3700 Mansell Road, Suite 220, Alpharetta, Georgia 30022 770.625.5050

The Basics of Mergers and Acquisitions

By: Hutchison & Mason, PLLC

The acquisition of a business may be structured in a variety of ways, including, an asset sale, a stock sale, or a merger. The structure of the acquisition will be determined by a variety of accounting, business, legal, and tax considerations. Regardless of the structure of the transaction, acquisition agreements have the following four common and very important features which are examined in this article: (a) representations and warranties; (b) pre-closing covenants; (c) conditions precedent to closing; and (d) indemnification.

Representations and Warranties

The seller and the buyer will make representations and warranties to the other in the acquisition agreement. The seller's representations and warranties typically make up the largest part of the acquisition agreement. Representations and warranties serve three important purposes. First, they are informational. The seller's representations and warranties, coupled with the buyer's due diligence, enable the buyer to learn as much as possible about the seller's business prior to signing the definitive acquisition agreement. Second, they are protective. The seller's representations and warranties provide a mechanism for the buyer to walk away from, or possibly to renegotiate the terms of, the acquisition, if the buyer discovers facts that are contrary to the representations and warranties between the signing and the closing. Third, they are supportive. The seller's representations and warranties provide the framework for the seller's indemnification obligations to the buyer after the closing.

Prior to signing the acquisition agreement, the buyer will want to learn as much as possible about the seller's business. Therefore, the buyer will require the seller to make extensive representations and warranties about its business. Many of these representations and warranties will be specific to the seller's industry. However, the most common representations and warranties include: (a) corporate organization, authority, and capitalization; (b) assets; (c) liabilities; (d) financial statements; (e) taxes; (f) contracts, leases, and other commitments; (g) employment matters; (h) compliance with laws and litigation; (i) product liability; and (j) environmental protection.

From the seller's perspective, if the buyer is paying the purchase price in cash at the closing, the most important representations and warranties the seller can elicit from the buyer are those governing the buyer's corporate authorization and financial condition (i.e., the buyer's ability to pay the purchase price). If the buyer is paying the purchase price over time or by issuing stock, the seller will require more extensive representations and warranties from the buyer.

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Mergers and Acquisitions: Pre-Closing Covenants

The second major feature of merger and acquisition agreements is the inclusion of various pre-closing covenants, or promises to do something, or not do something, during the period between the signing of the acquisition agreement and the closing. Generally, covenants are absolute; however, some may be subject to a "reasonable efforts" qualification. Other than covenants relating to corporate approvals and governmental filings and approvals, compliance with a particular covenant may be waived by the party that benefits from the covenant.

There are two types of pre-closing covenants: negative covenants and affirmative covenants. Negative covenants restrict the seller from taking certain actions prior to the closing without the buyer's prior consent. Negative covenants protect the buyer from the seller taking actions prior to the closing that change the business that the buyer expects to buy at the closing. Typical negative covenants include: (a) not changing accounting methods or practices; (b) not entering into transactions or incurring liabilities outside the ordinary course of business or in excess of certain amounts; (c) not paying dividends or making other distributions to stockholders; (d) not amending or terminating contracts; (e) not making capital expenditures; (f) not transferring assets; (g) not releasing claims or waiving rights; and (h) not doing anything that would make the seller's representations and warranties untrue.

Affirmative covenants obligate the seller or the buyer to take certain actions prior to the closing. Typical affirmative covenants include: (a) allowing the buyer full access to the seller's books, records, and other properties; (b) obtaining the necessary board and stockholder approvals; (c) obtaining the necessary third party consents; and (d) making the required governmental filings and obtaining the required governmental approvals.

Mergers and Acquisitions: Conditions to Closing

Merger and acquisition agreements generally also contain several conditions to closing, which are certain obligations that must be fulfilled in order to legally require the other party to close the transaction. Other than conditions to closing relating to corporate approvals and governmental filings and approvals, compliance with a particular condition to closing may be waived by the party that benefits from the condition. The interplay between pre-closing covenants and conditions to closing is important. If a particular matter is addressed solely as a covenant, the buyer's only remedy for the breach of the covenant will be monetary damages. However, if a particular matter also is addressed as a condition to closing, the buyer can walk away from the transaction if the condition is not fulfilled. In addition, and perhaps equally as important, the buyer may be able to use the threat of not closing as leverage to renegotiate the terms of the transaction.

All merger and acquisition agreements provide that, as a condition to closing, the representations and warranties of the parties must be true and correct at the closing, and that the pre-closing covenants have been performed or fulfilled prior to the closing. This is generally confirmed by each party delivering a written certificate to that effect to the other party.

Other typical conditions to closing include: (a) receipt of the necessary third party consents; (b) receipt of the necessary governmental approvals; (c) receipt of legal opinions and other closing documents; (d) receipt of certain financial statements or the achievement of certain financial milestones; (e) receipt of employment or non-competition agreements from key employees; and (f) satisfactory completion of the buyer's due diligence of the seller's business.

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Mergers and Acquisitions: Indemnification

The last major feature of typical merger and acquisition agreements is indemnification. However, indemnification provisions are unusual in agreements for the acquisition of a public company. Indemnification provisions protect the parties from certain matters that occur after the closing and allocate the risks and responsibilities for these occurrences between the buyer and the seller. Indemnification provisions typically address breaches of covenants or representations and warranties that are discovered after the closing. In addition, indemnification provisions address items that are disclosed in the seller's representations and warranties and for which the seller retains responsibility after the closing. An example is pending litigation, the outcome and amount of damages of which cannot be predicted and reflected in the purchase price. Therefore, the buyer may require the seller to remain responsible for the litigation after the closing. The buyer may also request separate indemnification for environmental and tax liabilities beyond the seller's representations and warranties.

Generally, indemnification provisions are heavily negotiated, and the seller will seek to limit its post-closing indemnification obligations in several ways. First, the seller will try to limit the time period after the closing for which it has indemnification obligations. In theory, this time period should be based upon the reasonable period of time within which the buyer, through reasonable diligence, should have discovered the breach and misrepresentation or, if applicable, the time period within which a third party would make its claim. In practice, the parties generally agree on a period of one to three years after the closing. Exceptions may be made for environmental and tax liabilities, for which the time period may be the applicable statute of limitations.

Second, the seller will try to impose a cap on the total amount of its indemnification liability. Many sellers try to cap their liability at an amount less than the total purchase price. Many buyers will agree to a cap equal to the total purchase price. If the seller's business is "clean," the risk to the buyer in agreeing to an indemnification cap may be small.

Third, the seller will try to negotiate a "basket" or a "deductible" on its indemnification obligations in order to eliminate small indemnification claims. A "basket" or "deductible" provides that the seller does not have liability to the buyer until the amount of the buyer's losses exceed a certain amount. In the case of a "basket," when the buyer's losses exceed the agreed upon "basket" amount, the seller is liable for the total amount of the losses. In the case of a "deductible," when the buyer's losses exceed the agreed upon "deductible" amount, the seller is liable only for the excess amount of the losses above the "deductible."

In order to ensure that there are funds available to satisfy the seller's indemnification obligations, the buyer may require that a portion of the purchase price be held in escrow by a third party for a period of time after the closing. Alternatively, the buyer may hold back a portion of the purchase price and give the seller a promissory note for that portion but retain the right to offset the promissory note to satisfy its indemnification claims.

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