



Overview of Private Company Mergers and Acquisitions

This memorandum provides an overview of a typical acquisition of a US-based privately held corporation (though we also discuss some aspects of limited liability company (LLC) acquisitions, and many of the matters discussed also apply to public company transactions). It first describes the basic types of mergers and acquisitions (M&A) and then discusses the development over time of the key elements of an acquisition: (1) the business transaction, (2) the documentation and (3) any necessary regulatory matters.

I. Transaction Basics

There are three basic types of acquisition: (1) asset purchase, (2) purchase of stock or other ownership interests and (3) merger. Consideration paid for the acquisition may include cash, stock of the buyer, assumption of seller liabilities or a combination of these elements. Factors including tax and financial accounting considerations, impact on earnings and cash flow, risk management, transaction mechanics, and required corporate, governmental and third-party approvals are taken into account in determining transaction structure and form of consideration. The tax treatment of the transaction is often the most important structural factor.

A. Asset Purchase

In an asset purchase, the buyer acquires only identified assets and liabilities of a company, not the company itself. With successful negotiation, the buyer can select which of the seller's assets to acquire (such as inventory, equipment, contract rights and intellectual property) and which not to acquire (such as contaminated real estate or obsolete inventory). Within limits, the buyer can also negotiate which outstanding or contingent liabilities to assume and not to assume. Buyers should nevertheless be aware of successor liability doctrines in various jurisdictions, which are exceptions to the general rule that the seller retains all liabilities that the buyer does not specifically assume.

For tax and liability reasons, it is often said that buyers prefer to buy assets and sellers prefer to sell stock. With an asset acquisition, the buyer can step up the tax basis of the acquired assets to fair value and then depreciate the assets using the higher basis. If the seller is a corporation, in most cases the substantial tax disadvantages of an asset deal to stockholders of the seller (likely double taxation at the corporate and stockholder levels) lead to a stock or merger transaction. As a result, asset purchases are most common in the acquisition of divisions or wholly owned subsidiaries of corporations and in the acquisition of tax pass-through entities such as LLCs.

B. Stock Purchase

In a stock purchase, the purchaser buys the outstanding stock of a corporation directly from the corporation's stockholders. The target corporation need not be a party to the transaction and may remain unchanged after the closing (other than having different ownership), retaining all of its assets and liabilities. Stock purchases are typically preferred by sellers, because all liabilities are transferred along with ownership of the company, there is no double taxation and there is no need for selling stockholders to liquidate the company after the transaction. This type of purchase could also take the form of the acquisition of all of the membership interests of an LLC, although as noted above the acquisition of an LLC is more commonly structured as an asset acquisition, because there is no particular tax disadvantage to the seller's members.

C. Merger

In a merger, one corporation merges with another to become a single ongoing corporation. One company is designated the "surviving," and the other the "disappearing," corporation. By operation of law, the surviving corporation acquires all of the assets and succeeds to all of the liabilities of the disappearing corporation, and the disappearing corporation ceases to exist as a separate legal entity.

In a merger, the stockholders of the acquired corporation typically receive cash, stock of the surviving corporation or some combination of stock and cash.

When a combination of stock and cash is offered, stockholders of the surviving corporation sometimes have the right to choose which form of consideration they would like to receive (all cash, all stock or any combination of the two), within defined limits. A merger may be taxable or nontaxable to the acquired corporation's stockholders, depending on the mix of consideration received by such stockholders.

In most cases, the merger must be approved by the boards of directors and a majority of stockholders of both corporations (though some state statutes and corporate charter documents may require a supermajority vote). Mergers are most commonly used where there is a sufficient number of stockholders to make a stock sale impractical, since generally only a majority of stockholders must approve a merger. While rarely exercised, "dissenters' rights" may be invoked by stockholders of the acquired corporation who formally oppose the merger to have the value of their stock determined by a judicial procedure involving an appraisal. As a result, many merger agreements give the buyer an "out" if more than a small percentage of the seller's stockholders perfect their dissenters' rights.

D. Variations

Numerous variations on these structures include:

- reverse triangular mergers, in which the buyer incorporates a subsidiary that merges into the target company, and
- two-step transactions, in which the buyer acquires a controlling interest in the target through a stock purchase and follows that transaction with a merger to eliminate or "freeze out" the remaining minority stockholders.

E. Transaction Stages and Timing

The typical acquisition of a substantial business involves three key events: (1) a letter of intent or term sheet, (2) a binding definitive purchase or merger agreement and (3) closing. In some cases, particularly those involving public companies or smaller targets, there may be no letter of intent, and the signing of the agreement and the closing may be simultaneous.

In most cases, completing a substantial transaction in two months would be considered lightning speed, while a transaction completed in a heavily negotiated or regulated context may take six months or longer.

II. Stage 1: Through the Letter of Intent

A. The Business Transaction

The first step in an acquisition is for the buyer and seller to find one another and define their respective goals in the transaction. This process may be aided by investment bankers, lawyers, accountants, technical experts and others. The buyer often undertakes a preliminary “due diligence” investigation of the seller. Once each party is satisfied that the other is a good match, they begin to discuss the terms of the transaction, generally with a view to signing a letter of intent. We recommend that each party consult with counsel before committing to any specific form of transaction, and certainly before signing a letter of intent, for the reasons discussed below.

B. The Documentation

If an investment banker is retained, a preliminary step will be the negotiation and execution of the banker’s engagement letter. In addition, the parties will almost always sign a nondisclosure agreement (NDA) before they exchange confidential information.

The parties’ first major step in the transaction is typically the execution of a letter of intent (or, in some cases, agreement on a signed or unsigned memorandum of understanding or term sheet). The letter of intent is a short document signed after the management teams have reached an agreement in principle.

The letter of intent describes the most important elements of the transaction including the type of transaction, price and form of consideration, payment terms and any key contingencies, such as the availability of buyer financing. The letter of intent does not obligate the parties to complete the transaction, though most letters of intent do include some additional terms that are binding. Those may include exclusivity agreements in which the seller agrees not to negotiate a sale with third parties for an agreed period of time, confidentiality agreements and agreements that each party will be responsible for its own transaction expenses. Caution should be exercised that the letter of intent is not so detailed that it could be construed as a definitive agreement.

In rare cases, the letter of intent may call for the buyer to pay the seller a nonrefundable deposit or to put earnest money into escrow. A seller may receive a nonrefundable deposit (1) for granting an exclusivity period to the purchaser, during which period the seller will not negotiate with any other potential buyer, or (2) if the seller is in a particularly strong bargaining position, for the purpose of covering some of the seller’s costs in the transaction.

From both the business and the legal standpoint, the letter of intent should be taken almost as seriously as the definitive purchase agreement, because the letter outlines the key elements of the transaction. Because the basic structure and terms of the transaction are established at this stage, it is essential that each party have a full understanding of the business, tax and legal ramifications of the proposed transaction before finalizing the letter of intent. Binding or not, the letter tends to be viewed as “sacred” by the parties, who will be unlikely to agree to the modification of a basic provision set forth in the letter of intent or to the addition of a new provision that is so basic that it should have been included in the letter initially. Further, in some circumstances, courts have held that even nonbinding letters of intent create a binding obligation to negotiate in good faith based on the terms set forth in the letter.

Perhaps the most important impact of a well-prepared letter of intent is psychological. Because the parties have signed their names to a proposed transaction, they tend to be committed to its conclusion. The letter of intent gives them the confidence needed to invest the substantial time and money involved in pursuing the transaction. It helps maintain the parties' commitment during the ensuing detailed negotiations and establishes the broad context in which the details can be put in proper perspective. For these reasons, the letter of intent generally should be confined to the true essentials of the transaction.

C. Regulatory Matters

Regulatory contacts with the transaction may be (1) affirmative, (2) negative or (3) informational.

Affirmative regulatory contacts require agency approval prior to closing. For example, a buyer may not purchase or operate a bank, radio station or nuclear power plant without having the relevant government agency issue the necessary approvals. Similarly, prior government approval may be required before governmental permits will be transferred.

A negative regulatory contact requires a filing with the relevant agency, with the closing permitted if the agency does not act to delay or stop the transaction within a specified time period. The most common example is the Hart-Scott-Rodino premerger notification requirement, which requires notice to both the US Federal Trade Commission (FTC) and the US Department of Justice (DOJ) of proposed acquisitions of businesses valued in excess of US\$ 76.3 million (amount is adjusted annually for inflation) if certain "size of the parties" tests are met. The filing provides extensive information designed to enable the antitrust enforcement agencies to evaluate any anticompetitive implications of the acquisition. If neither the FTC nor the DOJ requests additional information or attempts to stop the acquisition within the specified time period (usually 30 days, or 15 days in the case of a tender offer), then the transaction may proceed, with the closing occurring after the waiting period is over or is terminated early.

The Foreign Investment and National Security Act of 2007 (FISIA) operates similarly. It provides for a voluntary filing made by non-US companies acquiring control of US assets or voting securities when the acquisition could have an adverse effect on US national security. If cleared, the transaction may proceed without concern for its national security implications.

Finally, informational regulatory contacts are illustrated by examples such as (1) the filing of notices of the issuance of unregistered securities with the US Securities and Exchange Commission (SEC) and (2) the US Department of Commerce survey of foreign investments in the United States (administered by the Bureau of Economic Analysis), which requires the submission of rather detailed and ongoing reports of foreign investment of more than a specified value in US business enterprises.

These are only a few examples of the many regulatory contacts that may affect an acquisition. Even those contacts that are informational should be taken seriously, however, since failure to comply may constitute a civil or even criminal offense.

Typically, regulatory approvals are not sought until after the letter of intent or definitive agreement is signed. However, to the extent that a waiting period is involved, the parties may wish to make the required regulatory filings as soon as the letter of intent is signed so that the waiting period can commence. Most sellers, however, will resist any public filings until the definitive agreement is signed to avoid publicity and the resulting uncertainty among customers, suppliers, employees and others. To the extent that regulatory approvals will be difficult to obtain, the parties should work closely together to establish an approval strategy and may wish to provide in the letter of intent for the eventuality of a failure to obtain, or delays in obtaining, the necessary approvals.

III. Stage 2: Through the Definitive Purchase Agreement

A. The Business Transaction

After the letter of intent is signed, the buyer usually commits substantial additional resources to its business, legal, accounting and other due diligence investigations of the target company. This investigation serves two purposes. First, it should satisfy the buyer that the target company has the desired attributes. Second, it should develop facts sufficient to enable (1) the buyer to negotiate the definitive purchase agreement (such as the seller's representations and warranties), (2) both parties to agree on any important terms not detailed in the letter of intent and (3) both parties to renegotiate, if necessary, the fundamental terms depending on the results of the due diligence review.

Due diligence is usually multifaceted and tailored to the particular situation of the seller. The buyer may commission a valuation of the seller or certain key assets. The lawyers will review minute books and charter documents, the issuance of securities, key contracts and loan documentation, governmental permits, employment matters, pending litigation, environmental proceedings and other fundamental legal matters affecting the seller's business. The accountants will investigate the target's financial statements, accounting practices, internal controls, tax compliance, inventories, etc. Other experts, such as environmental engineers or technical specialists, may make inquiries appropriate to the particular transaction. These days the due diligence is usually done primarily through a Web-based, password-protected "virtual data room" containing a comprehensive collection of financial information and legal documents regarding the target.

Most of the due diligence is performed by the buyer because, especially in a cash deal, the seller's only due diligence is likely to be an evaluation of the buyer's ability to pay the purchase price and to fulfill any ongoing commitments made to the seller. If the seller will receive stock of the buyer as consideration in the transaction, the seller will likely choose to perform due diligence on the buyer, which could be as extensive as the buyer's due diligence investigation of the seller.

In parallel with the due diligence process, during this stage the parties also fine-tune the structure of the transaction, negotiate and draft the purchase agreement and any ancillary agreements (described below), and prepare to submit any required regulatory filing that will be a part of the transaction.

B. The Documentation

The definitive agreement sets forth in binding form the full terms of the acquisition. When the agreement is signed, the parties are obligated to complete the transaction, subject to various conditions to closing, such as obtaining any required stockholder, regulatory or third party approvals. Most definitive agreements also provide for a number of other, ancillary agreements and documents. These may include promissory notes, security agreements, bills of sale, noncompetition and employment agreements, escrow instructions, officers' certificates and legal opinions. Generally, the forms of these ancillary agreements are attached to the definitive agreement, but they are not signed until closing.

The negotiation and drafting of the purchase agreement are substantially affected by the due diligence investigations. For example, if the buyer discovers a material contingent liability not previously disclosed, it may negotiate a reduction in purchase price or a specific indemnity to cover the liability.

The content of the definitive agreement will vary greatly with the transaction, but the basic elements of a typical agreement include (1) the specific identities of the parties (including any new companies formed for purposes of the transaction), (2) an exact description of what is being sold, (3) an exact description of the price and payment terms, (4) lengthy and detailed representations and warranties of the seller (and often its significant shareholders) including accuracy of financial statements, condition of assets, payment of taxes and many others, accompanied by a series of detailed disclosure schedules of the seller and of the buyer (usually less extensive than those of the seller), (5) each party's agreements as to its conduct up to and beyond the closing, such as the seller's agreement to conduct its business in the ordinary course without unusual transactions, (6) conditions that must be fulfilled before either party is obligated to close, (7) termination upon occurrence of certain events such as termination by the target as a result of its board's exercise of fiduciary duty, as well as breakup fees, if applicable, (8) details as to the time and mechanics of closing, (9) indemnities related to breaches of the agreement or the representations and warranties, (10) dispute resolution provisions and (11) miscellaneous clauses relating to various aspects of the parties' legal relationship.

At the signing of a definitive purchase agreement that provides for a later closing, executed copies of the agreement are exchanged by the parties together with any other documents agreed to be signed at that time. Such documents might include an escrow agreement and signed escrow instructions that govern the conduct of the closing.

C. Regulatory Matters

Depending on the type of regulatory matters involved and the time required for each (some approvals may take several months), work begins in earnest in this area. It is typically after the execution of the definitive agreement that the agencies involved will be contacted and the regulatory applications will be prepared and filed.

IV. The Auction Process Alternative

As an alternative to Stages 1 and 2 above, many sellers attempt to maximize value by conducting a private auction. It is not uncommon for a buyer to offer a high price to induce a seller to enter into a letter of intent with an exclusivity clause, then reduce the price through the due diligence phase of the transaction. An auction can be an effective tool to counter this buyer technique.

One of the key elements of a private auction is to find a reputable investment banker or business broker with good knowledge and contacts in the industry in which the seller operates. The banker or broker will work with the company to develop an anonymous one- or two-page “teaser” describing the company, as well as a much more comprehensive offering document, generally called a confidential information memorandum (CIM). The banker or broker, or the seller, will distribute the teaser to a selected, but often relatively wide, distribution list of potential buyers, and credible interested buyers will be required to sign an NDA to receive a copy of the CIM.

For an effective auction it is critical that the auction continue until the signing of the definitive agreement and that the definitive agreement contain as few conditions to closing as possible. To avoid a due diligence condition in the definitive agreement, the seller will typically give potential buyers the ability to conduct a due diligence review. In particular, the definitive agreement should not contain a condition based on the buyer conducting further due diligence to limit the buyer’s ability to renegotiate the price after signing the definitive agreement.

It should be noted that, in an auction process, once the seller signs a definitive agreement it must be highly confident that the transaction will close. If the transaction fails to close and the seller tries to remarket its business, it usually finds that other potential buyers will reduce the price that they are willing to pay. It is also important to avoid a condition that the buyer must obtain financing for the acquisition, as in practical terms that will give a buyer an option rather than an obligation to complete the transaction.

After a number of potential buyers have signed NDAs, received a CIM and had time to access the virtual data room, the banker or broker will typically request nonbinding expressions of price and terms. The banker or broker and the seller will then select a short list of buyers (generally three to five) to meet with management of the seller prior to making formal offers. It is also preferable to provide a form of definitive acquisition agreement to the potential buyers and ask for a mark-up together with their offer to keep their review and comments on a competitive basis. Ideally the seller and banker or broker will continue negotiating with two or more of the finalists before signing a definitive agreement.

The ability to conduct a successful auction will depend on market conditions, the attractiveness of the seller’s business, and the experience and effectiveness of the banker or broker.

I. Stage 3: To the Closing

The closing is the consummation of the transaction – the purchase price is paid, ownership is transferred to the buyer and final versions of the various ancillary agreements and documents are signed. Closings often involve numerous steps including not only the exchange of paperwork but also wire transfers, governmental filings, and issuance of press releases and others. Asset acquisition closings tend to be especially detail oriented – for example, an asset acquisition of a company owning facilities and vehicles would involve a separate instrument of transfer for each of them, with a deed recorded for each parcel of owned real estate and the title to each vehicle transferred.

In some transactions, there may be no consents or approvals required, or it may be possible to secure them prior to signing a definitive agreement, so the transaction may involve a simultaneous signing of the definitive agreement and closing.

A. The Business Transaction

After signing a definitive agreement, the seller will work to ensure that all conditions to closing are satisfied. This typically involves obtaining consent from third parties to the assignment of various contracts and/or leases to the buyer where required by the terms of those agreements, as well as making any necessary governmental filings or obtaining governmental approvals as described above. Depending on the type of consents or approvals required this process may take anywhere from a few weeks to several months.

Sale transactions can be potentially disruptive to employees of the seller, who often assume the worst and become fearful of retaining their jobs post-transaction. For this reason, sellers often enter into retention agreements with targeted employees, especially members of the management team. These agreements generally provide for payment of a bonus (often substantial) if the employee remains with the seller through the earlier of a sale or a certain date, usually a year in the future. These agreements usually also require that the employee accept employment with the buyer (at the same or higher compensation) if requested to receive the bonus.

At this stage, the buyer performs its final due diligence on the seller. A typical condition of closing is that all representations and warranties are true at the time of closing and that no material adverse event (MAE) has occurred. In the event the buyer discovers a material problem in the course of its investigation, it may have an “out” and refuse to close. In many cases, however, when a substantial deviation from the representations and warranties or an MAE occurs, the buyer will threaten to abandon the transaction only to provide the necessary leverage to negotiate a reduction in price or some other concession.

In addition to completing its due diligence, the buyer will become progressively more knowledgeable about the operations of the target company with a view to conducting a smooth closing and management transition – substantial preparation will be required in numerous areas from human resources to information technology. In many cases, particularly where a division or subsidiary of the seller is being sold, it is not practical to transition all services as of the closing. Therefore it is common for the seller to enter into a transition services agreement in which it agrees to provide certain services for a period of time postclosing, generally at cost.

That said, for risk management purposes, in most cases the buyer should carefully avoid actively taking operational control preclosing. The buyer may also make final arrangements for its financing and attend to other closing matters.

B. The Documentation

Any unfinished documents necessary for closing, such as title documents and officers' certificates, will be negotiated and prepared. All of the details of closing will be addressed. Final director or stockholder approval, as appropriate, will be sought at this time, and preparations will be made for the provision of tax opinions, legal opinions, "bring-down" certificates and other documents for delivery at closing.

At the closing, the parties will exchange all cash, stock and documents required under the agreement, such as notes, stock certificates, financing statements, bills of sale, deeds, etc. Legal opinions may be presented and any other conditions to closing satisfied, such as proof of necessary regulatory approvals or a certification that the applicable waiting period has expired.

C. Regulatory Matters

If not already undertaken, regulatory contacts are now actively pursued, since closing is typically conditioned on the receipt of the necessary approvals and/or expiration of the appropriate time period. The date of closing itself is frequently set as the day after final regulatory approval is received or the day after the expiration of a regulatory waiting period.

VI. Stage 4: After the Closing

Promptly upon closing, all security interests should be perfected by filing or recording, and any after-the-fact informational filings, such as those required by the Department of Commerce or the SEC, should be made. Thereafter, the parties will monitor any ongoing obligations under the various agreements, such as performance under commercial agreements, earn-out results and payments, interest or principal payments and covenants not to compete. Should a claim for indemnification or a breach of contract arise, the parties will resort to any dispute resolution provisions included in the agreements or, if necessary, to the courts.

Most importantly, the hard work of integrating the businesses of the buyer and the seller will begin in earnest. Experienced buyers know well that the real work of making the deal a success has just begun!

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