indicated by written records of the
            Investigator; or
         iii. was verifiably **developed by the Investigator** without
            the benefit of the information provided by the
            Company.”
   4. **Avoid liability for third party accidental disclosures**
   5. **Disclose on need to know basis**
      a. Notwithstanding the foregoing, Confidential Information may
         be disclosed to the directors, officers, employees, auditors and
         financial and legal advisers of the Investigator and its Affiliates
         who need to receive such information in order that the
         Investigator will be able to evaluate and negotiate the terms of
         the possible transaction or relationship with the Company.
         Investigator will advise such recipients of Confidential
         Information of the terms of this Agreement and will be
         responsible for any breach of the restrictions contained in this
         Agreement by such recipients.

b. **Basic Accounting Concepts and Financial Statements: (P315)**
   a. **Financial Statements**
   b. **Accrual v. Cash accounting**
   c. **Consolidation v. Combination**
      i. A business with subs rolling up into the parent who controls the sub then a
         consolidated statement is required, Interco transactions eliminated
      ii. Combination is same as consolidation, except that it applies to brother/sister
          relationship with more than 50% control.
   d. **EBITDA**
      i. Aka: Operating income + depreciation and Amortization
   e. **Purchase Method Accounting:**
The Purchase Price for the Target is Calculated
1. It is the sum of the Cash and Other Consideration Paid, plus
2. The Liabilities Assumed

The Purchase Price is Allocated Among the Assets Acquired Based Upon Their Fair Market Values

Allocate first to Cash, then to Other Current Assets (e.g., inventory and receivables) and Then to Fixed Assets (Real Estate, Plant & Equipment)

Goodwill:
1. To the extent that the purchase price exceeds the FMV of the targets assets, the excess is booked as goodwill
2. Calculation:
   a. Amount to Be Allocated is the Purchase Price For the Stock Plus Liabilities Assumed
   b. The Fair Market Value of the Assets Purchased is Less Than the Amount to Be Allocated
   c. The Excess of the Amount to be Allocated Over the Value of the Assets is Goodwill

Fundamental Valuation Techniques (Valuation Methodology H.O.)

Methods of Valuation

Market Approach
1. Comparable company analysis
   a. Prior Sales
   b. Stock Market valuation
   c. Standard multiples of cash flow or EBITDA

Asset Value
1. Net worth + (FMV of assets – BV of assets) = asset value
   a. Value of Assets less Debt
   b. Replacement value of Assets, less debt

Problem: How do you value intangibles and goodwill?

Income Approach
1. Multiple of earnings or cash flow
2. Discounted cash flow analysis of future cash flows

Discounted Cash Flow Analysis: “Every business is worth the sum total of all future cash flows discounted back to present value.” (IF ON TEST, SEE SLIDES FOR 1/16)

Equation:
1. Value = Discounted NPV of Future Cash flow less Debt Plus Excess Cash

Multiple of EBITDA approach:
1. *Multiple* times EBITDA = Enterprise Value, then
   a. *Multiple* varies based on industry and prospects of company
2. Enterprise value – Debt + excess Cash = s/h value

Two questions:
1. What is the value of future cash flows?
a. Determined by projected EBITDA less anticipated future investment

2. What is the proper discount rate?
   a. Function of cost of capital, expected return on investment and perceived risk
   b. As discount rate rises, the enterprise value decreases

iv. Terminal value: Estimates the value of the business after the last year of projections (Hypothetical sales price)
   1. Easy method is to multiply last year’s cash flow by assumed industry multiple
   2. Another method is to divide last year’s cash flow by the applicable discount rate

c. Synergies:
   i. Acquired business may be “synergistic” with the Purchaser’s business
      1. This may cause either additional profits or lower expenses, thereby increasing EBITDA and Cash Flow
      2. This may make the business more valuable to the Purchaser
   ii. Therefore, a synergistic purchaser usually has an advantage over a financial purchaser.
   iii. Negotiating:
      1. Who gets the benefit of the increase in cash flow caused by the synergies?
         a. See chart in slides.
   iv. Do mergers really create value?
      1. Acquisitions do create value as a result of economies of scale, other synergies and/or better management
      2. S/h of target firms reap most of the benefits as the final price is close to full value
         a. Target management can always say no
         b. Competing bidders often push prices up

d. Structure of the purchase price
   i. All Cash
   ii. Part cash and remainder by promissory installment note
      1. Issues with installment note:
         a. Interest rate
         b. Security for payment
         c. Relationship to buyers’ bank debt
         d. What happens on default?
         e. Is the note security for buyer to protect against Seller’s representations and warranties?
   iii. Earn out or contingent purchase price
      1. Based upon:
         a. Levels of net income
         b. Levels of operating income
         c. Levels of gross margin
         d. Levels of sales
2. Accounting issues
3. Keeping acquired business separate
4. The seller has no control

iv. All or part in buyer’s stock
   1. How to value buyer’s stock?
      a. Use Public market price?
      b. Use same valuation technique used for target?
   2. If buyer is using own stock to pay, buyer likely feels that stock is overvalued
   3. How do targets s/h obtain cash for buyer’s stock
      a. Open market sales
      b. Agreement to redeem in the future (put right)

4. Seller generally wants to be able to sell stock immediately

   d. Letter of Intent (P586-593, Fordham Article)
      a. Purpose of an LOI
         i. To commemorate an understanding (usually non-binding) concerning the price, structure and procedures for a proposed transaction
         ii. To establish the basis upon which the proposed buyer will proceed with due diligence of the Target
         iii. To protect the Buyer against the Target “shopping the deal” [No-Shop Clause]
         iv. To identify “deal killers” up front, and make negotiation of definitive agreements easier
      b. Is the LOI enforceable?
         i. What is the intent of the parties? (Pennzoil, p. 586)
            1. Do they intend to be bound?
            2. Is a further agreement contemplated? (Telstar, p. 591)
            3. Did the signers have authority?
               a. Investment banks generally think they have authority, but likely this authority is lacking.
         ii. Are the material terms of the agreement adequately described? (Telstar)
         iii. To what extent are one or both parties relying on the transaction to proceed?
      c. Good faith Letters of Intent
         i. Prospective Buyer is not being set up to be a “stalking horse” for a competitive bidder
         ii. Buyer is not engaging in the exercise of LOI in order to merely gain more information about a competitor
         iii. The Buyer has a reasonable likelihood of being able to close the transaction
      d. Implied Duty of Good Faith and Fair Dealing
         i. §205 of the Restatement of Contracts states that good faith and fair dealing is imposed upon each party in performing and enforcing a contract
         ii. Courts will enforce the good faith duty in LOI. (Fickes v. SunExpert, 762 F.Supp. 998)
      e. Tortious Interference Issue:
         i. A party who interferes with a contractual relationship involving an acquisition may be liable for having tortiously interfered with the contractual relationship b/w the purported buyer and seller. (Pennzoil, p. 586)
f. Who Gets the Synergies?
   i. See p. 4, slide 6: the concern is with the area “x”, and who gets the benefits of
      the synergies
   ii. Negotiations work with the seller saying that other synergistic opportunities
       exist, and the buyer replies with “I offer the synergy, w/o me, they don’t exist.

g. Note: in LOI, identify which parts are binding or not and identify a definitive
   agreement to be reached at a letter date if LOI is not to be binding.

h. Publicly Held Issued:
   i. A public announcement of a LOI is required to prevent insider trading, however, the deal may fall through.
      1. Therefore, in a public company, the parties work “like crazy” to get to
         a definitive agreement, skipping the LOI.
   ii. Duties of Directors
      1. The board has the right to exercise its reasonable business judgment, but it presupposes
         a. The exercise of Due Care
         b. Loyalty
         c. Independence
      2. Duty of Care
         a. Informed business decision after due inquiry
         b. Reasonable care to secure the best available transaction on
            behalf of s/h
            i. MBO may violate this duty
         c. Business Judgment Rule normally applies
            i. Smith v. Van Gorkum sets standard and sets forth personal liability upon directors
      3. Duty of Loyalty
         a. To act in good faith on behalf of s/h
         b. To not act out of self interest
         c. To not act out of fraud or deceit
      4. When Board doesn’t attempt to get best price, and unduly favors a
         bidder, it may violate its Duty of Loyalty
         a. Revlon v. MacAndrews,
            i. Held that in a sale of corporate control, the
               responsibility of the directors is to get the highest value
               reasonably attainable for the s/h.
         b. Courts apply a more stringent standard in the case of a MBO
            (Mills Acquisition v. Macmillian, 559A.2d 1261)
   i. Lock-ups:
      i. In a publicly held context, cannot unduly favor one bidder over another.
         Revlon, Paramount v. QVC.
      ii. No-shop clauses that are reasonable and subject to “fiduciary out” are
          permissible
      iii. Reasonable “break up” fees to reimburse the bidders lost expenses are
          permitted. (Paramount)
         1. For private company, it must be large enough to deter sale of company
2.

   a. Stock purchase
      i. Buyer purchases all of the issued and outstanding stock of the Target’s s/h, thereby acquiring all assets and all liabilities.
         1. Problem with stock purchase is that you are acquiring the company subject to all liabilities of the corporations.
      ii. In purchasing a publicly held company, one way to protect self from misrepresentation, have a hold back provision and perform due diligence.
         1. Liability extends to the amount of investment. So unless piercing the corporate veil comes into play, the parent won’t be liable for the sub.
      iii. Tax Consequences:
         1. Sellers of Target stock incur capital gains liability
         2. Buyers obtain the tax basis and the carryover of all tax attributes and detriments
         3. No “step-up” in tax basis of Target’s assets, and can’t attribute any of the purchase price to goodwill
            a. Assets within the corporation have the same cost basis as they did prior to acquisition as the assets belong to the corporation
      iv. Seller may retain certain assets by conducting a partial redemption in which stock is exchanged for an asset.
         1. Target s/h may retain certain assets of target not used by business but partially redeeming stock in the target in exchange for the retained assets
         2. The IRS looks at a partial redemption followed by a sale of the remaining stock as part of one transaction (Zenz stock purchase transaction)
   b. Asset purchase
      i. Buyer purchases assets used in the acquired business, with the ability to exclude certain assets
         1. May assume selected or no liabilities of the business
         2. Selling company may retain specified assets and liabilities
            a. In MO, creditors may go after s/h for 5 years following the sale of an asset.
      ii. Selling company normally liquidates following sale
      iii. If the corporation is not an S corp, transaction results in inefficient tax consequences
      iv. Tax Consequences:
         1. Tax at corporate level for the sale of the individual assets
         2. Second tax at s/h level for the liquidating distribution made on the stock.
      v. Buyer Advantage:
         1. Buyer gets a “step up” in basis of the assets purchased to extent of purchase price plus assumed liabilities
            a. Allocation of Basis
               i. Allocated first to cash and cash equivalents,
ii. Next to the FMV of all tangible assets,
iii. Finally to intangible assets, most notably Goodwill

2. Goodwill:
   a. Goodwill and other intangibles may be amortized over 15 years
   b. Ability to amortize is important as this allows buyer to reduce
      its after tax cost of acquisition

vi. Other Issues:
   1. Not all assets are assignable: If unassignable, and the protection of this
      right is valuable, reverse triangular merger, where target entity
      survives as wholly owned sub.
      a. Leases
         i. If you represent a tenant that has a clause in their lease
            that states, “in order to assign lease, consent from
            landlord required, which consent cannot be
            unreasonably withheld”
      b. Licenses
      c. Franchise Agreements
      d. Other Contracts
   2. Seller is left with a corporate shell to liquidate
   3. By agreement, seller can retain assets, which are distributed to s/h
      upon liquidation

vii. Installment Sales
   1. Target s/h sell stock in exchange for a note, and report capital gains
      income proportionately as the note is paid
   2. May be either a redemption of stock or a liquidating distribution

   c. Cash-out merger
      i. Forward Merger – Target is merged with or into the Acquiror, with the
         Target’s shareholders receiving cash
         1. For tax purposes, a Forward Cash Out Merger is treated as a sale of
            assets of the target to the buyer, followed by a liquidation. (Same as an
            asset sale transaction)
      ii. Reverse Triangular Merger – A subsidiary of the Acquiror merges with the
          Target, with the Target surviving, the Acquiror receiving stock of Target and
          the Target Shareholders getting cash.
          1. *Reason for reverse cash out merger is to avoid having to deal with
             each individual s/h. Even if a dissenting s/h, you can force them out.*
          2. A Reverse Cash Out Merger is treated as a sale of the Target’s stock.
             a. Capital gains treatment for target s/h
             b. No step up in tax basis of target’s assets
          3. All assets and all liabilities of target are now in wholly owned
             subsidiary of Buyer
          4. Buyer, through the target sub, acquires all tax attributes of the target

   d. S-corporation Transactions
      i. *JL: If you have a client that can go S, then do so, because you may sell the
         company and there is an enormous benefit to the buyer and seller.*
      ii. General:
1. S-Corp generally pays no tax at the corporate level
2. S/h are taxed on the earnings of the corporation
3. Therefore, if corporate assets are sold, there is usually only one tax, at the s/h level.

iii. Requirements:
   1. S/h must be U.S. resident individuals or certain qualifying trusts
      a. Corporations and partnerships do not qualify as s/h of S corp
      b. But a wholly owned sub of S corp may elect S Status
   2. Election must be made by all s/h
   3. Corporation must have only one class of stock – voting Common

iv. Exceptions:
   1. If a S corp elected S status within 10 years of the sale, there is a built in gains tax (BIG) incurred on the difference between the value and the tax basis of the sold asset (determined at the time the Corp. converted to S status)
   2. Does not apply if Corp was an S-corp since inception
   3. Tax is at highest corporate rate (35%)
   4. In effect, it causes some “double tax” upon sale of business assets

v. §338 election:
   1. It allows buyer and target to elect to treat stock sale transaction as an asset sale for tax purposes
      a. Benefits buyer b/c §338 election allows it to get “step-up” in basis of acquired assets (including goodwill)
      b. May be accepted by target if target has large loss (current or prior periods) that can shelter the tax gain.

2. §338(h)(10) election:
   a. Can be used on stock sales by S corp and by subsidiaries in a consolidated group of corporations
   b. Allows stock sale, with only one tax at s/h level, while the buyer gets a “step-up” in the tax basis of the acquired assets
   c. Doesn’t Escape BIG tax if applicable.

e. Tax Deferred Acquisitions
i. A Reorganization –
   1. Statutory merger of the target into the buyer or its subsidiary
      a. The Target’s s/h receive a substantial part (ie 50%) of consideration for Target’s shares in the form of Buyer’s stock.
      b. The Buyer’s stock received by the target s/h can be voting or non-voting.

2. As a result of the merger:
   a. There is no tax on the buyer stock received by the Target’s s/h
   b. The tax basis of the buyer stock received by the Target’s s/h is the same as the tax basis of the exchanged Target Stock
   c. The Target inherits the tax basis of Target in its assets (ie. no “step-up”) and all other tax attributes

3. Use of part in Cash In merger:
a. In an A reorganization, the Target S/h can receive part cash or other consideration (50% or less of value of the transaction
b. There is a tax (usually at capital gain rates) on the portion of consideration received other than in buyer’s stock

4. Alternative A Reorganization Formats:
   a. Stock of Parent Corp of the Buyer can be used in the merger instead of the Buyers stock [§368(a)(2)(D)]
   b. The merger of the Sub and the Target can be a reverse merger where target is survivor. [§368(a)(2)(E)]

ii. B Reorganization:
   1. General:
      a. Target S/h exchange all of their stock solely in exchange of Buyer stock
      b. Buyer’s stock must be voting stock
      c. Buyer must have control (80% or more ownership) of Target as a result of the transaction
      d. Buyer can use first tier subsidiary to effectuate the acquisition of Target’s stock
      e. Redemption of not more than 50% of Target stock may precede the B Reorganization
   2. Tax Consequences:
      a. Tax basis of targets’ stock owned by buyer is target s/h basis
      b. Target s/h have carryover tax basis in buyer’s stock
      c. Buyer, through its target sub, has targets’ tax basis in its assets

iii. C Reorganization
   1. Transfer of substantially all (more than 90%) of Target’s assets in exchange solely for Buyer’s voting stock.
   2. Liquidation of Target, with Target s/h receiving buyer stock
   3. A subsidiary of Buyer can be used as a transferee of Target’s assets

f. Practical Issues:
   i. Should tax motivations cause the sellers to take Buyer’s stock?
   ii. Don’t we have to value two companies in a stock for stock or stock merger transaction?
   iii. Why is the Buyer using his own stock if it is a good investment?
   iv. Know how the merger works, and analyze the tax consequences of each.

f. Acquisition Agreements [767-790; SPA; APA]
   a. What the acquisition agreement covers:
      i. Describes the transaction structure, purchase price and procedures for closing
      ii. Allocates risk between the buyer and seller for both known and unknown liabilities and obligations
      iii. Contains promises (i.e., covenants) of the parties
      iv. Contains indemnification procedures
      v. Contains the extent of commitment to close the transaction.
   b. What the Buyer wants:
i. Receiving what is expected at closing (the assets or the stock with “good title”)

ii. The option to “bail out” if the business is not what has been represented or what is expected

iii. Post-closing protection against contingent or unknown risks

c. What the seller wants:
   i. Certainty and speed of closing
   ii. Receiving the purchase price w/o risk
   iii. Not being at risk for the assets, liabilities or operations of the business after the closing

d. General Sections of Acquisition Agreements:
   i. Introduction and Description of Transaction
   ii. Consideration for Transfer of Business
   iii. Representations and Warranties of Seller
   iv. Representations and Warranties of Buyer
   v. Covenants of the Parties
   vi. Conditions to Closing
   vii. Termination Procedure and Remedies
   viii. Indemnification

e. Introduction and Description of Transaction
   i. Whereas Clauses:
      1. Questionable as to enforcement, so put them in as well, also
      2. Explicitly state that these whereas provisions are part of the agreement.
      3. Defined terms are generally capitalized
   ii. Description of Parties to the Stock Purchase Agreement
      1. S/h as sellers in a stock purchase transaction
      2. The Corporate Target is often a party to the agreement, even if it’s a stock purchase
      3. In some states, spouses to the s/h are necessary
      4. Need to be sure that stock option and stock warrant holders are parties
   iii. Description of the Form of the Transaction
      1. Stock purchase for all of the capital stock of the corporation
      2. Consider using a merger transaction in order to not have each of the s/h sign the Acquisition Agreement and avoiding the recalcitrant s/h
         a. If trying to acquire a company with a large number of s/h, go with the merger.
      3. Be certain that all of the capital stock is being acquired:
         a. Review the stock record books of the corporation
         b. Pay particular regard to stock options, stock warrants, and conversion rights of debt and preferred stock
      4. Include in the introductory language, “subject to the terms and conditions of this Agreement…” Key Phrase
   iv. Parties to the Transaction
      1. In the context of an asset purchase, parties to the transaction should include the selling corporation
2. It may be wise to include the principal s/h of the selling corp – indemnification purposes

v. Description of assets purchased (particularly important that this is detailed)
   1. Try to state that it is “all of the assets of the Seller, except for the excluded assets.”
   2. Describe the assets purchased as “all of the assets used in the business of the seller.”
   3. It is good to give a description of the assets, and include schedules for the exhibits for fixed assets, and Intellectual Property Assets
   4. Issue: Slide 20 of Week 6 excludes cash from assets:
      a. This creates the threat that assets will be converted to cash, (conversion of A/R) or
      b. Liabilities will be incurred to increase cash. (not paying A/P)

f. Definition
   i. Defines Terms used throughout the Agreement
   ii. Certain definitions are concepts applicable to most acquisition agreements
      1. Material adverse change
      2. Knowledge
      3. Ordinary Course of Business
      4. Best Efforts
      5. Subsidiaries
      6. Threatened
      7. Environmental Laws

g. Purchase Price
   i. Most agreements have a purchase price adjustment for fluctuations in cash correlating to decrease in AR and increase in AP.
      1. Generally, put good faith money in escrow,
      2. And upon balance sheet valuation at closing any differences may be pulled out of escrow.
   ii. General
      1. Simple purchase price provided for in cash at closing
      2. All or part of the purchase price could be paid with a promissory note
      3. Part of the purchase price could be contingent
         a. e.g., an earn out based on future profits, gross margins or other measures.
   iii. Adjustment of Purchase Price
      1. Adjustments usually made for change of events from the financial statements used to set price to the time of closing
      2. Usually, the adjustment is measured based upon the change of net worth of the target’s business or assets being acquired
      3. There are sometimes difficult accounting issues involved in determining the adjustment
      4. A difficult concept is the timeliness of the financial statements
      5. Adjustment is a large cause of arguments
   iv. Payment
      1. Cash
2. Note
   a. Is the note secured? By what?
   b. What is the ability of the buyer to pay?
   c. Is the ability to pay dependent upon the profits of the sold business?
   d. Will the note subordinate to the bank borrowed debt to pay the cash portion of the purchase price?

3. In advising client regarding deferred payment, consider:
   a. Will your client have all of the continuing risks of the business with none of the upside?

4. From the seller’s perspective, if he is going to get a contingent payment, then he will likely want it from the top of the I/S.
   a. Start at Gross income and work down to Net income in negotiations

5. Escrow
   a. If a representation or warranty is incorrect, the buyer wants damages for breach and the escrow account allows for these damages.
      i. The buyer is being indemnified by the seller for any breach claims against him.

6. Know the issues and value, and the protection of that value

   g. Due Diligence
      a. Preliminary questions:
         i. Purpose: Make sure that the projections used to put the cash flows together to value the company are reasonable. Relies on accurate rep of company.
         ii. When: After the parties are bound, the seller will have to take some risk and trust the buyer and allow some due diligence, however, he will not be absolutely bound until due diligence is complete
         iii. How: Include a condition for closing contingent on results of completed due diligence
             1. In exchange, seller may request a deposit, confidentiality
             2. Limit the length of due diligence period with ability to cure
      b. Relationship of Due Diligence to Reps and Warranties (p.786)
         i. Items discovered in due diligence are normally set forth in schedules to APA or SPA
         ii. Reps and Warranties are usually consistent with what is discovered in due diligence
         iii. But does buyer have an obligation to tell seller or target of facts discovered in due diligence investigation which are inconsistent with reps & warranties? (Sandbagging)
      c. Reduction of Risk
         i. Planning and assisting the investigative due diligence process
         ii. Identifying business, regulatory, and legal risks
         iii. Providing for indemnification against damages and loss
      d. The purpose of due diligence
         i. Identify and quantify possible risks
ii. Fulfill duty of due care  
iii. Confirm assumptions and facts upon which the transaction and the purchase price are based  
iv. Validate reasons for acquisition  
v. Identify terms to be covered by sellers’ representations and warranties.

e. From Seller’s Perspective  
i. Limit to reasonable access during normal business hours  
ii. So as not to interfere with normal business operations  
iii. In a manner that will reasonably maintain confidentiality  
iv. Buyer indemnifies seller against any damages caused by due diligence

f. Corporate Due Diligence:  
i. Corporate Governance Documents (Articles, Bylaws, Minutes)  
ii. Corporate Structure (subsidiaries, partnerships, LLC’s, and other related companies)  
iii. Capital Structure – the classes of stock, warrants, and options. Identify the amount and record holders  
iv. Identity of Directors and Officers

g. Financial Due Diligence  
i. Current and historical Audited statements  
  1. What accounting principles were used?  
  2. Any apparent differences in assets, expenses or revenues?  
     a. Particular attention to receivables and inventory flux  
  3. How were reserves established?  
  4. How and when is revenue recognized?  
ii. Compare to financial projections, and discern differences  
iii. Review debt structure and loans

h. Operational Due Diligence  
i. Organization Chart  
ii. Marketing, Revenue, and expense synergies  
iii. Identity of product lines and sales and margins by product  
iv. Determine high concentration of customers or suppliers  
v. Method of marketing: distributors, independent sales reps or sales force  
vi. Analysis of competition

i. Asset Due Diligence  
i. Current Assets  
  1. A/R  
  2. Inventory: location, consignment, amount, mix….  
  3. Pre-paids: type, transferability, usefulness…  
ii. Fixed Assets – title, condition and adequacy  
  1. Real estate  
  2. Equipment  
     3. Physical inspections are important, regardless of confidentiality  
iii. Intangible and Intellectual Property  
  1. Protected IP  
     a. Patents  
     b. Trademarks
c. Copyrights
2. Patent Applications
3. Infringement Claims by and against Target
4. Other intangible or IP
   a. Formulae
   b. Computer software

j. Contracts
   i. Real estate and personal property leases
   ii. Licenses (particularly of patents and trademarks)
   iii. Employment and consulting contracts
   iv. Forms of agreement used with distributors, sales representatives, …
   v. Supply, requirement and production agreements
   vi. Change of control Provision - Particular attention to any contract which would terminate because of the transaction

k. Employment Matters
   i. Compensation and job description
   ii. Employment agreements
   iii. Incentive compensation plans, pensions, health benefit plans
   iv. Personnel policies and handbooks, performance reviews
   v. EEO Reports, OSHA reports
   vi. Collective Bargaining Agreements

l. Environmental Compliance
   i. Compliance Reports
   ii. Storage tanks
   iii. Use and disposal of hazardous waste
   iv. Environmental inspection of facilities

m. Risk management
   i. History of litigation
      1. Product liability
      2. Employment
      3. Commercial
   ii. Insurance Coverage
      1. Property damage
      2. Liability
      3. Claims made v. Occurrence
      4. Self-insurance arrangements and trusts

h. Representations and Warranties
   a. Seller’s Representations and Warranties (protects buyer)
      i. Purpose:
         1. Obtain disclosure of material facts
         2. Documentation of certain aspects of due diligence
         3. Provide a means for buyer to “walk away” if facts are not as represented – misrepresentations or breaches of warranty
         4. Provide a benchmark for indemnification of buyer against known or unknown facts, liabilities, or adverse occurrences
      ii. Negotiations: Where along the line are we going to meet?
1. **Stringent**: all items are explicitly stated in detail

2. **Mild**: As is, where is

3. **Seller**:
   a. Wants all assets and business sold “as is, where is”
   b. Wants to know that the purchase price is net of all risks
   c. Allows the buyer to “kick the tires” (perform due diligence) but then is at risk

4. **Buyer**:
   a. Argues that seller is in best position to know of risks and doesn’t want to have to find all of the risks
   b. Risks were created during the seller’s tenure
   c. Buyer is basing price upon facts discovered during due diligence

iii. **Discovery of misrepresentation during due diligence**:

1. **Section 10.1 of SPA; §11.1 of APA**
   a. CBS: investigation and closing with knowledge of misrepresentation doesn’t void the rep or warranty
   b. Section makes absolutely clear that even if buyer knows of misrepresentation or breach, buyer can close and sue as long as reps and warranties survive closing

2. **Possible Remedies**:
   a. Buyer can refuse to close b/c a condition for closing has not been met
      i. Clause: Material misrepresentation or breach of warranty, then buyer can normally walk away. Seller wants only material, noncurable breaches to provide walk away option. Buyers wants free rein to walk.
      ii. Consider the nature and relative impact of the misrepresentation or breach
      iii. Is buyer really getting what he wants out of the business?
   b. Close, and proceed to obtain indemnification:
   c. Give seller the choice of closing and indemnify, or not closing

3. **Anti-sandbagging clause**: Provision prevents buyer from having knowledge of misrep or breach and failing to notify prior to closing.
   a. “All reps and warranties of the target…shall survive the closing (unless buyer knows or had reason to know of any misreps or breaches at time of closing.)

iv. **Common Concepts**

1. **Joint and Several**
   a. In torts, joint liability imposed on joint tortfeasors that allows enforcement of the entire judgment against any one of the tortfeasors
   b. In contracts, the parties are each jointly liable and separately liable for each breach of a representations, warranty or covenant
c. “The Seller’s hereby jointly and severally represent, warrant and covenant as follows:”

2. Materiality:
   a. Seller wants a breach of rep or warranty only if it is material
   b. Buyer wants any breach to allow a failure of a condition to close or the right towards indemnity
   c. How to and who does determine materiality?
   d. Danger of “double” materiality by providing materiality standard in indemnification language
      i. Works to advantage of seller, as more hurdles are established for buyer to clear

3. Material Adverse Impact: [SPA §3.15, APA §6.2]
   a. As a measure of harm caused by a misrepresentation or breach of warranty
   b. Buyer wants the ability to terminate the deal if there is any misrep or breach
   c. Seller will not want the buyer to be able to walk away if the breach is relatively harmless
   d. Consider: (how to shift burden)
      i. “there are no lawsuits that will cause a material adverse effect on the company (pro-seller)
      ii. “…may have…”
      iii. “…that could reasonably be expected to have a…”
      iv. “will or could reasonably be expected to have…” (pro-buyer)

4. Knowledge – limiting reps and warranties to the “knowledge” of seller
   a. Qualifier requiring buyer to have a “smoking gun” to prove seller had knowledge (See definition in SPA)
      i. Places burden on buyer
      ii. Shifts risks of “unknown liabilities” on buyer
      iii. Limits buyers’ “walk away” rights
   b. Whose knowledge?
      i. Employees,
      ii. Just principal owners?
      iii. Directors and officers?
   c. Does the seller have to perform it own due diligence, or can it simply assert an “ignorance defense”?
      i. **Buyer**: Wants group to be broad w/ constructive knowledge and include “known or should have known” to eliminate the ignorance defense.
      ii. Pro Buyer provision: (Requires investigation by seller)
         1. “Whenever in this Agreement, a representation or warranty is qualified by “Seller’s knowledge” or words of similar import, such term means Seller’s best knowledge and belief after due inquiry.”
5. Timing [SPA §7.1]
   a. True and correct as of the date of the contract
   b. True and correct as of the date of the closing
   c. Issue of continuing violations after the closing.

6. Indemnification issues: [SPA §10.2]
   a. Public company: No indemnification after closing, so due
diligence is essential.
   b. What is the subject matter of indemnification?
      i. Against material misreps and breach of war
      ii. Against other specific items
   c. For what period of time (survival period)? [SPA §10.5]
   d. Is there a minimum threshold, window or deductible? [SPA
§10.6]
      i. Seller wants a pure deductible [slide 2, p.15, week 7]
      ii. Buyer wants a threshold that, once it is reached, buyer
may sue for all damages
   e. What are the procedures for indemnification? [SPA 10.8]
      i. Escrow

7. Alternative remedies:
   a. Common law fraud or misrepresentation
   b. Federal Securities Laws
      i. Rights under federal securities laws cannot be waived
         under §14 of ’33 Act, and §29 of ’34 Act
   c. Rule 10b-5 applies in the case of a stock sale
      i. There is a sale of a security
      ii. There is no sale of business exception (Landreth)

b. Disclosure
   i. General:
      1. Can be placed either in separate schedules (See APA) or in one
disclosure schedule or letter (See SPA)
      2. Disclosures contain lists of items referred to or exceptions to the reps
& warranties
      3. Issue: Is the seller liable after closing for items disclosed?\n      4. What obligation is there upon the seller to update the disclosure?
         a. Notification [SPA §5.5]
         b. Accuracy of Representations [SPA §7.1]
         c. Disclosure doesn’t excuse seller’s indemnification obligations
         [SPA §10.2]
      5. SPA compromise: IF something is disclosed and added to disclosure
list, buyer has choice of continuing, or alternatively decide not to sue if
deal is consummated.

c. Specific categories of seller’s reps and warranties
   i. Organizational:
      1. Each corporation and its affiliates [SPA §3.1]
      2. Foreign Qualifications
      3. Capitalization [SPA §3.3]
ii. Legal Representations
1. Authority [SPA §3.2, APA §3.2]
2. No conflict or violation [SPA §3.2(b), APA §6.1(c)]
   a. No Conflict with Contracts
      i. Asset purchase
         1. Most written contracts require written consent to assign
         2. If there is no requirement to be reasonable, the other party may be able to arbitrarily withhold consent
   ii. Stock Purchase:
      1. Unless change of control provision, no consent is necessary
      2. This is a particular issue relating to employment agreements – Golden parachute provisions

iii. Financial Representations
1. Represent the accuracy of financial statements [SPA §3.4]
   a. Audited and unaudited interim statements
   b. Accuracy of books and records
2. Represent there are no liabilities (known or unknown) other than:
   a. Reflected on financial statements
   b. Arising in the ordinary course of business since date of last financial statements
3. Warranties: (most important rep/ warranty)
   a. Financials fairly present:
      i. The financial condition shown on the B/S
      ii. The results of operations as shown on the I/S and cash flows
      iii. Interim financials can be qualified by end of year audit adjustment which are immaterial and consistent with prior years
   b. See stringent rep on p.9, slide 3, Week 8.
   c. Use of closing B/S to adjust the purchase price: P.9, sl. 1, wk 8

iv. Liabilities
1. Buyer position: [SPA §3.10]
   a. Wants warranty that there are no liabilities (known or unknown, contingent or liquidated), other than
      i. Reflected on audited/ interim B/S
      ii. Incurred in ordinary course of business since last B/S
    b. Wants similar warranty concerning the closing B/S used to adjust the purchase price
2. Seller position
   a. To the extent possible, seller wants no risk of loss after closing
   b. If seller must assume some post-closing risk, it wants to limit it:
      i. Not liable for unknown or contingent liabilities
ii. Wants buyer to assume all B/S liabilities and those listed on disclosure schedule

iii. May also try to limit representation by “knowledge”

c. Wants to be able to walk away after closing w/o risk of loss following.

3. Provisions:

a. See varying degrees of warranties on p. 11 of week 8.

4. Taxes – push liability onto seller.

v. Assets:

1. General:

a. Sufficiency of assets for the business

b. Quality and condition of assets [SPA §3.7]
   i. Alternative for seller: “As is, where is”
      1. Allows buyer to inspect and perform due diligence

c. Title to the assets (Receiving assets free & clear of all encumbrances) [SPA §3.6]

d. Compromise provision: “Acquired assets constitute all of the assets and of such quality needed to operate the business as currently conducted…”

2. Specific Asset types:

a. Real Estate [APA §6.2(c)]
   i. Title insurance is a necessity and usually a condition for closing
   ii. Includes both owned & leased real estate
   iii. Environmental issues handled in separate warranty
   iv. Concern about not losing Zoning or use permit as a result of sale

b. A/R [SPA §3.8]
   i. Issues related to proper accounting:
      1. *Valid* receivables for products and services completely delivered.
      2. Any disputed A/R?
   ii. Are the receivables *Collectible*?
      1. Assurance may be made through a warranty:
         a. “If A/R not paid within 6 months, buyer has right to charge seller.” Time frame varies as applicable

c. Inventory [SPA §3.9]
   i. Value of inventory as reflected in B/S – lower of cost or market
   ii. Quality of inventory
   iii. Quantity of inventory (not excessive for business, or obsolete)
   iv. Right to sell inventory w/o infringing on rights of others
v. Source of supply warranty:
   1. If supply discontinues, value of business may evaporate. (Week 8, p.16, slide 1)

d. Equipment
   i. Title (liens filed with Secretary of State)
      1. Note: Government generally owns equipment for factories that make product for gov.
   ii. Quality & condition
   iii. Suitability
   iv. OSHA compliance
   v. See provision, week 8, p.16 slide 3

e. I/P [SPA §3.22]
   i. Types:
      1. Trademarks
      2. Copyrights
      3. Patents
      4. Trade Secrets – often true secrets are not patented, b/c company doesn’t want the information out there. See “tough” trade secret rep – p.18, week 8, slide 3.
   ii. Issues:
      1. Identification of all necessary IP
      2. Right to use all IP necessary for business w/o infringing on rights of others
      3. No infringement by Others
      4. Licenses of IP by Target
      5. Licenses of IP to 3rd parties
   iii. Note: Warranty is false if employee contains the necessary formulae in his head
      1. Require written instructions prior to closing and have technicians test
      2. Rub: Seller may not want to give you the information until closing
      3. Remedy: escrow contingent on formulae being correct
   iv. Employment w/ respect to IP [SPA §3.22(c)(ii)]
      1. In effect: All former and current employees have executed contracts assigning all rights to any inventions,… to acquired company.
      2. Make employees loyal and retain rights

d. Employment issues:
   i. Contrast b/w Asset and Stock Purchase:
      1. Asset
         a. Employees are being terminated by seller and buyer may selectively hire
         b. Severance obligations belong to seller
c. Seller is left with terminating employee benefit plans

2. Stock:
   a. Assumes all employment obligations and benefit plans
   b. Is responsible for all consequences of terminating employees

ii. Liability to employees: [APA §3.23]
   1. Assumption of employment agreements
   2. Possible bonus payments due upon sale
   3. Change of control provisions that allow employees to voluntarily leave and get severance
   4. Severance obligation’s upon termination of targets employees
      a. Contractual – Golden parachute
      b. On account of company policy
      c. Ethical
      d. Who pays severance obligations?
         i. Asset – seller pays
            1. But is this fair if buyer can determine who he hires?
               a. Have buyer covenant that he will hire all employees
            2. If seller does not pay severance to terminated employees, buyer is stuck with morale problem
         ii. Stock – Buyer pays

iii. WARN Act: See handout
   1. If an company has more than 50 employees at a plant that will be closed, company must provide notice 60 days prior.
      a. Plant closing is deemed to occur upon termination of more than 50 employees at a location of 100 or more employees company wide
         i. No requirement that you tell employees that you know, if less than 60 days, then payment of severance for the remainder
      b. “Stay” money – to keep good employees
   2. Asset:
      a. If sufficient employees are not rehired by buyer, WARN Act notification obligations upon seller are triggered
      b. If buyer rehires sufficient employees, then WARN Act avoided.
      c. Dilemma as buyer decides who to hire, yet seller is liable under the act
         i. Seller will negotiate # of employees hired w/ covenant to enforce
         ii. If WARN Act triggered, buyer indemnifies seller

e. Retaining Key Employees:
   i. Employee retention [APA §7.11]
      1. Make employment contracts a condition for closing
      2. Consider restrictions against competition
a. Concerns over enforcement
b. Make non-compete limited to legitimate interests [SPA §2.4]

3. Stay bonus if employee stays during transition
4. New Incentive compensation plan

f. Employee Benefit Plans
   i. Types:
      1. Qualified Retirement Plans
         a. Defined contribution
            i. NO issue of funding, but plan must either be terminated or assumed
            ii. Upon termination, assets could be frozen or distributed to employees or their IRA
            iii. Plan assets could also be transferred to another plan of buyer
         b. Defined benefit – Insure that plan is adequately funded
            i. Buyer may force termination
            ii. Stock – buyer assumes responsibility for proper funding
               1. Actuary determines proper funding
               2. Insurance may be purchased to assure funding
            iii. Asset – the seller may terminate the plan, buyer not responsible then.
      c. Multi-employer pension plans
         i. MEPA is a union plan which more than one employer makes contributions
         ii. It is a defined benefit plan
            1. Provides that upon withdrawal from plan, employer is liable for its share of underfunding, which is enforced
            2. As soon as you seller has a union, you should
               a. Determine if there is a MEPA fund, and
               b. See if it is underfunded
         iii. In asset purchase, seller is liable,
            1. For seller to avoid withdrawal liability, buyer must put up bond, something like agree to contribute for 5 years and agree to assume liability.
            iv. In stock purchase, buyer is liable
      2. Welfare Benefit plans
         a. Health, Retiree medical, …
         b. In stock purchase, all plans are assumed
         c. In asset purchase, plans may be terminated
   ii. Legal Foundation:
      1. ERISA
         a. Dual administration of Dept. of Labor and IRS
      2. Funded Qualified Pensions Plans covered by Pension Benefit Guaranty Corporation Insurance
iii. Compensation (reps and warranties)
   1. List of employees and compensation levels
   2. Description of all severance obligations
   3. Employment contracts, plans
   4. No underfunding of any DBP
   5. No unfounded obligations to retirees

iv. Other: [APA §3.24]
   1. EEO
   2. OSHA
   3. Fair Labor Standards Act
   4. COBRA
   5. Worker’s Comp.

v. Collective Bargaining [APA §3.24(b)]
   1. Does buyer have an obligation to negotiate with a union?
   2. IN Stock purchase, target retains union status and contracts
   3. IN asset purchase
      a. “Successor clause” may mandate that seller require buyer to assume labor contract
      b. If a majority of the buyer’s employees in a bargaining unit were members of a union, then must be recognized
         i. Must make sure that non-union outnumbers union
      c. Duty of buyer and union to negotiate in good faith for collective bargaining agreement
   4. Issues:
      a. IF buyer requires a change to labor agreements, such change must be a condition of closing
      b. It is unrealistic for the buyer to assume that it can decertify or eliminate the union
      c. It is advisable to have a discussion with the union representative before a general announcement of the transaction.
      d. Know right to work state vs. non-right to work
         i. Right to work: Nobody is forced to join a union even if majority votes for it
         ii. Non-right to work: If majority of collective bargaining unit votes for union, then all are union

g. Environment:
   i. Either at the plant, discharged by the plant, or conditions that existed at the facility that caused bodily harm
   ii. Testing:
      1. Make environmental testing part of due diligence
         a. Determine potential liabilities
         b. Sets up possible ∆ for innocent purchaser of asset
      2. Testing is usually done in phases, with phase I being a general inspection
3. Issue of who does the testing – buyer or seller
   a. Seller doesn’t want to know if something is wrong, and
      sometimes, the seller won’t test, but if buyer tests, still won’t
      want results.
   b. Sometimes, law firms will test

iii. Allocation: [SPA §11.3]
   1. Buyer wants complete protections against all environmental risks
      a. Known or unknown
      b. Discovered or undiscovered by testing
      c. Whether caused by target or predecessor
   2. Seller wants no exposure after closing
      a. Buyer should assume all risks of facilities after testing
      b. Some sellers want to be indemnified by buyer after the sale
      c. At very least, limit to knowledge

h. Contracts
   i. A list of all material contracts is usually required in the contract warranty
   ii. Warranty that each contract is enforceable and valid
   iii. Warranty of no default by any party to contracts
   iv. Due Diligence:
      1. Review all contracts to ensure that none will terminate due to
         transaction.
      2. No conflict provision [SPA §3.2(b)]
      3. No default provision [SPA §3.17(d)
      4. Compromise Week 9, pt. 1, p. 13 sl. 3
         a. Limited to material
         b. Limited to knowledge

i. Closing
   a. Seller:
      i. Covenants
         1. Allow buyer access to seller’s assets, personnel and records (SPA
            §5.1)
         2. Operate business only in ordinary course and to preserve business
            intact (SPA §5.2)
         3. Restricting any changes of contracts, employment conditions,
            …without buyer’s consent (SPA §5.3, referring to §3.160
         4. Use best efforts to satisfy conditions for closing. (SPA §5.8)
         5. “No shop clause” prohibiting negotiations with other potential buyers
            (SPA §5.7)
      ii. Conditions for closing
         1. Conditions precedent for buyer’s obligation to close, failure of which
            allows buyer to terminate obligation to consummate transaction w/o
            being in default. (Art. 7 of SPA)
         2. Conditions precedent for Seller’s obligation to close, failure of which
            allows seller to terminate w/ being in default. (Art. 8 of SPA, §5.3 of
            APA)

b. Buyer
i. Closing Conditions
   1. Some conditions could have the effect of giving the buyer a virtual
      unrestricted right to walk away.
      a. Buyers’ satisfaction with the results of due diligence
      b. A condition for the availability of financing for the buyer
   2. See pro-buyers conditions on p. 2 of week 9 part II.
   3. Performance by seller of all covenants [SPA §7.2]
   4. Obtaining all necessary consents [SPA §7.3]
   5. Opinion letter from Seller’s counsel [SPA §7.4(a)]
   6. NO legal proceedings to impede transaction [SPA §7.5]
   7. NO material adverse change to business, assets or prospects of seller.

   c. Accuracy of Reps and Warranties
      i. Buyer wants them to be absolutely true and correct
      ii. Seller wants to limit buyer’s ability to walk only if misrepresentation would
          cause a materially adverse effect
      iii. Compromise: Provide a condition that there is not a material misrep for some
           conditions, and absolute accuracy for others
           1. See p. 3 of week 9, pt. II.
   d. Termination provisions [SPA §9.1, §9.2]
      i. Mutual consent
      ii. By either party if transaction not closed by a stipulated date (drop dead date)
          1. Except if terminating party has breached
      iii. By the non-breaching party on account of breach by other party
      iv. By the buyer or seller if its respective conditions for closing haven’t been
          satisfied
   e. Indemnification Provisions
      i. Buyer wants: [SPA §10.1]
         1. Protection against misrepresentations,
         2. Protection for specified risks
         3. Ease of collection for indemnities and provide means for collection
         4. Unlimited time period and amounts for indemnification
      ii. Seller wants:
         1. No responsibility for a business it no longer owns
         2. Hurdles against buyer’s attempts at indemnification
         3. Limitations in regard to the time and amount of indemnification
      iii. What if buyer elects to close in the face of a breach by the seller?
         1. CBS v. Ziff Davis
      iv. *Anti-sand bagging clause* – buyer has no knowledge of any facts or
           circumstances that would serve as the basis for a claim against the seller,
           buyer shall be deemed to have waived in full any breach of which buyer has
           knowledge at closing.
      v. Merger: At closing, the contract merges into the title, and the contract no
         longer exists, so the reps and warranties are eliminated
      vi. Source of collection:
         1. Escrow [SPA §10.8]
         2. Set off against a promissory note, or
a. Earn out, or  
b. Part of purchase price  
3. By obtaining and collecting judgment against the seller  
4. Remember: There usually is no indemnification source for publicly traded target after it is acquired.

vii. Favorable provision for buyer [SPA §10.2]

viii. Issues:  
1. What if buyer is also protected by insurance? Should decrease indemnification claim  
2. Is indemnification reduced by tax benefit of loss?  
3. What is the measure of damages for a misstatement of income or EBITDA? – Indemnification for diminution in value  
4. Who controls the defense and settlement of 3rd party claims?

ix. Possible Limitations on Indemnification:  
1. Time for making claims [SPA §10.5]  
   a. Allows for buyer to go through 1 full year of operations and one full audit  
   b. Contractual limitation  
   c. Certain things should have no limit  
      i. Fraud,  
      ii. Environmental,  
      iii. Title,  
      iv. Authority to enter into  
      v. Taxes – 3 year statute of limitation  
   d. Deductible or threshold amount [SPA §10.6]  
      i. Buyer wants a threshold, not a deductible, as this allows buyer to receive all damages once threshold met, not amount over deductible.

2. A “Cap” or maximum amount  

x. Other:  
1. ADR  
2. Expenses – seller gets buyer to pay attorney fees  
3. Indemnification for brokers – who pays  
4. Choice of law – red herring issue  
5. Manner of notices – Email is not accepted yet  
6. Public announcements and confidentiality

j. Financing the Acquisition [732-746]  
a. Payment of purchase price:  
   i. Cash  
   ii. Note payable to seller  
   iii. Stock of acquirer or its parent  
b. Amount necessary to finance the acquisition  
   i. To pay cash portion of purchase price  
   ii. To pay off debt which is assumed by buyer  
   iii. To pay the expenses of the transaction  
   iv. To provide for the ongoing working capital needs of the business
1. As sales increase, the need for cash rises

v. See net purchase price calculations in week 11.

c. Sources of cash to finance the acquisition:
   i. Funds internally generated by the Acquiror
      1. Cash on buyer’s B/S
      2. Borrowing against buyer’s assets
      3. Borrowing against buyer’s future cash flow
   ii. New equity investment – outsiders take stake
   iii. Cash acquired from target
iv. Borrowing against the assets and/or future cash flows of the target (Money lent upon demonstration that corporation can generate income)
   1. Use Real estate loans
   2. Use equipment as collateral
   3. Use A/R and inventory as collateral
   4. Borrow against historical cash flow
   5. Borrow against projected increases in cash flow
v. Traunches of Debt
   1. Senior Secured
      a. Secured by A/R and inventory
      b. Usually varies by the amount of A/R and inv.
   2. Senior Debt
      a. Can be secured by fixed assets
      b. Is usually a function of cash flow (2.5 times EBITDA)
   3. Subordinated Debt (junk bonds)
      a. Subordinated to senior and secured debt, so that payments cannot be made if the more senior debt is in default
      b. Usually carries much higher int. rate
      c. Usually is unsecured
   4. Subordinated debt is often convertible into common stock
vi. Equity
   1. Common Stock:
      a. Can be voting or non-voting
      b. Participates in the growth in the value of the company
      c. Receives dividends when and if declared
   2. Preferred stock
      a. Usually carries set dividend rate, which may be cumulative
      b. Usually has no voting rights
      c. May be convertible to common stock
      d. Unless convertible, does not share in growth
vii. Goodwill
   1. For tax purposes: Goodwill is amortized over 15 years
   2. For financial statements: Good will doesn’t get amortized, but is periodically adjusted for impairment
d. LBO Fall out:
   i. In event of financial failure, secured creditors seize assets to detriment of unsecured creditors
ii. Law developed a means to protect these creditors:
   1. Uniform Fraudulent Transfer Act
      a. Defines insolvency as occurring when assets are less than liabilities
      b. A transferor who is unable to pay debt when due is presumably insolvent
      c. Transfer is fraudulent when the transferor is insolvent and transfer is in exchange for less than reasonable equivalent value
   2. Fraudulent Transfers:
      a. §548 of Bankruptcy Code
         i. Gives trustee the right to void a fraudulent transfer
         ii. Fraudulent transfer could mean subordinating lien or claim of secured lender to rights of unsecured general creditors
         iii. Trustee may attempt to recover benefit of fraudulent transfer from the sellers
      b. Remedies:
         i. Creditors may ask court to void transfer to the extent necessary to satisfy claims
            1. This may cause secured creditors to lose lien
               a. Why should bank be liable? – they know that the money is really going to the s/h and if the corp is insolvent b/c of transaction, then they should be liable
            2. May cause recovery against purchase price received by s/h
      c. Other “equitable” relief
         i. Equitable subordination:
            1. The rights of the “secured” creditor will be subordinated
            2. In Meritor savings, the bank was equitably subordinated, b/c they loaned money knowing of insolvency
         ii. Mellon Bank:
            1. Assigns excess of purchase price over assets as “broadcast rights” therefore, they are not insolvent.
         iii. Know that there are two views:
            1. One that values goodwill and applies a B/S approach (Mellon), and
            2. One that looks to ability to pay (Meritor)
         iv. Weiboldt v. Schottenstein (p.734) insolvency approach applied:
            1. S/h, officers and lenders may be held liable under act
v. *Schottenstein II* (p.744) – BofD – liable
   1. If there is a fraudulent conveyance, many people may be liable

vi. Solution: Put together pro-formas showing ability to pay debts as they become due.

d. Possible Solutions:
   i. Demonstrate through reasonable projections that bills will be paid when due
   ii. Obtain independent “solvency opinion”
   iii. Have guarantee of buyer of unsecured debt for a time period sufficient to get over statute of limitations for avoidance of fraudulent transfer

k. Publicly Held Companies
   a. Differences
      i. Regulatory laws and bodies
         1. SEC
         2. State securities laws and regulators
         3. NASD and the exchanges
      ii. Special fiduciary duty of directors to public s/h
      iii. Probable early disclosure of negotiations
   iv. *Reps, Warranties, and indemnification do not extend beyond the closing*
      1. Reps and warranties are primarily used as a condition for closing.
      2. Due diligence becomes extremely important
   v. *Buyer is usually not negotiating with true owners*

b. Processes for acquiring a publicly held company
   i. Negotiated mergers
      1. Issues:
         a. May have to be disclosed – *Basic v. Levinson*
         b. Enter into a letter of intent or straight into merger agreement
            i. Public announcement is made, which may attract other suitors
         c. Proxy solicitation of s/h
            i. Covered by Rule 14d-6.
      2. Negotiated (single step) Merger
         a. Advantages:
            i. Cheaper
            ii. Easier to finance b/c no payment for stock until purchase is complete
               1. May used the assets of the target to finance
            iii. Can use assets and cash flow of target to finance acquisition
         b. Disadvantages:
            i. Very public at early state
            ii. Lengthy process (60 days or more)
            iii. Susceptible to competing bids or tender offers
         c. Procedure:
i. Merger requires vote of s/h
   1. In DA, simple majority
   2. Rules 14A and Reg. SX control
   3. State law regarding mergers, including dissenting s/h rights
      a. In DA, Dissenting s/h has appraisal rights to cash, but if stock for public stock, then no rights.
      b. Exchange rules require vote of issuer if over 20% of the stock of issuer is issued

3. Two step merger: (most often method used)
   a. Advantages
      i. Faster control b/c no approval from SEC prior to offer
      ii. Less susceptible to competitive offer b/c it is faster
      iii. Buyer controls process
      iv. Tender offer can be made conditional on minimum amount of shares tendered
         1. Usually supermajority, but sometimes 90% b/c some states don’t even require a vote if you meet this ownership threshold
   b. Disadvantages:
      i. Difficult to finance b/c assets and cash flow of target may not be used (Drexel Burnham – bridge financing of merger until final financing in place)
      ii. Without protections for buyer, tender offers may attract competing bids
      iii. From board’s perspective, no control unless buyer needs board’s support

4. Tender Offers (see nutshell)
   a. No pre-disclosure is necessary
   b. Must file schedule 13(d) once “beneficial ownership” (Inclusive of right to buy) is 5% or more
      i. Have right to buy 5% or more of stock
      ii. Acquiror will by 4.9% before tender offer
      iii. Schedule 13(d) requires a statement of ownership
   c. File Schedule 14d-1 once offer is made
   d. Offer can be coercive (Such as two tier offer)
      i. Make an offer at $50/ sh and if you tender, then you get $50, BUT if you wait until the merger, then you only get $40.

5. Three Piece Suit
   a. Obtain “Lock-up” of a significant block of shares
      i. From large s/h
      ii. Buy an option to purchase from the target
   b. Make a tender offer at the same price, conditional upon a minimum amount of tender
c. Engage in the merger following control of enough shares to effectuate merger

ii. In the Context of the negotiated bid:
   1. Buyer wants:
      a. No competition from competing bid
         i. Lock up and prevent
         ii. No-shop clause
         iii. Lock up on
            1. Important (crown jewel) assets
            2. Stock
         iv. Termination or break up fee
         v. Poison pill used against competitors
      b. Quick transaction
      c. Access to information
   2. Seller’s Board wants:
      a. Board chooses buyer and terms of the transaction
         i. If buyer is choice of board,
            1. The board will also fear hostile 3rd party offers (even at a higher price)
      b. Protection against s/h suits
   c. Duty to Auction
      i. Smith v. Van Gorkham (p.41)
         1. Board has duty to be informed and exercise due care in doing so.
      2. Board blindly followed recommendation of president to sell company to Pritzger family
      3. The Business Judgment Ruel did not protect the directors b/c they were not informed, failing to exercise due care
      4. Although the price was at a substantial premium, the board was required to investigate the price
         a. GE credit had extended another offer
      5. Directors Personally liable for not exercising due care
      
      ii. Revlon v. MacAndrews (p. 101)
         1. Once the breakup of a company becomes inevitable, the board has a duty to obtain the best offer for the s/h.
         2. Once corporate control is to be transferred, duty of directors is to obtain highest price (or best deal) for s/h – an auction is mandated
         3. The Lock-up granted and poison pill favored bidder w/o an auction
         4. Not obtaining the highest price for s/h violates directors duty of due care and loyalty
            a. Note: B/c I-banks are paid on a commission; their interests fall in line with the s/h.
      iii. Arnold v. Society for Savings Bancorp (p. 131)
         1. Applicability o Revlon in arm’s length transaction
         2. When there is an exchange of stock, you don’t have the auction duty (depending upon the stock)
a. There is no change of control when “control of both companies remains in a large, fluid changeable and changing market.”

iv. When are Revlon Duties Triggered?
1. When is a decision to transfer control made?
2. Does it apply to MBO?
   a. MBO occurs when the management doesn’t feel that the value of the offer adequately values company
   b. Revlon duties are triggered.
      i. Management on board have significant duty of loyalty issues
   a. Change of the stock into cash, debt and options.
4. Is transfer of actual control the trigger, or “effectual control”? Bass v. Evans
5. How about when there is a proposed merger of equals? Paramount v. Time

v. At a minimum, Revlon requires that there must be the most scrupulous adherence to ordinary principles of fairness in the sense that s/h interests are enhanced, rather than diminished, in the conduct of an auction for the sale of corporate control. This is so whether the “sale” takes the form of an active auction, a management buyout, or a “restructuring” Mills Acquisition

I. Selecting a buyer and the terms
   a. Unocal Standard (p.89)
      i. Defensive action taken by board in the form of a discriminatory self-tender in reaction to hostile two-tier offer.
      ii. Court imposed an enhanced standard of review of board decisions blocking outside bidders.
      iii. Test is triggered by use of defensive measures:
         1. Reasonable and informed determination in good faith that threat exists, and
         2. Act in proportionally to the perceived threat
      iv. If test is met, then burden shifts to raider; if not then burden is on BofD to prove “entire fairness”
         1. Fair dealing
         2. Fair price
   b. Strategic Combinations
      i. Paramount v. Time & Warner Bros.(p.103)
         1. Time had selected Warner Bros. For merger as this was in best interest of long term goals
         2. Court did not second guess decision, holding that the Revlon duties were not triggered b/c Unocal two prong test was met.
            a. Shares were being merged, therefore, s/h were protected
      ii. Paramount’s acquisition of Viacom
         1. Court: Change of Control b/c Summer Redstone controlled Viacom
         2. S/h should get a control premium
3. Court relies on fact that there was a competing QVC offer
4. Held: Defensive tactics unreasonable and therefore void.

m. MBO and Freeze Out Mergers
   a. MBO
      i. Inherent issues:
         1. Special duty of care
         2. Recognition that the board may have conflicts of interest, and therefore may not be able to fulfill their duty of loyalty
         3. If management wins, there is an almost certain s/h suit accusing the board of favoritism
   ii. Revlon Duties are triggered
         1. Must be a fair auction
         2. Management must not be favored
   iii. Independent Committee must be independent and w/o prejudice
         1. With own legal advisors
         2. With its own financial advisors
   iv. Mills Acquisition v. Macmillan (p.721)
         1. Management used internal and company advisors in auction that favors KKR.
         2. Independent committee, but really the auction was conducted by the management or its agents.
         3. Clearly favored management’s bid over that of the bidder using management’s investment bankers and lawyers
         4. Prematurely ended auction by placing a Lock-out on the crown jewels
   v. RJR Nabisco
         1. Independent committee of the board
            a. Each member has no financial interest in any bidder or the outcome
            b. Hired its own lawyer and investment banker
            c. Conducted protracted and lengthy auction
         2. Utilized its business judgment, exercising due care
         3. Court finds that Revlon doesn’t require an Enhanced Business Judgment Rule (as in Unocal)
   b. Must there always be an auction?
      i. Barkan v. Amsted Industries (p. 725)
         1. MBO
         2. Process managed by an independent committee
         3. Investment banker advised committee
         4. When the board has no independent means of determining the adequacy of an offer, it must “Canvass the Market”
         5. If the board has reliable evidence of the market, it can approve the transaction
         6. Must contain a fiduciary out
      ii. Two ways to enter into a binding merger agreement.
         1. Canvass the market, or holding an auction
         2. Sign a negotiated offer containing a fiduciary out.
a. Fiduciary Out:
   i. Waives a no-shop clause when counsel advises board of risk that court may later find agreement unreasonable
   ii. Allows board to not recommend a deal when it no longer feels that it is in the best interest of s/h
   iii. A reasonable “termination fee” is permissible
      1. Can’t be restrictively high – 2-3% of deal

3. But out is not necessary where market was fairly and completely canvassed

c. Freeze out mergers
   i. General:
      1. Follows a successful tender offer
      2. S/h vote not meaningful b/c buyer has control
         a. May have right to appraisal remedies
         b. No such remedy is available for a stock for stock offer if the stock received is publicly traded.
   ii. Entire Fairness Standard
      1. Since parent and subsidiary is on “both sides” of the transaction, the board must be entirely fair with the minority s/h. Mayflower Hotel Corp.
      2. Entire Fairness Requires:
         a. Fair dealing
         b. Fair price
   iii. UOP v. Weinberger (p.72)
      1. Signal was in a superior negotiating position, and didn’t disclose that $24/share would have been fair (Directors were on target board)
      2. S/h were not adequately informed and received appraisal remedy.
      3. Deal failed to pass either fair dealing or fair price.
      4. This case stands for the proposition that a court can’t turn around a transaction, and the only remedy is appraisal
   iv. Glassman v. Unocal
      1. Delaware standards allow for a merger of a 90% owned entity
      2. Modifies Weinburger so that when there is 90% parent-sub situation, we are not going to make the parties go through an appraisal, and a strict application of the entire fairness standard.

n. Poison Pills [p. 94-100]
   a. Purpose
      i. Dissuade hostile or unwanted solicitation of tenders of shares by s/h.
      ii. Place control of the process with the B of D
      iii. Make it economically unfeasible to take over control of the target without the consent of the Target’s board
   b. Mechanics
      i. Each share of stock obtains s/h rights as a dividend declared by Board
      ii. The “flip-in” rights give the s/h (except for the raider) the right to purchase additional stock at a deep discount to market or receive a distribution of additional stock
iii. The “Flip-over” gives s/h the right to receive buyer stock in a 2nd stage freeze out merger

c. Function
   i. Can be discriminatorily used against an unwanted raider
   ii. May be redeemed in order to accommodate a negotiated friendly acquisition of the target
      1. Has redemption value of $0.01 per share or something of that nature to allow corp to pull rights back in.

d. Legality
   i. Moran v. Household International (p.96)
      1. Poison pill adopted to ward off prospective unwelcome tenders falls within the business judgment rule
      2. Did not cause a chill to all legitimate take-over attempts
      3. Under Unocal, the pill is a proportional good faith reaction to a perceived risk
         a. Court applies Unocal test to determine that this was proper use in relation to perceived threat
         b. Gives BofD the opportunity to determine what is in the best interests of the s/h.
         c. Allows the board to maintain control over the takeover process.

e. Avoidance
   i. Tendering with a condition of the board to redeem the pill
   ii. Tendering with a very high minimum condition on the number of shares tendered
   iii. Tendering with a proxy from s/h to remove board
      1. Many boards are staggered, so this is difficult to do.

f. Redeeming the Pill
   i. The Household court warns that the Board may have a fiduciary duty under certain circumstances to redeem the s/h rights
      1. Eliminates the “just say no” defense
      2. Fiduciary standard of Unocal.
   ii. When legitimate purpose of giving board time to evaluate and determine alternatives has been accomplished, the proper purpose for the pill has been extinguished.
   iii. In most instances, a non-coercive offer can’t be permanently blocked by a poison pill. Capital City v. Interco (p. 992)

g. Options to Poison Pill
   i. Dead hand pill: Limits redemption of poison pill only to continuing directors (usually illegal)
   ii. No hand pill: Provides that a new board of directors can’t redeem the pill for a delayed period after election. (usually illegal)

h. Target’s ability to “Just say no”
   i. If the Target’s board reasonably believes that the price offered by the raider is inadequate the target will not be forced to redeem pill. Moore v. Wallace Computer Services
However, if the price offered is an outstanding and high price, in excess of any conceivable alternatives, the target will likely be forced to redeem the pill when the board is forced to redeem the pill, it is the s/h who are the decision makers.

Anti-trust Issues [p.407-410; 514-517]

a. Statutes:
   i. §7 of Clayton Act – prohibits merger b/w two companies “where in any line of commerce in any section of the country, the effect of such acquisition … may be substantially to lessen competition, or tend to create a monopoly.”
   ii. §1 of Sherman Act – If the acquisition is a contract “in restraint of trade”
   iii. §2 of Sherman Act makes monopolization a crime
   iv. §5 of FTC Act: If the acquisition will constitute an unfair method of competition
   v. Various states as well

b. Relevant Issues
   i. Definition of the relevant market
      1. The relevant product market is “determined by the reasonable interchangeability of use or the cross-elasticity of demand b/w the product itself and substitutes for it.” Brown Shoe Co v. U.S.
         a. Functional interchangeability
         b. Price Elasticity
   ii. Geographic market
      1. “a geographic market is the area in which consumers can practically turn for alternative sources of a product and in which the antitrust Δ faces competition.” FTC v. Staples
         a. SMSA – Standard Metropolitan Service Area
   iii. Concentration and market shares within identified market
      1. Measure using the Herfindahl-Herschman Index (HHI)
      2. The HHI is determined by adding the squares of the market share of each competitor within the relevant product and geographic market
   iv. Factors mitigating concentration
      1. Ease of entry into the relevant product, service or geographic market
      2. Acquisition may cause efficiencies which will benefit customers
      3. There is a potential failure of the acquired company

c. Pre-notification of Acquisition
   i. Hart-Scott-Rodino: requires notification of a significant transaction to the FTC and the DOJ prior to completion of the transaction
   ii. Test:
      1. Size of entity
         a. Target has sales or assets of $10M and buyer has sales or assets of at least $100M, or
         b. Target has sales or assets of at least $100M and buyer has sales or assets of at least $10M
      2. Size of transaction
         a. $50M
   iii. Prenotification
1. Can be filed based upon the contract or just letter of intent
2. Designed to determine whether there is potential lessening of competition
3. Both target and acquiror file a separate notification form
4. It is based upon the assets and business of the ultimate parent
5. Hefty filing fee (minimum = $45K) – Unless specified differently in contract, buyer pays.
6. Supposedly kept confidential
   a. If trying to get the deal done quickly, you may go for early termination… then made public, but
   b. If you want to keep confidential, stay away from early termination.

   d. Waiting periods
      i. If FTC and DOJ take no action in 30 days, then deal may proceed
      ii. Parties may ask for early termination of the waiting period, and if granted, it is published in the federal register
      iii. If FTC wants further investigation, it makes a “second request” for further information.
         1. Request is significant, often stopping deal
         2. In contract: “all applicable waiting periods under the HSR Act have terminated” make condition for closing

e. Penalties and remedies
   i. Failure to file causes massive penalties including a $10K per day fine
   ii. If FTC or DOJ object, they may seek an injunction
   iii. If transaction proceed, the FTC or DOJ could seek rescission and divestiture
   iv. Agreements are often made in settlement of FTC or DOJ concerns, such as agreed divestitures, opening up certain markets, or prohibition of certain practice

f. Hart-Scott-Rodino can relate to IP or licensing agreements as well.